# GLOBAL TAX REFORM -THE TAX CHALLENGES OF TODAY'S ECONOMY

**Semra Mehmed Gyokche**
Varna Free University "Chernorizets Hrabar"
E-mail: semra.gyokche@gmail.com

***Abstract:*** *This paper discusses the problems that brought up to the decision of changing the global taxation in order to avoid multinational enterprises (MNEs) not paying their fair share. The aim is to explain the mechanism of the two-pillar solution that has been discussed and agreed by the members of the Organisation for Economic Co-Operation and Development (OECD) and how this mechanism will help for the fair distribution of tax in today's economy.*[1]

***Keywords:*** *global minimal tax, two-pillar solution, re-allocation, MNEs*

## Introduction

Since the early 2000s there have been concerns about the international taxsystem just not keeping up with the current economic climate. These concerns are often associatedwith the so-called digital economy or modern economy and companies such as Google, Apple, Facebook, Nike, Amazon. The main problem is about tax competition, when a particular country is imposing lowtax rates to compete against countries with higher tax rates.There have also been concerns about mobility of income and the reliance onintangibles. The idea that income can just be booked in different countries and that the factthat so much value comes from

[1] By today's economy the author means - the new economic circumstances caused by the digitalization and globalization of the economy over the last decade.

intangibles, means that those intangibles themselves can beplaced in different countries on paper and that income can be allocated to differentcountries.

There are two main problems that have to be solved:

1. The first is that the current rules provide that the profits of a foreign company can only be taxed in another country where the foreign company has a physical presence. One hundred years ago, when business revolved around factories, warehouses and physical goods, this made perfect sense. But in today's economy, MNEs often conduct large-scale business in a jurisdiction with little or no physical presence there.

2. The second problem is that most countries only tax domestic business income of their MNEs, but not foreign income, on the assumption that foreign business profits will be taxed where they are earned. The growth of intangibles, like brands, copyright and patents, and companies' ability to shift profitsto jurisdictions that impose little or no tax, means that MNE profits often escape taxation. This is further complicated by the fact that many jurisdictions are engaged in tax competition by offering reduced taxation – and often zero taxation – to attract foreign direct investment.

In recent years, there have been debates about a significant reform to international tax rules that apply to multinational companies. Following a July 2021 announcement by countries involved in negotiations at the Organisation for Economic Co-Operation and Development (OECD)1, in October there was a further agreement on an outline for the new tax rules by more than 130 jurisdictions.

Large companies would pay more taxes in countries where they have customers and a bit less in countries where their headquarters, employees, and operations are. Additionally, the agreement sets up the adoption of a global minimum tax of 15 percent, which would increase taxes on companies with earnings in low-tax jurisdictions.

“In 2013, the OECD ramped up efforts to address these challenges in response to growing public andpolitical concerns about tax avoidance by large multinationals” (OECD/G20 Base Erosion and Profit Shifting Project, October 2021)[2]. The current rules still allow largemultinationals to earn significant income in a jurisdiction without paying corporate income tax there. New business models that rely heavily on intellectual property have made it easier for MNEs to shiftprofits to low-tax jurisdictions. Globalisation has increased unhealthy tax competition. Now, 136 countries and jurisdictions, representing more than 90% of global GDP, have joined theTwo-Pillar Solution establishing a new framework for international tax and agreed a DetailedImplementation Plan that envisages implementation of the new rules by 2023.

**Definition**

“The Two-Pillar Solution is comprised of Pillar One and Pillar Two. Pillar One aims to ensure a fairer distribution of profits and taxing rights among countries with respect to the largest MNEs, which are the winners of globalisation. Tax certainty is a key aspect of the new rules, which include a mandatory and binding dispute resolution process for Pillar One but with the caveat that developing countrieswill be able to benefit from an elective mechanism in certain cases, ensuring that the rules are not too onerous for low-capacity countries. The agreement to re-allocate profit under Pillar One includes the removal and standstill of Digital Services Taxes (DST) and other relevant, similar measures, bringing an end to trade tensions resulting from the instability of the international tax system. It will also provide a simplified and streamlined approach to the application of the

[2] Two-pillar Solution to Address the Tax Challenges Arising from the Digitalization of the Economy, October 2021. https://www.oecd.org/tax/beps/brochure-two-pillar-solution-to-address-the-tax-challenges-arising-from-the-digitalisation-of-the-economy-october-2021.pdf

arm's length principle in specific circumstances, with a particular focus on the needs of low capacity countries.

Pillar Two puts a floor on tax competition on corporate income tax through the introduction of a global minimum corporate tax at a rate of 15% that countries can use to protect their tax bases (the GloBE rules).Pillar Two does not eliminate tax competition, but it does set multilaterally agreed limitations on it. Tax incentives provided to spur substantial economic activity will be accomodated through a carve-out. Pillar Two also protects the right of developing countries to tax certain base-eroding payments (like interest androyalties) when they are not taxed up to the minimum rate of 9%, through a "Subject to tax rule" (STTR)"(OECD/G20 Base Erosion and Profit Shifting Project, October 2021)[3].

There is a brief explanation of the key elements of the Two pillar solution in the document published by the OECD (Table 1).

**Table 1**[4]

**Key elements of the two-pillar solution**

| Pillar One | Pillar Two |
|---|---|
| Taxing rights over 25% of the residual profit of the largest and most profitable MNEs would be re-allocated to the jurisdictions where the customers and users of those MNEs are located. | GloBE rules provide a global minimum tax of 15% on all MNEs with annual revenue over 750 million euro. |
| Tax certainty trough mandatory and binding dispute resolution, with an elective regime to accommodate certain low-capacity countries. | Requirements for all jurisdictions that apply a nominal corporate income tax rate below 9% to interest, royalties and a defined set of other payments to implement the "Subject to Tax Rule" into their bilateral treaties with developing Inclusive Framework members when requested to, so that their tax treaties cannot be abused. |

[3] Two-pillar Solution to Address the Tax Challenges Arising from the Digitalization of the Economy, October 2021. https://www.oecd.org/tax/beps/brochure-two-pillar-solution-to-address-the-tax-challenges-arising-from-the-digitalisation-of-the-economy-october-2021.pdf
[4]Two-pillar Solution to Address the Tax Challenges Arising from the Digitalization of the Economy, October 2021. https://www.oecd.org/tax/beps/brochure-two-pillar-solution-to-address-the-tax-challenges-arising-from-the-digitalisation-of-the-economy-october-2021.pdf

| Pillar One | Pillar Two |
|---|---|
| Removal and standstill of Digital Services and Taxes and other relevant, similar measures | Carve-out to accommodate tax incentives for substantial business activities |
| The establishment of a simplified and streamlined approach to the application of the arm's length principle in specific circumstances, with a particular focus on the needs of low-capacity countries. | |

### Pillar One – Re-allocation of taxing rights

Pillar One's goal is to shift part of taxing rights from the jurisdiction of domicile to market jurisdictions, i.e. where the MNEs' customers are situated. Pillar One would require sizeable multinational tech companies such as Amazon, Google, and others to pay more taxes in countries with customers or users regardless of where they operate. Taxing rights on more than USD 125 billion in earnings will be transferred to market jurisdictions under Pillar One. Under this Pillar, which will be signed in 2022 and implemented in 2023, multinational companies having a worldwide turnover of more than **20 billion euros** and a pre-tax profit of more than 10% of revenue (known as supernormal profit) would be required to pay 25% of the profit before tax. This 25% will be shared among nations based on a nexus-based allocation mechanism, which is currently being negotiated (Figure 1).

Profits will be shifted significantly across countries as a consequence of the Pillar One plans. However, it needs measures to prevent double taxes via either a credit or exemption system. Profit shifting raises the possibility of double taxation since countries may not apply the laws in the same manner. The agreement to re-allocate earnings under Pillar One includes the elimination and suspension of Digital Services Taxes (DST), Equalisation levy and other necessary, comparable steps, putting an end to trade tensions caused by the insecurity of the international tax system. It will also offer a simpler and streamlined method to applying the arm's length principle in certain situations, emphasising the requirements of low-capacity nations.

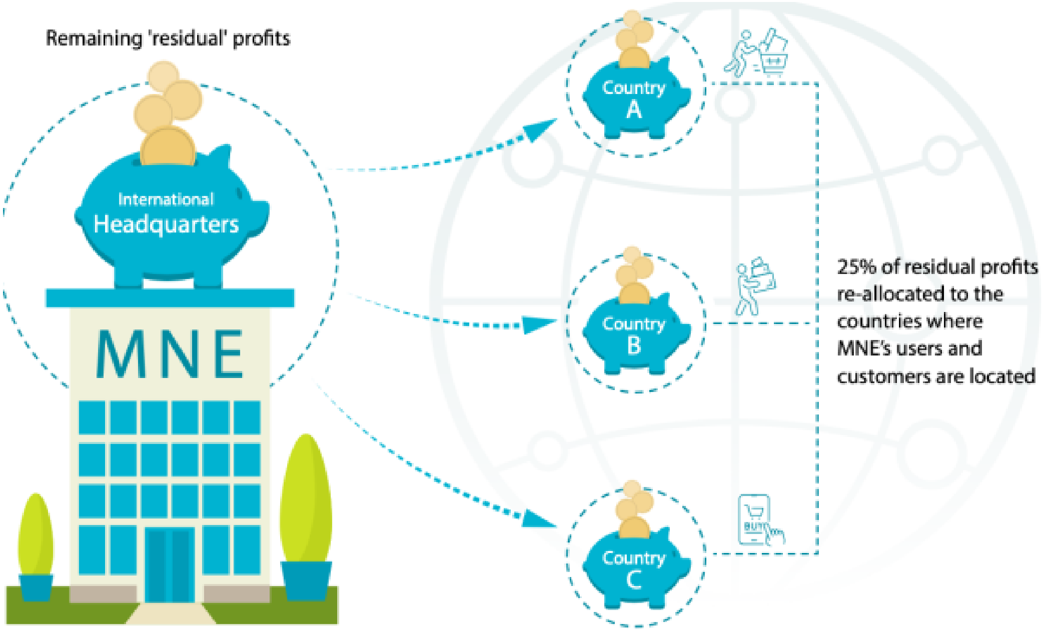


**Figure 1**: Re-allocation of taxing rights[5]

**Pillar Two – Global Minimal Tax**

Pillar Two establishes a floor for tax competitiveness on corporate income tax by instituting a worldwide minimum corporation tax of 15%, which nations may employ to safeguard their tax bases (the GloBE rules). This implies that everywhere an MNE operates, tax competition will now be hampered by a minimum amount of taxes. The worldwide minimum tax rate would apply to multinational corporations with global revenues of 750 million euros ($868 million). Governments may continue to establish whatever local corporate tax rate they choose, but if businesses pay lower rates in one nation, their home governments could "top up" their taxes to the 15 % level, removing the benefit of transferring earnings. On the other hand, a

[5] Two-pillar Solution to Address the Tax Challenges Arising from the Digitalization of the Economy, October 2021. https://www.oecd.org/tax/beps/brochure-two-pillar-solution-to-address-the-tax-challenges-arising-from-the-digitalisation-of-the-economy-october-2021.pdf

carve-out enables nations to continue to provide tax incentives to encourage real-world economic activity, such as constructing a hotel or investing in a factory. At a rate of 15%, the global minimum tax is projected to produce about $150 billion in additional tax collections worldwide under Pillar Two. If all nations pass such legislation, the 15% corporation tax floor will be implemented in 2023 (Figure 2).

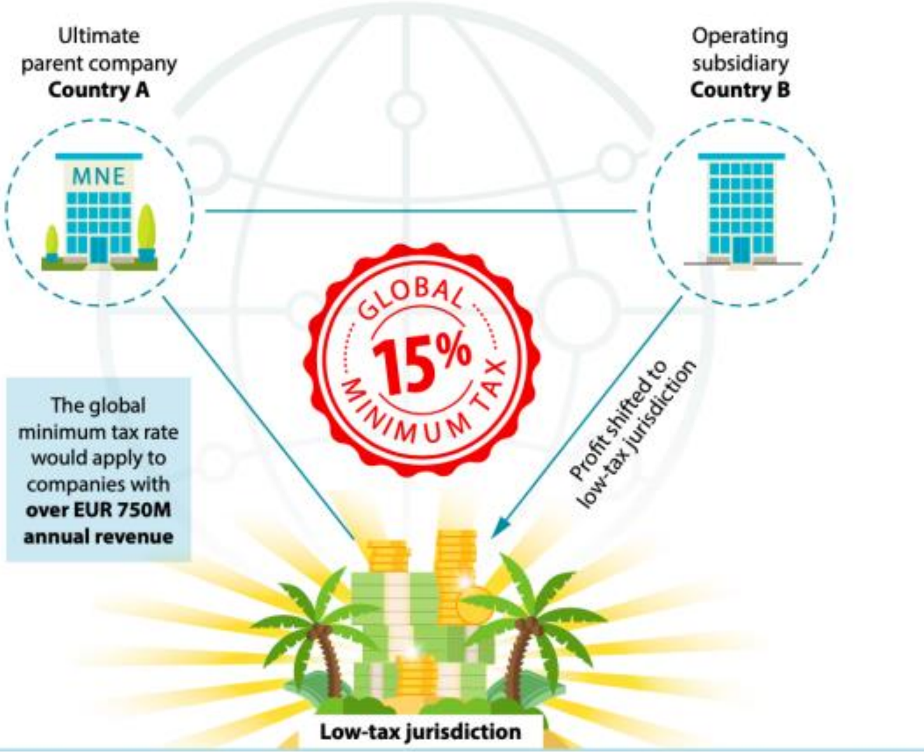


**Figure 2**: Global minimal tax[6]

**Expected results**

"The OECD estimated corporate tax avoidance costsanywhere from USD 100-240 billion annually, orfrom 4-10% of global corporate income tax revenues.

[6] Two-pillar Solution to Address the Tax Challenges Arising from the Digitalization of the Economy, October 2021. https://www.oecd.org/tax/beps/brochure-two-pillar-solution-to-address-the-tax-challenges-arising-from-the-digitalisation-of-the-economy-october-2021.pdf

Developing countries are disproportionately affectedbecause they tend to rely more heavily on corporateincome taxesthan advanced economies. Countries'inability to tax MNE profits have given rise to unilateralmeasures at the national level, such as Digital ServicesTaxes (DST), and the prospect of retaliatory tariffs.Such an outcome could cost the global economy upto 1% of global GDP and hamper recovery efforts fromthe COVID-19 crisis. Again, this would hit developingcountries harder than more advanced economies. Theimplementation of the Two-Pillar Solution will avoidtrade wars and prevent uncertainty that would adverselyimpact trade and investment"(OECD/G20 Base Erosion and Profit Shifting Project, October 2021)[7].

With the Two-Pillar Solution, all types of economies –developing, emerging or with a higher GDP – will benefitfrom extra tax revenues. Under Pillar One, taxing rightson more than USD 125 billion of profit are expected tobe reallocated to market jurisdictions each year. With respect to Pillar Two, the global minimum tax of 15%is estimated to generate around USD 150 billion inadditional global tax revenues annually. These extrarevenues will be particularly welcome, as governmentsneed to fund the COVID-19 recovery.

**Conclusion**

This agreement is historic in accepting for the first time the need to apply a formulaic method to apportion at least part of the total global profits of the MNEs concerned, complemented by proposals for a global anti-base-erosion tax. These elements point a way forward to further reforms that could be comprehensive and long-lasting.

However, as presently formulated Pillar One is only a stop-gap solution, creating a special tax regime for only around one hundred of the largest and most

[7]Two-pillar Solution to Address the Tax Challenges Arising from the Digitalization of the Economy, October 2021. https://www.oecd.org/tax/beps/brochure-two-pillar-solution-to-address-the-tax-challenges-arising-from-the-digitalisation-of-the-economy-october-2021.pdf

profitable MNEs, and allocating only a small share of their profits. The vast bulk of MNEs' profits would continue to be allocated under the current inappropriate and ineffective rules. While its initial limited scope may be necessary for political reasons, the aim should be to create a basis for a more comprehensive and long-term solution.

The global minimum tax proposed in Pillar Two could be transformational, but as currently designed would be unfair and ineffective for MNE host countries. The priority given to home countries in the GloBE, coupled with the low minimum rate of at least 15%, would not remove the incentive for MNEs to shift profits out of source countries which mostly have rates of 25% or higher.

Undoubtfully the losing side in this global tax reform will be the jurisdiction with no or low tax rates. Bulgaria is also an attractive tax destination with a corporate tax rate of 10 %, but the country has already been losing tax revenue due to profit transfers from MNEs operating in Bulgaria to "tax havens". And eventually if the global tax reform will be implemented, this could affect the Bulgarian economy in positive way and my increase the corporate tax revenue.

This global tax reform is a massive step forward, but should not remain the first step towards solving the most difficult problems arising from the globalization and digitalization of today's economy. This change is vital especially in this moment, because there is a demanding need of increasing public funding in order to fight the consequences of the pandemic, and last but not the least tomake progressin the ecological and digital transition.

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