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In this article, the author argues that OECD plans to promote international rules for profit tax assessment will not work, and he suggests a reform that centers on a withholding tax on qualified payments and revises the right to deduct royalties from taxable profit.

According to plans released by the OECD's base erosion and profit-shifting inclusive framework, a share of residual profit earned by qualified multinational enterprises is to be taxed by market jurisdictions. Further, minimum taxation is to be enforced worldwide. To achieve both goals, an international agreement on common rules of profit tax assessment has been proposed.

This article questions whether that kind of ambitious reform will succeed and recommends a less sweeping one that places withholding tax on qualified payments at its center and amends the right to deduct royalties from taxable profit.

The BEPS Inclusive Framework

The world of business is no longer as it was a hundred years ago when the basic rules of international corporate taxation were fixed, and it is becoming increasingly clear that those rules cannot meet the challenges of digitalization. Realizing that, the G-20 commissioned the OECD to invite interested countries to jointly revise the allocation of taxing rights, and 139 have accepted the invitation to make it more difficult for large MNEs to avoid taxes through profit shifting.

New Taxing Rights of Market Jurisdictions

The subject matter is complex, and tax observers speak of negotiations more like a marathon than a sprint. Still, the key points are meant to be in place by July when the G-20 leaders meet in Venice for their summit.

The OECD published its proposals for reform last October, dividing them into two pillars. Pillar 1 is intended to reallocate the taxation of MNEs that conduct their business worldwide and earn abnormally high profits. The focus is on the well-known internet giants, and which other MNEs should be included has not yet been decided. The reform aims to allocate the right to tax supernormal profits more fairly by favoring so-called market jurisdictions, which currently have no right to tax profit earned on remote sales.

Contrary to what one might expect, the jurisdictions where MNEs are domiciled can by no means be considered the beneficiaries of the current allocation of taxing rights. They would be if the profit "their" MNEs earned on foreign business accrued to them untaxed, but the rules allow MNEs to establish subsidiaries in low-tax jurisdictions and have their foreign profits taxed there. Because provisions designed to avoid double taxation ensure that profit contributions are taxed only once, shifting profits shields those profits from high taxation in the jurisdiction where the ultimate parent company is domiciled. Profits are deemed to have been definitively taxed even if at a low rate in a third country.

Combating Profit Shifting

Under the Trump administration, the United States, where most internet giants are headquartered, attempted to combat profit-shifting strategies with a radical but unilateral reform of corporate taxation. On the initiative of France and Germany, the OECD has proposed the introduction of internationally coordinated rules based on the U.S. tax reform. In simplified terms, pillar 2 is meant to prevent the undertaxation of corporate profits by preventing rates from falling below a minimum level that would ideally be binding worldwide. In other words, MNEs should no longer have either the incentive or legal means to shift their profits to countries where taxation is not a significant burden.

Summarizing the OECD's proposals, one must emphasize two objectives: (1) achieving interjurisdictional fairness in the allocation of taxable supernormal profit; and (2) combating profit shifting. Although the objectives are pursued under separate pillars, the proposed measures are closely linked in terms of technical implementation. In the first stage, the inclusive framework must agree on new and revised profit allocation rules to be applied to supernormal profit only; changes to the taxation of normal profits are not envisaged. Each jurisdiction should then have the right to impose its own profit tax rate on its allocated share of supernormal profit.

The OECD has proposed an allocation based on relative sales. The idea is that those jurisdictions where more business is conducted should also be entitled to tax a larger share of supernormal profit. From the point of view of interjurisdictional tax equity, that makes sense.

Ensuring Effective Minimum Taxation

However, countries such as France and Germany fear that a fair allocation of taxable supernormal profits and a reduction in profit-shifting activities will not be enough. Their concern is that it will be impossible to change international rules sufficiently to eliminate their effect on the choice of location for real entrepreneurial activities. After all, MNEs do not only compare nominal tax rates; they also take into account country-specific provisions that narrow the tax base to their advantage, such as the options for offsetting losses or depreciating assets.

The OECD's pillar 2 proposals therefore aim for agreement on effective minimum tax rates rather than merely nominal ones. The effective rates are those resulting from the interplay of nominal rates with the rules on assessing taxable profit. That makes the rules on profit assessment more important: first, for the fair international allocation of taxable profit; second, for the prevention of pure profit shifting by MNEs; and third, to limit the scope for tax-base narrowing and thus restrict competition for the location of real entrepreneurial activities.

At first glance, the OECD's two-pillar concept seems well thought out and to promise huge progress in international corporate taxation. Even so, skepticism is warranted because of the need for international agreement on jointly applicable rules for profit tax assessment, for which there is as yet no practical model.[1] Common rules for assessing taxable profit can be found only in some jurisdictions, with the United States, Germany, and Canada being oft-cited as examples. However, it makes a considerable difference whether complex sets of rules such as those governing corporate income taxation are implemented domestically or internationally. Even EU-wide efforts over the last 20 years to design common rules for assessing taxable profits have proved unsuccessful. It thus seems highly unlikely that more disparate countries will agree on common rules. Moreover, not even harmonizing the assessment of taxable profit will suffice to make the OECD's proposal effective, as the following observation should make clear.

The Problem of State-Controlled MNEs

In China, the state exerts direct control over entrepreneurial decisions. That is achieved not only through corporate taxation but also through corporate ownership, a dual control that enables

[1] For that reason, the OECD proposes reliance on consolidated financial accounts prepared under U.S. generally accepted accounting principles or international financial reporting standards.

forms of intervention in business activities that are not possible in free market economies. Imagine an internet giant in which the Chinese state is a majority shareholder and that earns supernormal profit with its worldwide activities. As a taxing state, China will be reluctant to share the right to tax its supernormal profit with other countries. Now, the source of supernormal profit in the digital economy is typically something intangible, such as software code. That makes it easy for the Chinese state, as the controlling shareholder, to avoid the need for profit sharing. To do so, it would merely need to set up a purely domestic company to which the internet giant would sell its software codes while retaining the right of economic use. Through that restructuring, the supernormal profit would accrue to the purely nationally operating company and no longer be subject to supranational profit sharing. The amount of license fees that the internet giant would have to pay for the use of the software codes could be tailored so that it would no longer generate supernormal profit. Those kinds of arrangements can be prevented only if the state refrains from directly controlling corporate decisions, which, in the general view, China is far from doing.

Reservations like that suggest that the challenges of digitization cannot be solved by assuming that the international community will agree on a common set of rules for assessing taxable profit. Instead, solutions must be found that do not require such wide international agreement. To determine what those might be requires understanding why the current tax rules are so difficult to transfer from the old economy to the new.

Sources of Supernormal Profits

Supernormal profit results from scarcity. In the old economy, scarcity stems predominantly from the limited availability of natural resources and factors of production — for instance, oil and high-quality land. Those scarcities are often natural and perfectly compatible with competition. For example, there are many sources of oil, and supernormal profit is earned only when one company's extraction costs are lower than those of its competitors. Because oil is a largely homogeneous commodity with competition for its supply, it is possible to determine prices at arm's length and thus assess taxable profit with a high degree of verifiability.

Those conditions are much less satisfactorily fulfilled in the new economy, in which supernormal profit results predominantly from patented scarcity. The use of software codes — the prerequisite for generating sufficient revenue to cover the high costs of development — is constrained by legal means. At the same time, economies of scale and network externalities prevent effective competition; there is a tendency toward natural monopoly.

With a market share now exceeding 90 percent, Google's search engine provides a striking example of that phenomenon. Because of non-homogeneity and lack of competition, software codes are difficult to price at arm's length, leaving internet companies ample ability to have their profits accrue where they are taxed most lightly.

Those observations can be applied more generally to all companies whose profits are predominantly earned from the development of intellectual property.[2] IP can rarely be priced at arm's length, and its role is many times greater in the new economy than in the old. Therefore, the taxation of income from IP must be placed at the center of any planned reform of international corporate taxation. (The taxation of supernormal profit earned on natural resources is avowedly not an object of the inclusive framework's reforms.)

Royalty Taxation

The essential rules on international corporate taxation are compiled in two texts — namely, the OECD and U.N. model tax conventions. The texts differ only in the details, with the U.N. model tending to accommodate developing countries in allocating tax rights. The U.N. model is used as a guideline by OECD countries when they negotiate tax treaties with developing countries. The OECD model, on the other hand, is used as a basis by OECD jurisdictions when they negotiate treaties among themselves.

[2] Nadine Riedel and Tom Karkinsky, "Corporate Taxation and the Location of Patents Within Multinational Firms," 88 *J. Int'l Econ.* 176 (2012).

Both address the taxation of IP income in article 12. The OECD model insists that royalties "shall" be taxed only by the jurisdiction where the right holder is resident. The U.N. model is less one-sided, stipulating that royalties "may" be taxed in the right holder's jurisdiction of residence, thus not precluding taxation in the source jurisdiction.

The U.N. version of article 12 can be justified by the fact that in the international sphere, two jurisdictions must cooperate if profit is to be made from IP. The right holder's country of residence must allow the expansion of business abroad, and the foreign country must open its market to the business. Neither concept is self-evident. For example, the United States imposed export restrictions on vaccines during the COVID-19 pandemic, and Google has been blocked in China for years. Because the situation requires cooperation by both jurisdictions, it seems intuitively fair and equitable for both to have a share of the taxation of the contributed profit.[3] In its technical implementation, that would amount to profit splitting.

One might object that jurisdictions have always had to cooperate in international trade. Even in the old economy, it is mutually advantageous not to restrict exports and imports. However, trade in the old economy is much more reciprocal than in the new economy because the internet giants are not evenly located around the world. Rather, technological factors favor a strong regional concentration, as Silicon Valley amply demonstrates. Supernormal profit accruing from digital business models is thus also highly concentrated geographically. That raises the question of how the right to tax supernormal profits from IP can be fairly shared internationally.

The recently introduced U.N. model article 12B shows a practicable method for doing that, although it has neither been adopted by the OECD model nor included in the OECD's new proposals. U.N. article 12B allows the source country to impose withholding tax on revenue from automated digital services. At the same time, the country of domicile retains the right to tax the resulting profit. That is an extremely simple and elegant solution, and it begs the question why the OECD is not using it as a general model for reforming international corporate taxation.[4]

There are two possible reasons for that. One is that the United States refuses to restrict reforms to MNEs that make their money with internet-based services — supernormal profits are also being earned outside automated digital services. Consider, for example, Apple's electronic devices or the production of vaccines using messenger RNA technology. In those cases, revenue cannot be equated with profit contributions because there are nonvanishing costs per unit sold — that is, so-called variable costs. If a withholding tax on revenue were to be applicable to those sales, there would be the risk of violating the principle of net income taxation, which prohibits the taxation of costs.

The second reason stems from a problem that arises whenever an MNE has transferred the right to use IP to a permanent establishment outside the country of domicile. Then, under OECD model article 12, the income is taxable in the PE's jurisdiction and shielded from further taxation in the jurisdiction of the MNE's domicile. By strategically placing PEs and pricing royalties, profits can be shifted almost arbitrarily between an MNE's subsidiaries. That possibility is rooted in the underdiscussed problem that with affiliated companies, no economically convincing distinction can be made between royalty payments and profit distributions. The tax treatment of royalty payments between affiliated companies is based solely on the legal analogy with royalty payments between nonaffiliated companies.

That analogy must be questioned. After all, it creates the basis for shifting profits that MNEs

[3] That notion of tax equity is theoretically underpinned by Richter, drawing on game theory in general and Shapley value theory in particular. *See* Wolfram F. Richter, "Aligning Profit Taxation With Value Creation," 13 *World Tax J.* 3 (2021).

[4] Andres Báez Moreno and Yariv Brauner, "Taxing the Digital Economy Post BEPS . . . Seriously," 58(1) *Columbia J. Transnat'l L.* (2020); and Richter, "Taxing the Residual Profit of Multi-National Enterprises: A Critique of Formulaic Apportionment and a Proposal," EconPol Policy Brief No. 35 (2021). For a comparison of the OECD's approach with U.N. model article 12B and proposals of residual profit allocation, see Richard Collier, Michael P. Devereux, and John Vella, "Comparing Proposals to Tax Some Profit in the Market Country," preliminary draft, Oxford University Centre for Business Taxation (2021).

earn on intangibles abroad. Because profit is taxable in the PE's jurisdiction and royalty payments are taxable in the right holder's jurisdiction of residence, MNEs are pretty free to decide in which of the two jurisdictions the return on intangibles is to be taxed.[5]

Proposal for Reform

If the above analysis is accepted, the conclusion must be that OECD model article 12 should be replaced by a rule based on articles 12A and 12B of the U.N. model. First, a limited withholding tax (w) should be allowed on payments for royalties, automated data services, and other politically agreed supplies if they are deductible under profit taxation. Second, royalties should be deductible only for the licensee if the licensor is not an affiliated company. Third, only a specific proportion (p) of a PE's residual profit contribution should be subject to profit taxation at the rate (t) in the source jurisdiction. By fixing p, profit splitting would be implemented. That parameter would have to be internationally agreed, but not greater than 50 percent.[6] Fourth, the jurisdiction where the recipient of payments taxed at source is domiciled should be obliged to avoid double taxation. That should apply to both profit taxes and withholding taxes.

If a PE's expenses are no longer deductible, that will inevitably increase taxable profit so that there is no reason to levy withholding tax. Taxation in the PE's jurisdiction would be ensured, and the strong incentive to avoid it by business restructuring would remain only if the product of p and t differed from w.

The proposal will be reasonable only if the payments that are liable for withholding taxation do not have to cover variable costs, as with automated digital services. Whenever variable costs are not negligible, the rule outlined above must be suitably adapted. In particular, it should be ensured that variable costs are deductible from withholding tax — either through assessment or negotiated standardized rates. Further, the jurisdiction where payments taxed at source are collected must ensure through suitable regulations that any double taxation is avoided. In any case, a system of international profit taxation that allows variable costs to be deducted from payments subject to withholding tax is far easier to implement than one requiring international agreement on a common corporate tax base (which is anyway insufficient to prevent state-controlled countries from manipulating profit by way of corporate ownership).

According to the OECD's plans, consumer-facing businesses should be included in the reform. Clearly, a special solution must be found for those businesses if profit contributions earned on them are to be subject to withholding tax. The model for the solution could be the one the EU has applied for VAT because the taxation of e-commerce sales in the country of destination raises similar enforcement and administration concerns as levying a withholding tax on consumer-facing businesses. From July 1 the EU is solving the problems by allowing online sellers and electronic interfaces to declare and pay VAT due on all supplies of goods and services in a single electronic quarterly return. A similar "one-stop shop" solution would have to be found for the collection of withholding tax on consumer-facing businesses.

Ensuring Stability via a Tax Cartel

Admittedly, it is not enough to devise new rules for international corporate taxation: It is also necessary to ensure that jurisdictions see an advantage in adopting the rules rather than going their own way. After all, sovereign jurisdictions cannot be forced to comply. That means that adopting the new rules must offer advantages, particularly to those countries whose business models are based on exploiting the old rules. Those countries are often small, and because their fair share of the supernormal profit of large MNEs will be equally small, they are unlikely to be tempted by the prospect of being allowed to tax it.

It is therefore necessary to focus on the MNEs and remove their incentive to take the bait offered by small jurisdictions. In principle, that can be achieved by making it advantageous for MNEs to direct internal payments to countries that comply with the taxation rules. In concrete terms, that

[5] However, OECD model article 12(4) allows the jurisdiction where royalties are deducted from profit tax to reject declared prices if they do not pass an arm's-length test and if the payer and payee are affiliated in the sense that they have a "special relationship."

[6] For a justification, see Richter, *supra* note 3.

could mean that double taxation of interjurisdictional payments is eliminated only if both jurisdictions involved apply the new rules. For example, the deductibility of variable costs in the context of withholding taxation could be conditioned on the jurisdiction where the payments are collected being compliant. Alternatively, withholding tax exemption for profit distributions to affiliated companies could be conditioned on the payee being domiciled in a compliant jurisdiction. In short, the countries adopting the new rules should form a cartel or, to give it a more positive term, a club whose membership offers tax advantages. (Similar proposals have been made when trying to impose common minimum standards for global climate policies.)

The bottom line is that the inclusive framework should refrain from advancing the reform of international corporate taxation along the lines of the OECD's two-pillar solution. International harmonization of profit tax assessment is too ambitious an undertaking. It will also not have the hoped-for effect on all those countries that do not want to forego direct control on corporate decisions. The OECD should examine whether a less ambitious reform of corporate taxation that places withholding tax on selected payments at its center might not be more expedient. The new article 12B of the U.N. model should be the starting point for those discussions. ■