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Summary and Analysis of the OECD's Work Program for BEPS 2.0

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Key Findings

- The OECD is continuing its work to develop proposals that could change international taxation rules.
- The current work program focuses not only on policies that would impact how much multinational businesses pay in tax, but also which countries that tax will be paid to.
- The policies being considered raise numerous questions of administrability, compliance costs, and coordination.
- The OECD should work toward a solution that creates stability for the international tax system while not pursuing policies that could drive distortions for business activity.

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Introduction

On May 31, the Organisation of Economic Co-operation and Development (OECD) released its work program[1] on addressing the tax challenges of digitalization. This work follows on the heels of the OECD/G20 Base Erosion and Profit Shifting (BEPS) project and is in some ways a continuation of that work. The work program identifies options to change rules that define where multinational businesses pay taxes and policies that would put in place worldwide minimum taxation for businesses.

The current effort is being made not only by the G20 and OECD countries, but also by the Inclusive Framework (IF) on BEPS.[2] This is a group of 129 countries[3] that is working to implement changes to international tax rules.

The work plan outlines various approaches and questions that need to be addressed by the end of 2020. The plan is ambitious in the scope of issues it intends to address, the time in which it expects a conclusion, and the number of parties engaging in the negotiation.

The policy options identified in the work plan are organized into two separate pillars. Pillar 1 addresses taxing rights and nexus rules, while Pillar 2 outlines a global minimum tax and a tax on base-eroding payments. The document discusses the options that are being considered under each pillar and issues that would need to be resolved.

In addition to outlining the policy proposals connected to each pillar, the work plan includes a section that outlines some questions that the OECD will be working to answer with economic analysis. Each option will have various ramifications for tax revenues, location of economic activities, and tax complexity.

Given that it is a work program rather than a final policy document, there are many unanswered questions. There are many potential combinations of the options presented both in how they would be designed and how they might fit together with other options or with the current international tax rules. The results from various combinations could differ substantially for small exporting countries versus large importing countries or for industries that rely on significant physical production with high levels of machinery and labor relative to those sectors that rely more on intellectual property and other intangible assets.

The work program identifies goals of creating new international tax rules that minimize complexity for businesses and tax administrations, avoid both double taxation and double non-taxation, and align taxation with the location of economic profits. The OECD and the IF should work diligently to ensure that the project results in a solution that creates certainty for taxpayers, avoids unnecessary complexity, and is informed by sound economic analysis.

1 OECD, "Programme of Work to Develop a Consensus Solution to the Tax Challenges Arising from the Digitalisation of the Economy," OECD/G20 Inclusive Framework on BEPS, May 31, 2019, https://www.oecd.org/tax/beps/programme-of-work-to-develop-a-consensus-solution-to-the-tax-challenges-arising-from-the-digitalisation-of-the-economy.pdf.

2 OECD, "Inclusive Framework on BEPS," July 2018, https://www.oecd.org/tax/flyer-inclusive-framework-on-beps.pdf.

3 OECD, "Members of the Inclusive Framework on BEPS," March 2019, https://www.oecd.org/tax/beps/inclusive-framework-on-beps-composition.pdf.

Countries should be aware of the trade-offs that the current project presents. A global approach to corporate income taxation would likely undermine the sovereignty countries currently have to determine how they tax corporate income, and it would directly stymie the competition among countries to design tax systems to promote growth and minimize the distortionary effects of corporate taxation.

Background

Taxation of multinational businesses creates complex issues for many governments and businesses around the world. In 2013, the BEPS project was launched by the OECD and G20 countries. Since then, significant work has been done to address behavior by multinational corporations that can result in low rates of taxes paid.

Businesses that operate in more than one country are often able to optimize their tax burden by shifting profits from high-tax jurisdictions to low-tax jurisdictions. This profit-shifting behavior can have an impact on an individual country's tax revenues, but it can also provide a setting in which some businesses invest more (even in high-tax jurisdictions) than they otherwise would.[4] Efforts to measure the revenue loss due to profit-shifting behavior have established a range of estimates.[5]

The OECD worked on 15 separate action items to address BEPS and concluded the majority of its work on those items with reports published in 2015.[6] However, the Action 1 report and recommendations[7] connected to tax challenges of the digitalization of the economy left many countries unsatisfied. Since the 2015 Action 1 Report was published, an interim report was issued in 2018 that provided an update on the OECD's analysis of the tax challenges of digitalization.[8]

4 For example, Mihir A. Desai, C. Fritz Foley, and James R. Hines, "Economic Effects of Regional Tax Havens," NBER Working Paper Series, Working Paper 10806, October 2004, https://www.nber.org/papers/w10806, find that establishing affiliates in tax havens can also bring economic benefits to non-tax haven jurisdictions. This is partially because the lower tax burden achieved through utilizing a tax haven affiliate can lower the cost of capital for investing outside of tax havens within the same region.

5 See OECD, "Measuring and Monitoring BEPS, Action 11 - 2015 Final Report," OECD/G20 Base Erosion and Profit Shifting Project, 2015, https://read.oecd-ilibrary.org/taxation/measuring-and-monitoring-beps-action-11-2015-final-report_9789264241343-en#page17; Nadine Riedel, "Quantifying International Tax Avoidance: A Review of the Academic Literature," *Review of Economics* 69(2), 2018, 169-81, https://www.degruyter.com/downloadpdf/j/roe.2018.69.issue-2/roe-2018-0004/roe-2018-0004.pdf; and Ernesto Crivelli, Ruud A. de Mooij, and Michael Keen, "Base Erosion, Profit Shifting and Developing Countries," International Monetary Fund, May 29, 2015, https://www.imf.org/en/Publications/WP/Issues/2016/12/31/Base-Erosion-Profit-Shifting-and-Developing-Countries-42973. The OECD published a range of $100 billion-$240 billion in lost revenue per year due to base erosion and profit shifting. Riedel reviewed estimates that ranged from 2-30 percent of corporate tax income being shifted out of high-tax countries. Crivelli and his coauthors produced an estimate that identified a revenue loss of 1.3 percent of GDP for non-OECD countries and 1 percent of GDP for OECD countries.

6 OECD, "BEPS 2015 Final Reports," 2015, https://www.oecd.org/ctp/beps-2015-final-reports.htm.

7 OECD, "Addressing the Tax Challenges of the Digital Economy; Action 1: 2015 Final Report," OECD/G20 Base Erosion and Profit Shifting Project, 2015, https://read.oecd-ilibrary.org/taxation/addressing-the-tax-challenges-of-the-digital-economy-action-1-2015-final-report_9789264241046-en#page1.

8 OECD, "Tax Challenges Arising from Digitalisation – Interim Report 2018," OECD/G20 Base Erosion and Profit Shifting Project, 2018, https://read.oecd-ilibrary.org/taxation/tax-challenges-arising-from-digitalisation-interim-report_9789264293083-en#page1.

Throughout the course of 2018 various proposals for implementing taxes that target the digital economy were published including a European Union approach to digital services taxes and a physical presence standard that would include digital nexus.[9] Additionally, countries including the U.S., Germany, France, and the UK began outlining approaches that they recommended for global adoption.[10] These proposals were packaged into a policy note published by the OECD in January 2019 and a subsequent consultation document.[11]

Following a public consultation in March 2019, the proposals have now, in one form or another, made their way into the work program published in May.[12]

Pillar 1 – Revised Nexus and Profit Allocation Rules

In broad terms, Pillar 1 of the OECD work program is about taking a business's global taxable income and changing current rules that define which countries can tax that income. The three separate Pillar 1 approaches would all give market countries (where products are sold or where users reside) a larger share of that taxable profit, but they would use different methods.

Currently, if a German manufacturer spends significant resources to promote its products in India by developing customer lists, promoting its brand, and gaining market share, it could potentially do so without ever establishing a physical office in India. This could result in many sales into India without the company owing corporate income tax in India (the tax would be paid in Germany, the country of residence), although it is likely that other taxes like India's Goods and Services Tax (GST) would apply. However, the Pillar 1 options envision realigning international tax rules so India could potentially tax a share of that manufacturer's corporate income in addition to its sales. India's share could be based on several metrics including the company's level of investment in marketing its product to India's customers, along with its global profitability.

Another example would be a social networking company headquartered in the United States that allows users to join the network for free and has a large user base in France. The data from those users could be valuable to advertisers that are interested in reaching French consumers. The social networking firm may have no employees, servers, or even advertising sales agents in France. The current system would usually allow that company to pay no corporate income tax in France and potentially have no consumption tax liability in France either. Instead the tax would be owed in the U.S., where the software designers work, or in the countries where the servers and advertising sales employees are. One of the options under consideration in Pillar 1 would allocate some of that company's taxable profits to France simply based on the French users and an attribution of value creation (and thus profitability) to those users since their data is valuable to advertisers. This

9 Daniel Bunn, "A Summary of Criticisms of the EU Digital Tax," Tax Foundation, Oct. 22, 2018, https://taxfoundation.org/eu-digital-tax-criticisms/.

10 Thomas Escritt, "Germany's Scholz wants global tax floor to stop evasion," Reuters, Oct. 20, 2018, https://www.reuters.com/article/us-germany-tax/germanys-scholz-wants-global-tax-floor-to-stop-evasion-idUSKCN1MU0X8.

11 See OECD, "Addressing the Tax Challenges of the Digitalisation of the Economy – Policy Note," OECD/G20 Base Erosion and Profit Shifting Project, Jan. 23, 2019, https://www.oecd.org/tax/beps/policy-note-beps-inclusive-framework-addressing-tax-challenges-digitalisation.pdf; and OECD, "Public Consultation Document: Addressing the Tax Challenges of the Digitalisation of the Economy," OECD/G20 Base Erosion and Profit Shifting Project, Feb. 13-March 6, 2019, http://www.oecd.org/tax/beps/public-consultation-document-addressing-the-tax-challenges-of-the-digitalisation-of-the-economy.pdf.

12 Daniel Bunn, "Tax Competition of a Different Flavor at the OECD," Tax Foundation, March 19, 2019. https://taxfoundation.org/tax-competition-of-a-different-flavor-at-the-oecd/.

approach relies on an assumption that those users are creating value for a business while using a free service.

The three main options discussed under Pillar 1 are:

1. Modified residual profit split method
2. Fractional apportionment method
3. Distribution-based approaches

Modified Residual Profit Split (MRPS) Method

Current international tax rules sometimes utilize the calculation of both normal and super-normal returns to determine where tax is owed by multinational businesses. A normal (or routine) return is calculated as the required rate of return on business investments. A business's profits meet a normal rate of return when the revenues from their investments in products and sales both cover their costs and meet a minimum level of profitability. Super-normal returns are those above a routine return and are also referred to as residual profits. Current rules allocate both normal and super-normal returns where investment risks and physical presence exist, but the rules for that allocation can be complicated. If super-normal returns are generated from assets and operations in multiple jurisdictions, the tool for distributing those returns for tax purposes is called the residual profit split.

The MRPS in Pillar 1 would envision allocating normal returns to resident taxing jurisdictions using current standards while allocating super-normal returns using new metrics that would give more taxing rights to market jurisdictions. According to the work program, the MRPS method would follow four steps:

1. Determine the total (normal and super-normal) profits to be split;
2. Remove normal profits using either current methods or a new simplified approach;
3. Determine what portion of the super-normal profits should be allocated among taxing jurisdictions (including those that currently do not have the right to tax those profits); and
4. Allocate those super-normal profits using an allocation key to the relevant tax jurisdictions.

There are numerous ways that this proposal could eventually be implemented, but it is worth pointing out that the base of the proposal rests on current methods for allocating normal returns among taxing jurisdictions. This means that only super-normal profits would be split in a different way than currently, and some share of those profits would be allocated to market jurisdictions.

However, there is a high level of complexity even in current rules for measuring taxable profits and determining what share of profits are normal or super-normal. Disagreements between tax authorities and businesses regularly arise[13] because of differences of opinion in applying current methods to determine tax liabilities. These disputes add considerable complexity both for businesses and governments in determining how much tax liability is owed by businesses in which jurisdiction.

Fractional Apportionment Method

The fractional apportionment method envisions redefining taxing rights based on a formula that would potentially apply to all income earned by multinational corporations. The formula would use several factors (the work plan mentions employees, assets, sales, and users) along with weights for each of those factors to determine where taxable profits should be allocated.

This approach represents a serious challenge for both agreement and implementation. For the fractional apportionment option to meet the OECD's goal of not creating new rules that would ultimately tax the same income twice (or more) a fractional apportionment system would require alignment of countries' definitions of taxable income along with the adoption of the same allocation formula. Even among OECD countries there is a wide variety of ways that countries have decided to tax corporate income.[14] Bringing these systems into alignment in order to keep the apportionment system from taxing the same income more than once would be a monumental task.

Formulary apportionment has been in place for the federalized tax systems of Canada and the United States for many years. However, the application of allocation formulas in Canada is much more uniform than in the U.S.[15] In the U.S., all states have the option to either administer a corporate income tax or not, and if they do, they can choose what formula to use in determining how much corporate income would be taxed in their state. In theory all states use the same factors (employees, assets, and sales) in their formulas for determining taxable profits, and this was originally the case when a uniform standard was adopted in the 1950s. However, since that time many states have moved away from the three-factor formula when it has been in their interest. In 2018, just five U.S. states used all three factors for apportioning taxable corporate income, while a majority used either single sales factor or overweight sales as a factor in their formulas.[16] States that do this are effectively reducing tax burdens on businesses that are located in their jurisdiction (most of the property and payroll may also be in that state) but only a fraction of their sales in that state. This can increase the tax burden on out-of-state companies. Similar incentives would also exist at the global level, and a lack of coordination in applying either the factors or the formula across countries could result in significant tax uncertainty and potential double taxation.[17]

13 According to OECD, "Mutual Agreement Procedure Statistics for 2017," 2018, https://www.oecd.org/tax/dispute/mutual-agreement-procedure-statistics.htm, transfer pricing cases took 30 months to resolve on average and less than one-third of cases started since January 1, 2016 were resolved by the end of 2017.

14 Daniel Bunn, Kyle Pomerleau, and Scott A. Hodge, *2018 International Tax Competitiveness Index*, Tax Foundation, Oct. 23, 2018, https://taxfoundation.org/publications/international-tax-competitiveness-index/.

15 Joann Weiner, "Formulary Apportionment and the Future of Company Taxation in the European Union: Company Taxation and the Internal Market," CESifo Forum, 2002, https://www.econstor.eu/bitstream/10419/166108/1/cesifo-forum-v03-y2002-i1-p10-20.pdf.

16 Taxadmin.org, "State Apportionment of Corporate Income," Jan. 1, 2019, https://www.taxadmin.org/assets/docs/Research/Rates/apport.pdf.

17 Clemens Fuest, Thomas Hemmelgarn, and Fred Ramb, "How would the introduction of an EU-wide formula apportionment affect the distribution and size of the corporate tax base? An analysis based on German multinationals," *International Tax and Public Finance* 14(5), October 2007, 605-26. https://link.springer.com/article/10.1007/s10797-006-9008-6.

The work plan mentions using a financial accounting regime as part of the fractional apportionment method to determine profits that should be allocated among taxing jurisdictions. Using financial rather than tax accounting standards to determine taxable profits would be a significant departure from current practice. The gap between taxable income which is reported to tax authorities and book income which is generally reported to investors or the public can be significant. Book income does not account for net operating losses or capital investments like taxable income does.[18] Additionally, there is wide variation in the way countries treat both net operating losses and capital investments for tax purposes.[19]

The fractional apportionment approach seems to identify the diversity in corporate tax laws across the globe and the challenge of unifying those laws for consistently taxing corporate income. It then would potentially abandon tax accounting in favor of more standardized financial accounting (with some potential adjustments). Pairing profit measurement using financial accounting with a fractional apportionment method would override many national policies designed to reduce the distortionary effects of corporate income taxation. Even if financial accounting was used, the differences in U.S. and European financial standards would still create challenges for uniformly measuring profits.

Distribution-based Approaches

Both the MRPS and the Fractional Apportionment methods would, in different ways, create very difficult implementation challenges. An alternative approach would be to use a more basic formula for determining how much of a company's global profits should be taxed in a market jurisdiction. This approach could determine a baseline level of profitability that should be assigned to market activities including marketing, distribution, and activities related to users. From that baseline level of profit, various levers could increase, decrease, or exempt certain profits from taxation in a market.

As an example, imagine a U.S. company that spends $1,000 on marketing and distribution activities in France. France could apply a distribution-based approach that would attribute a 10 percent baseline taxable profit to those expenditures, implying a tax base of $100. However, if the company's global profitability is 15 percent, the baseline taxable profit could be levered up to a higher amount, implying a higher tax base in the market country. On the other hand, if the company's global profit margin is 5 percent, the distribution-based approach could decrease the taxable profit margin in the market country.

Applying a distribution-based approach would be much more challenging than the example implies. It would require measuring marketing and distribution activities associated with one particular country and deciding how to calculate global profitability and other metrics that would impact the profit margin taxed in market countries. If multiple countries choose different definitions of marketing expenses, or calculate global profitability using financial accounting instead of tax accounting, or rely on different justifications for the level of taxable profit, such a lack of coordination could easily lead to double taxation.

18 Nicole Kaeding, "Taxable Income vs. Book Income: Why Some Corporations Pay No Income Tax," Tax Foundation, May 2, 2019, https://taxfoundation.org/why-corporations-pay-no-income-tax/.

19 Daniel Bunn, Kyle Pomerleau, and Scott A. Hodge, *2018 International Tax Competitiveness Index*.

Any formulaic approach would have the problem of applying a uniform standard to a broad set of businesses with various circumstances and models for selling their products. For some companies or countries, a distribution-based approach could work as a safe harbor or backstop if those entities choose to opt-in to the distribution-based approach to avoid facing the challenge of administering the MRPS method or some other more complex system for allocating revenues.

Cross-Cutting Issues

The work plan points out that the Pillar 1 options have some challenges in common in order to create tax certainty, avoid double taxation, and tax economic profits where they are generated.

These include:

- The use of business line and regional segmentation;
- Design scoping limitations;
- Treatment of losses.

Because different industries may have different results using the various Pillar 1 options, the OECD is considering whether to tailor the approaches to accommodate the unique situations that businesses face in various industries or regions. An advantage of such an approach would be to make sure that certain industries or lines of business do not become overtaxed or taxed beyond their economic profits. However, segmenting companies into one industry or another could prove quite complicated, especially for businesses that work in multiple sectors in multiple countries. Additionally, regional segmentation could create various incentives for businesses to grow in some regions and avoid doing business in other regions simply for tax reasons. These different options could create incentives for businesses to advocate for particular carveouts or to restructure to minimize their tax burden based on where the lines are drawn.

Design scope limitations could outline the boundaries of the new taxing rights by setting thresholds. However, if the new taxing rights only apply to businesses of a certain size (based on revenues or some other metric), then that size threshold could create incentives for businesses near the threshold to minimize their exposure to the new taxing right.

The working paper points out the need for appropriate treatment of business losses under any of the Pillar 1 approaches. Many tax codes around the world allow businesses to deduct their previous losses against their current profits so that the corporate tax applies to their average profitability over time. Any Pillar 1 solution should take care to ensure that the treatment of business losses in connection to existing taxing rights are extended to the new taxing rights. The work program mentions an option to use a sort of global loss carryforward provision (the “earn out” approach to losses) that would allow a company to face tax from market jurisdictions only once it has earned profits beyond its losses.

Each Pillar 1 proposal comes with its own set of trade-offs on both the revenue side and the impact on real economic activity. However, if the OECD is to meet its goals of creating tax certainty and avoiding double taxation (and double non-taxation) this will require the careful design and agreement on whichever option is chosen.

For fractional apportionment it would require all countries around the world to align their tax bases and enforcement of tax laws on international income. This would represent a significant shift from the current array of tax systems and historical and political reasons that have led to that variety. It would effectively mean that countries around the world would subject their corporate tax systems to a more centralized design of taxation of multinationals. This would be a significant political challenge in part because it would require countries agreeing to undermine their own tax sovereignty.

The profit split and distributional approaches require building a new structure on top of an already complex foundation—applying one method to one portion of taxable income and another method to the rest. Transfer pricing disputes and concerns by taxpayers about governments shifting their auditing standards and requirements reveal how difficult and costly the current system can be to manage.[20] By relying on that system for routine returns and a separate, new system for non-routine returns it is possible that disputes over which profits are taxable in which jurisdictions could grow rather than diminish. Such a result could lead to more tax uncertainty than is currently present in the international system and increase burdens for compliance and administration.

With any of the approaches, there should be an expectation that agreement at the OECD should lead to removal of unilateral efforts by countries that have cropped up in recent years, including diverted profits taxes and digital services taxes.

Pillar 2 – Global anti-base erosion proposal

Pillar 2 is an extension of the original BEPS project in a more direct way than Pillar 1. The policies outlined in Pillar 2 could lead to significant changes to policies that are directed at base erosion and profit shifting. These policy changes include a global minimum tax (GloBE) and a tax on base-eroding payments. The vision behind this approach is that despite a country's own efforts and the BEPS recommendations, some businesses are still able to locate profits in low-tax jurisdictions, and countries are looking for new ways to tax that income. However, there has been very little effort to determine whether recently adopted anti-BEPS policies have been sufficiently effective.

The narrative surrounding BEPS and continued with Pillar 2 is that countries have pursued lower corporate tax rates as competitive measures to attract investment. Though there has certainly been a trend in declining statutory corporate tax rates over the last several decades, corporate tax revenues as a percent of GDP among OECD countries have been relatively stable.[21] This is partially due to the fact that as countries have reduced their corporate tax rates, they have broadened their corporate tax bases. Some countries have done this in ways that have been particularly harmful to business

20 OECD, "Mutual Agreement Procedure Statistics for 2017."

21 See Daniel Bunn and Elke Asen, "Higher Corporate Tax Revenues Globally Despite Lower Tax Rates," Tax Foundation, Jan. 22, 2019, https://taxfoundation.org/higher-corporate-tax-revenues-lower-tax-rates/, and Daniel Bunn, "Corporate Tax Rates Around the World, 2018," Tax Foundation, Nov. 27, 2018, https://taxfoundation.org/corporate-tax-rates-around-world-2018/.

investments.[22]

While there may be a decent amount of tax competition on tax rates or special preferences for intellectual property and research and development, these policies have been paired with changes that limit investment allowances and create other distortions for businesses.

An additional backdrop to Pillar 2 is the fact that many countries around the world have been implementing policies to combat base erosion in various ways.[23] Many countries have Controlled Foreign Corporation (CFC) rules, thin-capitalization rules, transfer pricing regulations, and other policies which seek to minimize opportunities for businesses to shift their taxable profits to lower-tax jurisdictions. These policies each have various impacts on effective tax rates, where taxes are paid, and business behaviors.[24]

Despite countries' own efforts and the work at the OECD to recommend responses to base erosion, Pillar 2 lays out additional measures for protecting tax bases. These options include a global minimum tax (GloBE) and a tax on base-eroding payments. These policies could undermine the ability of some tax systems to minimize the distortionary effects of corporate income taxes either through appropriate treatment of business investments or through low statutory rates.

For example, several countries, including Estonia, Latvia, and Georgia, only tax corporate profits when they are distributed to shareholders. This allows businesses to grow by reinvesting their profits without facing a separate layer of tax until those profits are distributed. It is questionable whether the design of the global minimum tax could result in applying taxes to the reinvested profits in those countries simply due to the design of their corporate tax systems. The outcome will depend on how the minimum is measured and whether it will take all levels of tax on corporate income into account.

Also, depending on where the minimum tax is set, countries with low corporate income tax rates like Ireland (12.5 percent) and Hungary (9 percent) could see corporate profits generated in their countries taxed above their statutory rates. Jurisdictions with even lower rates could end up with very little to no ability to determine at what level corporate income should be taxed.

The Global Minimum Tax (Income Inclusion Rule)

The work program outlines various issues that will need to be considered for implementing a global minimum tax. In theory, a country would determine whether a company's foreign income has been taxed at the minimum level and apply tax to cover the difference between the minimum and the company's foreign tax rate if that foreign rate is below the minimum.

22 Elke Asen and Daniel Bunn, "Capital Cost Recovery across the OECD, 2019," Tax Foundation, April 2, 2019, https://taxfoundation.org/capital-cost-recovery-across-the-oecd-2019/.

23 Daniel Bunn, Kyle Pomerleau, and Sebastian Dueñas, "Anti-Base Erosion Provisions and Territorial Tax Systems in OECD Countries," Tax Foundation, May 2, 2019, https://taxfoundation.org/anti-base-erosion-provisions-territorial-tax-systems-oecd-countries/.

24 See for example Sarah Clifford, "Taxing multinationals beyond borders: Financial and locational responses to CFC rules," *Journal of Public Economics* 173, 2019, 44-71, https://www.sciencedirect.com/science/article/abs/pii/S0047272719300088; Peter H. Egger and Georg Wamser, "The impact of controlled foreign company legislation on real investments abroad. A multidimensional regression discontinuity design," *Journal of Public Economics* 129, 2015, 77-91, https://www.sciencedirect.com/science/article/abs/pii/S0047272715001243; Thiess Buettner, Michael Overesch, and Georg Wamser, "Anti profit-shifting rules and foreign direct investment," *International Tax and Public Finance* 25(3), June 2018, 553-80, https://link.springer.com/article/10.1007%2Fs10797-017-9457-0; and Ruud A. de Mooij and Li Liu, "At a Cost: The Real Effects of Transfer Pricing Regulations," International Monetary Fund, March 23, 2018, https://www.imf.org/en/Publications/WP/Issues/2018/03/23/At-A-Cost-the-Real-Effects-of-Transfer-Pricing-Regulations-45734.

The structure could potentially follow the United States' Global Intangible Low Tax Income (GILTI) policy. This policy applies a minimum rate of taxation to a company's foreign earnings and allows for a basic deduction against those earnings. It also limits foreign tax credits that would otherwise apply.[25]

There are dozens of ways for the global minimum tax to be put into practice. The first issue is defining what the minimum will be and how it will be measured. Imagine if the minimum tax is set at 10 percent and a company has a subsidiary in a foreign jurisdiction with a statutory corporate rate of 25 percent. However, if the subsidiary has an effective tax rate of 5 percent because it is deducting costs associated with capital investments it has made or has loss carryforwards, the question follows as to whether the foreign statutory rate or the effective rate should trigger the minimum tax for that subsidiary.

The proposal also contemplates options for calculating the minimum tax in situations where companies have multiple subsidiaries across multiple jurisdictions. The options are to aggregate foreign subsidiaries' effective tax rates with either a blending approach like GILTI or a country-by-country (or even more narrow) approach.

If a company has six foreign subsidiaries in six different jurisdictions and their tax rates vary from 0 percent to 30 percent, one approach would be to design the minimum tax to apply if the average tax rate of those subsidiaries is below the minimum. The work program refers to this approach as blending, which could be done at the global level, jurisdictional level, or even the entity level.

One challenge for the minimum tax is defining what counts as meeting the minimum. The difference between statutory and effective rates can vary significantly even among countries with identical statutory rates. As shown in Table 1, Austria, Chile, the Netherlands, and Spain each had the same statutory corporate tax rate in 2017. However, the differences in the way their tax systems treat capital investments, inventories, and other items create variation not only in effective average rates but especially in effective marginal tax rates.

So, while a business may in theory owe a 25 percent tax on its profits, deductions for losses or capital investments could lower the company's effective tax rate. This is often especially true for businesses that are eligible for research and development tax credits or have income that qualifies for a patent box. These domestic provisions vary across the globe and it will be important for companies to understand how the measurement of the minimum tax rate will take those policies into account.

25 Kyle Pomerleau, "A Hybrid Approach: The Treatment of Foreign Profits under the Tax Cuts and Jobs Act," Tax Foundation, May 3, 2018, https://taxfoundation.org/treatment-foreign-profits-tax-cuts-jobs-act/.

TABLE 1.

Comparison of Statutory and Effective Tax Rates, 2017

Country	Combined Statutory Corporate Tax Rate	Composite Effective Average Tax Rate	Composite Effective Marginal Tax Rate
Austria	25%	23.7%	13.7%
Chile	25%	31.8%	31.3%
Netherlands	25%	23%	9.7%
Spain	25%	24.8%	17.3%

Note: The effective tax rates in the table take into account the way tax policies impact various industries and investments (composite measurements). Individual businesses or industries could have higher or lower effective tax rates depending on their particular situation.
Source: OECD Corporate Tax Statistics Database, https://www.oecd.org/tax/beps/corporate-tax-statistics-database.htm

Calculating whether a company's income is undertaxed relative to the minimum at the entity level, country level, or global aggregate would rely on consistently calculating effective rates of taxation in the same way across countries with very different approaches to corporate taxation.

The work program mentions as a potential simplification that the policy could rely on financial accounting to determine whether income is being taxed at the minimum level. As mentioned previously, the difference between taxable profits and financial profits is significant.[26] Even though the work program leaves an opening for adjustments to financial accounting in order to make the minimum tax workable, it is likely that departures from tax accounting could create significant new challenges for ensuring that there is neither double taxation nor that losses and write-offs for capital investments are not included in the tax base.

The work program discusses the minimum tax as a potential extension of a country's own CFC rules. If that is to be the case, then the tax should follow the principles of well-designed CFC rules and apply to passive income rather than active income, apply to entities that are clearly connected to the domestic tax systems (ownership test), and have an application threshold that is clearly defined to minimize uncertainty for businesses when building new capacity in foreign subsidiaries. Additionally, making the minimum tax optional could allow countries that choose to apply the minimum tax (in many cases in addition to their CFC rules) to do so in a way that does not create double taxation and does not punish investment. Countries that choose not to apply the minimum tax would be exercising their tax sovereignty over whether to leave certain types of income untaxed (or taxed at low rates).

26 Nicole Kaeding, "Taxable Income vs. Book Income: Why Some Corporations Pay No Income Tax."

Tax on Base-Eroding Payments

Just as the global minimum tax could follow the outline of a recently adopted U.S. policy (GILTI), the tax on base-eroding payments draws inspiration from the Base Erosion Anti-abuse Tax (BEAT) which was also included in the U.S. tax reform of 2017.[27] According to the work plan there are two approaches to the tax on base-eroding payments:

1. Undertaxed payments rule

2. Subject to tax rule

An undertaxed payments rule would deny deductions or potentially apply withholding taxes to otherwise deductible or untaxed cross-border payments if those payments are not subject to a minimum tax in the country of destination. How that minimum tax on payments would be measured raises the same questions as the proposal for a global minimum tax.

The subject to tax rule would only provide treaty benefits to payments that face a minimum level of tax.

The key challenge in taxing specific payments is the compliance burden on businesses to track the tax rate associated with payments as they cross borders. To the extent that the policy will tax payments that are truly base-eroding, businesses will likely respond by rearranging payment flows to stay just above the minimum tax threshold.

The BEAT in the U.S. tax reform was estimated to raise nearly $150 billion over ten years,[28] so depending on how broad or narrow the new tax on base-eroding payments is, such a policy could result in significant new taxes paid. Coordinating this policy with respect to the scope of the overall minimum tax and the Pillar 1 options will prove critical in ensuring that the combined effect does not result in double taxation.

For any given income stream, it would be worth clarifying which set of rules (minimum tax or tax on base-eroding payments) should apply when, and whether if once one or the other applies that eliminates the need to apply the second level of analysis and taxation at all.

Without this ordering, a company could pay a minimum tax on foreign income that has already faced a tax on base-eroding payments or vice versa.

27 For more information on GILTI and BEAT, see Kyle Pomerleau, "A Hybrid Approach."

28 Joint Committee on Taxation, "Estimated Budget Effects of the Conference Agreement for H.R. 1, The 'Tax Cuts and Jobs Act,'" Dec. 18, 2017, https://www.jct.gov/publications.html?func=startdown&id=5053.

Economic Analysis and Impact Assessment

Appropriately, the work program includes an agenda for conducting analysis of the options for reforming international tax rules. This is much-needed work and the OECD has said that it plans to complete the initial analysis by October 2019. The analysis will identify pros and cons of the various approaches and work to measure how the proposals will change incentives for both taxpayers and governments. Additionally, the analysis will estimate the potential economic incidence or impact of the options and the revenue effects and how the distribution of revenues could change across taxing jurisdictions.

This work could help to steer the conversation towards proposals that create the least amount of economic distortion and allow countries to understand how the changes will impact their tax bases. Academics in the fields of economics and public finance have worked for years to analyze how taxes interact with international investment and location decisions. Recently, some studies have specifically analyzed how anti-base erosion policies impact business decisions for investment locations and tax revenues.

Data availability may be a challenge for the OECD in identifying economic effects. This could especially be true for the non-OECD countries that are part of the IF. However, even utilizing existing research on the effects of anti-base erosion measures could provide the OECD with some sense of the impact of various approaches.

In the conclusion of a recent review of profit-shifting mechanisms and magnitudes, the authors point to evidence collected on the impact of anti-base erosion measures on real investment.[29] Though the authors admit the evidence collected so far is scarce, it reveals that some anti-base erosion policies could negatively impact real investments by multinational businesses. It will be important for the OECD to review which of the Pillar 1 and Pillar 2 approaches will have the least damaging effects on real investment by businesses. They should also collaborate with economists who have closely studied how various anti-base erosion policies have changed business incentives, increased or decreased corporate tax revenues, and whether certain design features need to be avoided to minimize distortions and complexity.

It would be quite unfortunate for the OECD and the IF countries to chase after slightly more corporate tax revenue at the cost of investment and employment.

29 Sebastian Beer, Ruud A. de Mooij, and Li Liu, "International Corporate Tax Avoidance: A Review of the Channels, Magnitudes, and Blind Spots," International Monetary Fund, July 23, 2018, https://www.imf.org/en/Publications/WP/Issues/2018/07/23/International-Corporate-Tax-Avoidance-A-Review-of-the-Channels-Effect-Size-and-Blind-Spots-45999.

Conclusion

The OECD has a significant amount of work ahead to resolve this discussion. It is important, though, to have a clear picture of what success will mean for the project. Due to the nature of the proposals being considered and the associated challenges for implementation it is highly likely that whatever result comes in 2020 will be more of a starting gun rather than a finish line for realigning international tax policy. With that in mind, success at the OECD will include the following elements:

1. Identification of the scope and magnitude of the issues being addressed and how they are left unresolved by previous BEPS project efforts.

2. A clear set of recommendations on both taxing rights and anti-base erosion policies that do the least amount of harm to economic growth.

3. Economic assessment of the potential impact of the policies on cross-border investment, cost of capital, foreign direct investment, compliance and administration costs, and countries' tax revenue.

4. Commitment from countries to remove policies that conflict with the recommendations.

Without agreement at the OECD, the current state of unilateral measures and tax uncertainty could devolve into more chaos. It is possible that countries will be willing to trade some certainty on behalf of their taxpayers for higher levels of taxes paid, even if those taxes are paid in market jurisdictions. However, it will also be important for the agreed-upon solution to be designed in a way that does not hurt cross-border investment or create more distortions for business location decisions. Multinational businesses are often key to creating jobs and are relied upon for significant tax collection and tax payment by governments.[30] Adopting international standards that hurt the ability for businesses to grow their employment, production, and profitability could have long-term consequences for economies around the world.

From a broad standpoint, agreement at the OECD will require countries to give up some measure of their own tax sovereignty on policies they have designed to minimize the distortionary effects of the corporate income tax. Over the years tax competition has led to some countries adopting policies that are attractive to businesses because they have a more neutral rather than distortionary approach to taxing corporate income. This project could directly undermine that progress by introducing new levels of complexity and distortion that would ultimately have a negative impact on global trade and growth.

30 Scott A. Hodge, "Contrary to 'Fair Share' Claims, Businesses are Central to Tax Collection Systems," Tax Foundation, May 16, 2018, https://taxfoundation.org/fair-share-businesses-central-to-tax-collections/.