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Digital economy and structural change

Taxing the digital economy

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Good reasons for scepticism

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Digital taxation is currently a subject of intense debate. While France, the UK, Italy, Austria and Spain have already decided to introduce a digital tax, the EU ministers of finance were unable to agree on an EU-wide system in March, which the European Commission (EC) had hoped to introduce in order to prevent looming competitive distortions and a fragmentation of the single market as Member States went their own way on this issue.

However, all approaches which are based on the taxation of revenues instead of profits have major flaws. If a company is not allowed to deduct its expenses from its revenues, there is a risk that the tax eats up corporate capital. Start-up companies with lower margins would suffer most from such a tax.

Since large digital companies are widely thought to pay inappropriately low taxes, policymakers remain under pressure to act. But the tax gap is often exaggerated and governments themselves have created tax breaks for digital companies.

Tax experts are calling for international collaboration on this issue. The OECD's/ G20's BEPS Project aims at an international solution. This initiative focuses on three major tax policy challenges caused by digital business models: 1. the global reach of business functions and activities, 2. opportunities for profit shifting due to importance of intangible assets such as licences and brands, 3. options for taxing the user contribution to digital value creation locally, i.e. in the country of destination, and not in the country where the company has its seat.

The second issue is being addressed by recent modifications in international tax law; the two others, however, require new approaches. So far, no consensus has been reached on any of the proposals on the table. For example, taxing user contributions to value creation raises tricky definition problems. What activities amount to value creation? Where does value creation really take place? How should the related profits be allocated to the different countries?

As digital services expand into ever new areas of the economy ('smart everything'), the risk of a far-reaching, arbitrary taxation of entrepreneurial activities is increasing. This might become a problem, not least for the German industry, which invests considerable sums into digitalisation.

Disruption, the buzzword of the digitalisation discussions, may become an issue in international tax policy, too. Some of the far-reaching new rules currently under discussion could undermine basic principles of the current corporate taxation system.

In addition to an (international) digital tax, minimum taxes are one of the concepts under discussion. Their supporters point to elements of minimum taxation included in the recent US tax reform. However, it is still uncertain which way the international community will choose, even though a consensus is to be reached by end-2020. A re-allocation of international tax revenues in favour of foreign markets might lead to Germany losing some of its share.

Digital taxes are highly popular in Europe

Fundamental principles for the taxation of multinational companies* 1

The current, fundamental rules for international taxation have been in place for about a hundred years. Put simply, they are as follows:

– Passive income from entrepreneurial activity, i.e. above all dividends and revenue from licence fees, will be taxed in the recipient's country of residence (residence-based taxation).

– Active income, i.e. profits, will be taxed in the country where the company is doing business and generating revenues (source-based taxation).

– In the case of multinational companies, active income may be subject to taxation in all countries where the company has a permanent establishment. A permanent establishment gives a country the right to levy taxes.

– The second, more complex aspect is the (national) tax base, i.e. the share of a company's overall profits which is allocated to a (specific) country where the multinational runs a permanent establishment.

– As a rule, this share shall reflect the economic activities and the value creation of the relevant permanent establishment. However, this is difficult to determine, as multinational companies tend to engage in large-scale internal transactions, such as the exchange of inputs, services or rights.

– The international allocation of the tax base follows a comprehensive set of rules, which is currently being reviewed at the international level (see p. 5 et seq.).

– In practice, rules for the transfer prices (see p. 6–7) which multinationals have to use for the evaluation of internal transactions play a key role. These rules actually primarily determine the allocation of the (potential) tax revenues to the different countries.

* See Devereux, Michael P. and John Vella (2017). Implications of Digitalization for International Corporate Tax Reform. In: International Monetary Fund (ed.) (2017). Digital Revolutions in Public Finance. p. 93

Digital taxes have been a subject of intense debate in Europe for some time now. Several governments, among them those of France, the UK, Italy, Spain and Austria, have already decided to introduce them. As a rule, they propose to tax certain revenues generated by large (foreign) digital companies doing business with citizens and/or companies from the relevant country at a rate of 2–3% (5% in the case of Austria). The European Commission (EC) cited the national concepts and the related risks for the single market in its call for a uniform digital tax at the EU level. However, the EU ministers of finance were unable to agree on a common concept on 12 March. A tax on (gross) digital revenues is therefore probably off the table. In any case, such a tax was meant as an interim solution until more sweeping rules were established at the European and/or international level (see below).

Failed Commission concept had significant flaws

The digital tax proposal by the EC was to address "the problem that the current corporate tax rules are inadequate for the digital economy". The Commission pointed out that, under international rules, any revenues generated in a given country may only be taxed in that country if the company runs a permanent establishment there (see box). In addition, the Commission wanted to give the Member States the right to tax profits based on national users' contribution to value creation.

The failed proposal for a Directive of March 2018 defines the following as relevant taxable revenues:[1]

— revenues from placing advertising on a digital interface (i.e. in particular from the sale of online advertising space);

— revenues from making available to users a multi-sided digital interface which allows users to find other users and to interact with them, and which may also facilitate the provision of underlying supplies of goods or services directly between users;

— revenues from the transmission of data collected about users and generated from users' activities on digital interfaces.

According to the proposal, only large companies with worldwide revenues of more than EUR 750 m per year and taxable revenues of more than EUR 50 m p.a. in the EU were to be subject to this tax. The tax rate in the Member States was to amount to 3%.

However, the digital services tax has been criticised right from the beginning.[2] Three weaknesses in particular came under fire. First, levying a tax on (gross) revenues instead of profits is problematic. Second, European attempts to introduce a digital tax may weigh on the trade relationship with the US. And third, a digital tax is, in fact, a first step towards a far-reaching revamp of the international tax system.

[1] European Commission (2018). Proposal for a Council Directive on the common system of a digital services tax on revenues resulting from the provision of certain digital services. Brussels. 21 March 2018.

[2] Fuest, Clemens et al. (2018). Die Besteuerung der Digitalwirtschaft. Zu den ökonomischen und fiskalischen Auswirkungen der EU-Digitalsteuer. Ifo study commissioned by the Chamber of Industry and Commerce for Munich and Upper Bavaria. Advisory Board to the Federal Ministry of Finance (2018). Response to the EU proposals for taxing the digital economy. For a recent assessment see Olbert, Marcel and Christoph Spengel (2019). Taxation in the Digital Economy – Recent Policy Developments and the Question of Value Creation. ZEW Discussion Paper. No. 19-010.

Quite rightly, taxing (gross) revenues (minus VAT) instead of profits is regarded as a questionable interim solution at best. After all, such a system decouples taxes from profits; companies may have to pay taxes in a given country even though they do not make any profits there. This problem becomes even more serious if companies cannot deduct these digital taxes from the tax debt in their home country, for example because they do not make any or only a small profit there. In that case, companies would have to draw upon their equity to pay the taxes. This is a risk for low-margin companies in particular. A digital tax may therefore be harmful to start-up companies during their initial expansion phase.

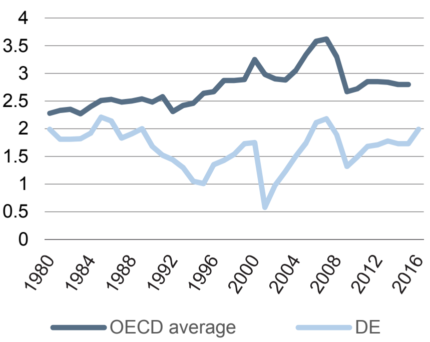
The EC has introduced high thresholds for taxation to reduce this risk. However, these thresholds lead to another problem: in its initial form, the proposed digital services tax appeared to be specifically directed at large US digital companies. Thus, the Commission's proposal might have been an additional hurdle for the upcoming EU/US negotiations on the cross-Atlantic trade relationship, which will be difficult anyway. The US ambassador's criticism of Austria's digital tax already points in this direction (FAZ.net, 9 April 2019).

Third, there are fundamental systematic concerns. The EC plans to tax end users' contributions to value creation of digital services at the place where the users reside (where their IP address is located). The resultant shift from the country-of-establishment principle to the country-of-destination principle is not only a major turning point for international tax law, but also harbours significant risks. Countries such as Germany, which rely heavily on exports and make major digitalisation efforts, might lose in two ways. Their companies might become less competitive as they may have to pay new taxes in their export markets (higher risk of double taxation), and their domestic corporate tax revenues might decline. As the proposed tax is solely targeted at digital business models it could create significant definition problems, given the digitalisation trend in the economy (see below, p. 11). Moreover, the redistribution effects of such a tax are uncertain. Platform or broker services providers might pass on (part of) this tax to the end user(s) and/or to sellers.

Taxation of the digital economy: A controversial issue

Taxes on corporate profits: Relatively steady revenues in the long run 2

% of GDP



Source: OECD

Nevertheless, many stakeholders in Germany are calling for a digital tax, too. Its supporters point to the gap between the rapid increase in digital revenues and comparatively low taxes on digital business activities. Of course, this discussion has its reasons. The tax burden on digital companies is often presented in a distorted way, and many commentators simply neglect the numerous question marks related to the taxation of revenues instead of profits.

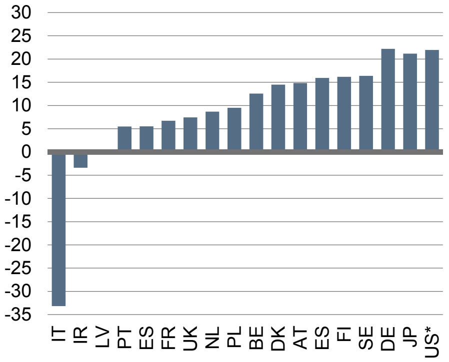
Supporters of a digital services tax are convinced that large, cross-border digital companies are not fairly taxed in numerous countries. The focus is on profits generated in countries where these firms serve numerous customers, but do not run a permanent establishment. In many countries, this applies above all to large Chinese and US digital companies. Under the current, international rules (see the box on p. 2), such profits are not subject to tax at all in the relevant countries. In addition, international digital companies are thought to have particularly good opportunities to shift profits to low-tax countries, including a number of EU Member States.

Several studies appear to support this view. The EC, for example, points out that the effective average tax rate for digital companies averages 9.5% in the EU, i.e. less than half the rate for traditional companies (23.2%; both rates for 2017).[3] While it is quite true that digital business models benefit from relatively

[3] European Commission – Fact Sheet (2018). Questions and Answers on a Fair and Efficient Tax System in the EU for the Digital Single Market.

Effective average tax rates for digital business models 3

2018, %

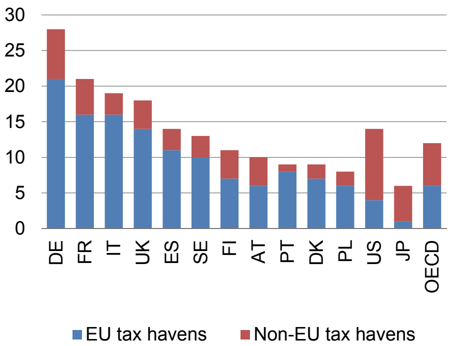


* California

Source: ZEW (Centre for European Economic Research), Mannheim and PWC (PricewaterhouseCoopers GmbH)

Calculated lost corporate tax revenue due to profit shifting 4

Tax losses in ... due to profit shifting to ..., in % of total corp. tax revenues, as of 2015



Source: Torslov, T.R. et al. (2018). The Missing Profits of Nations, NBER Working Paper, Online Appendix

low effective taxation in many countries (although not in Germany), this is to some extent due to government measures taken to promote innovation and investment in the digital economy, above all patent boxes. Patent boxes ensure a lower taxation of revenues from R&D activities and intangible assets such as licences and patents. In addition, traditional tangible assets play a relatively small role in the digital sector. Companies from traditional sectors have usually to write off expenses for such assets (machinery and equipment) over several years when they calculate their tax liabilities. In contrast, digital companies can deduct the expenses for the know-how of their employees (i.e. their most important asset) immediately in the form of wage payments.

Other observers point to studies which analyse the absolute amount of tax shifts. The OECD, for example, justified the BEPS Project by saying that tax shifts lead to a loss of 4–10% of total global corporate tax revenues. Based on figures from 2014 (the year in which the study was prepared), this is equivalent to USD 100–240 bn p.a. While a share of one-tenth is quite substantial, the large range of the estimate suggests that the calculations are subject to considerable uncertainties.[4] A study by the European Parliamentary Research Service released in autumn 2015 gives even higher figures.[5] It puts the equivalent tax losses in the EU at EUR 50–70 bn p.a. or 17–23% of the then corporate tax revenues.

According to a widely noticed, more recent study, multinationals around the world shift c. 40% of their aggregate profits (USD 1.7 tr in 2015) to low-tax countries.[6] This phenomenon is particularly evident in countries or regions where tax rates are relatively high in an international comparison. Due to such shifts, the EU loses almost 20% of its (theoretical) corporate tax intake. Within the EU, Germany, France and Italy are suffering most, with Germany losing 28% of its potential tax intake and France and Italy c. 20%, respectively. The US (c. 15%) are also among the major losers. However, in contrast to Germany, the US have recently (2017 tax reform) cut their corporate tax rate considerably and taken additional measures to prevent profit shifts (see p. 15).

To some extent, these high figures are due to the study's methodology. The authors use the same production function for the activities of local subsidiaries of foreign multinational companies and for those of domestic companies. This means that they assume productivity to be identical, provided that the ratio of labour and capital input is the same. However, economies of scale and (a likely) advantage in terms of know-how suggest that the respective foreign subsidiaries are more productive and tend to generate higher profits in low-tax countries. And above all, the authors assume that all movements of intangible assets to countries with below-average tax rates which do not go hand in hand with actual investments and/or the establishment of financing companies in these countries are tax-shift strategies.

To sum up, the differences between the taxation of traditional and digital business models are to some extent due to political support for the latter. Nevertheless, empirical studies confirm that large (foreign) companies (particularly from the digital sector) pay relatively low taxes in high-tax countries in the EU. The importance and urgency of the issue are, however, controversial.

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4 See also Hentze, Tobias (2019). The challenge of moving to a Common Consolidated Corporate Tax Base in the EU. German Economic Institute, Cologne, IW Report 2/19.
5 European Parliamentary Research Service (2015). Bringing transparency, coordination and convergence to corporate tax policies in the European Union. I - Assessment of the magnitude of aggressive corporate tax planning. Study for the European Added Value Unit.
6 Torslov, Thomas R. et al. (2018). The Missing Profits of Nations. NBER Working Paper 24701.

New opportunities for profit erosion and profit shifting?

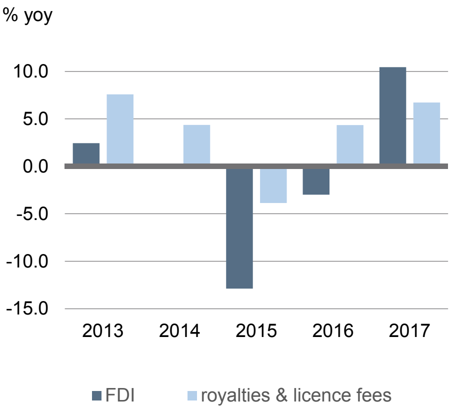
Institutions and groups which support a digital tax obviously see a need for action. However, any actual steps should be justified by more than just a hunch that tax revenues from the digital sector are inappropriately low. The OECD explains three relevant characteristics of digital business models:[7]

— Wide reach or importance without physical presence ("*scale without mass*"). Companies can use the internet and online platforms to create long-distance cross-border relationships with numerous customers and do business abroad without running a permanent establishment in other countries. Under current law, there is no nexus for a taxation of the profits they generate abroad.

— Considerable reliance on intangible assets, including intellectual property (IP). Brand names, the development and use of software (including algorithms which analyse large amounts of data generated by business on internet platforms) and creative (digital) content play a major role for the production or provision of services via the internet. As a result, modern, digital services can be provided at low variable costs. Expenses for royalties or licence fees have risen by an average of almost 5% p.a. during the past five years (2013–2017), whereas global goods trade and direct investment have increased by only just about 1% p.a. (Unctad World Investment Report 2018, p. 22).

— Participation of (end) customers or users in value creation and high value of data. Companies which use digital platforms to interact with their customers can analyse customer behaviour with the help of high-performance algorithms and use these data to increase their revenues, for example by re-selling the data and/or putting customer-specific advertisements on the platform (against a fee).

Strong growth in cross-border royalties & licence fees 5



Source: Unctad

While these features characterise digital business models, from the OECD's vantage point, they are obviously not limited to such businesses. Therefore, efforts to ring-fence such models or activities to establish a separate base for taxation would be problematic. Still, the supporters of a digital tax draw two conclusions from these ideas. First, they argue that digital business models make it particularly easy for multinationals to shift profits to countries with low tax rates. This behaviour has wider implications: If goods and services which were produced or provided domestically so far are now offered from abroad, a country will not only lose tax revenues, but remaining domestic providers will come under (additional) competitive pressure if the foreign country sets comparatively low tax rates. Second, many digital business models are supposed to be based in fundamentally new value creation processes, which are not taxed adequately (and, above all, not in the proper countries) under the current rules.

The international BEPS initiative for more fairness, coherence and transparency aims to secure national tax revenues

The international measures taken against profit shifting and base erosion within the framework of the BEPS (Base Erosion and Profit Shifting) initiative of the OECD and the G20 are based on these arguments, too. The initiative's main goals are to create a coherent international tax system, to improve transparency, to provide (more) certainty for businesses that do not take aggressive positions, and to secure (national) tax revenues. In general, it aims to tax profits in the country where they are generated. The international

[7] See OECD (2018). Tax Challenges Arising from Digitalisation – Interim Report 2018, p. 24 et seq.

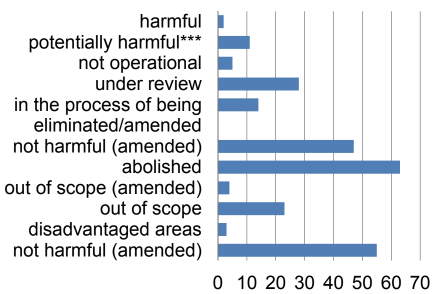
The 15 Actions of the BEPS Package* 6

1. Addressing the tax challenges of the digital economy
2. Neutralising the effects of hybrid mismatch arrangements
3. Designing effective controlled foreign company (CFC) rules
4. Limiting base erosion involving interest deductions and other financial payments
5. Countering harmful tax practices more effectively, taking into account transparency and substance
6. Preventing the granting of treaty benefits in inappropriate circumstances
7. Preventing the artificial avoidance of permanent establishment status
8. Aligning transfer pricing outcomes with value creation – intangibles
9. Aligning transfer pricing outcomes with value creation – risks and capital
10. Aligning transfer pricing outcomes with value creation – high-risk transactions
11. Measuring and monitoring BEPS
12. Mandatory disclosure rules
13. Transfer pricing documentation and country-by-country reporting
14. Making dispute resolution mechanisms more effective
15. Multilateral convention to implement tax treaty related measures to prevent BEPS

* Source: OECD

Result of the recent FHTP* review of preferential tax regimes 7

as of January 2019, absolute figures**



* Forum on Harmful Tax Practices, ** in total 255 regimes were reviewed, *** including those potentially, but not actually harmful

Source: OECD

community has agreed upon certain action recommendations along these lines in 2015. Since spring 2016, many countries and offshore centres (129 as of March 2019) have been working to implement these actions and collaborating in the “Inclusive Framework on BEPS”.

Each recommendation belongs to one of 15 Actions (see box). Action 1 focuses on the taxation of digital businesses with a particular emphasis on the features ‘scale without mass’ and user contributions. Actions 3 and 5 as well as Actions 7–10 deal with the issue of base erosion and profit shifting in a more narrow definition. Other Actions aim to improve the international cooperation of tax authorities and the transparency of (national) rules.

Action 3 addresses tax avoidance opportunities stemming from gaps in the international tax system. For digital companies, such opportunities arise mainly from shifting the ownership of intangibles and operative functions (such as running websites) to countries where such activities are not appropriately captured and monitored by the tax offices. The resultant company structures lead to inadequate taxation of the profits in both the users’ (end clients’) country of residence and the company’s home country. Action 3 aims to introduce effective controlled foreign company rules in order to make sure that such profits are taxed (at least) in the company’s home country. In fact, numerous countries have adopted rules that are (largely) in line with these standards, with the US (see p. 14) and the EU (in the form of a Directive) among them.

Action 5 focuses on preferential regimes for intellectual property (patent boxes). The BEPS initiative has defined minimum standards to ensure that tax deductions of expenses for the protection of intellectual property, such as licence fees, are in line with an adequate taxation of profits and that taxation occurs only in jurisdictions where “substantial activities” take place. In addition, any tax breaks for profits generated by the use of intellectual property must be proportionate to related expenses, for example for R&D, and the preferential treatment may be granted only in jurisdictions where such expenses are made. According to the OECD, the large majority of reviewed preferential regimes has been amended to reflect the new standards or abolished in the meantime. By the end of January, the Forum on Harmful Tax Practices (FHTP) classified only two regimes as harmful, and this categorisation applied only to grandfathering rules.

The recommendations of Action 7 aim to update the definition of “permanent establishment”. Together with other recommendations, they are intended to fortify the long-term core principle of international corporate taxation, which states that profits are to be taxed only in jurisdictions where a company has a (physical) presence (see above p. 2). The Action aims to restrict companies’ options for (artificially) avoiding the status of having a permanent establishment. For example, commissionaire structures for the sale of goods and services are to be classified as a permanent establishment (for example a permanent establishment run by an agent). This includes structures which are involved in selling advertising space on the platform of a multinational company to local companies. The international community successfully agreed upon the details in 2018, which may now be included in double taxation agreements. The BEPS Package has developed a simplified procedure for doing so.

Measures belonging to Actions 8, 9 and 10 foresee new or changed guidelines for transfer prices. For example, new standards for transfer prices for intangibles (Action 8) aim to restrict possibilities to shift profits to low-tax countries, for example by setting excessive (internal) fees to be paid to (licence) owners for the use of intangibles (licences, patents). Guidelines with similar aims apply to the shifting of risks and capital to other group companies (Action 9). This aims to restrict the practice of attaching high returns to transactions with foreign subsidiaries (permanent establishments) which do not, however, bear the related risks.

The new rules will introduce the arm's length principle ("ALP") for such transactions. Under the ALP, multinational and other affiliated companies need to align their transfer prices for cross-border internal transactions with market prices, at least for tax purposes. The transfer prices must be in line with prices for comparable transactions among independent actors on an external market. The OECD hopes that this principle will ensure that internal transfers (better) reflect value creation (especially in relation to intangibles, too) in the relevant permanent establishments.

Measures pursuant to Actions 11–13 (standards for relevant data, documentation and transparency) are to ensure that companies provide their transfer prices and other relevant information, such as data on (local) profits and tax payments, to the involved tax authorities. (To comply with the standards defined in Action 13 (country-by-country reporting) about 80 countries have passed respective regulations.)

Significant progress with the implementation of the BEPS Package

The international community has set different priorities and procedures for the implementation of the individual Actions (see box). Still, the BEPS Package consists only of recommendations – and while the participating countries have made political commitments, the international community cannot sanction countries which do not meet their obligations at all, which drag their feet or which are not involved in the initiative at all. Nevertheless, the number of participants is large and goes far beyond the OECD/G20 members. This creates major political pressure and, above all, legitimacy.

According to recent OECD reports, the international community has successfully implemented key parts of the BEPS Package. The participants have made substantial progress on important issues on the way towards creating a level playing field in terms of framework conditions for international taxation. Numerous countries, among them the EU and Germany, have amended their (tax) legislation in line with the recommendations, including on issues such as preferential regimes for intellectual property, which play a significant role for the digital economy. According to the OECD, several companies have already responded and adjusted their transfer prices or shifted intangibles back to their home countries.[8] This should have limited multinationals' options in terms of shifting or eroding profits. At the same time, supplementary measures have been taken, for example by the US (see below on p. 14). This shows that, for a number of countries, the measures are still not sufficient or appropriate, though.

At the same time, the BEPS Package has its disadvantages, too. Numerous new rules make the tax law even more complex and cumbersome. The transparency guidelines alone are detailed on no less than 600 pages, and compliance with them is quite expensive for many companies, which may require expert help to ensure that they meet all obligations. Similarly, the documentation and disclosure obligations under the transparency rules entail significant costs for the companies. In addition, the Centre for European Economic Research (ZEW) at Mannheim questions the measures since corporate tax planning usually aims at exploiting differences between tax rates and/or the taxation of individual activities, such as the use of intangible assets (patent boxes).[9]

Implementation principles for the BEPS Actions 8

The involved stakeholders have identified four out of the 15 Actions as priorities with (quasi) obligatory minimum standards, as those countries which comply with and implement them would suffer if others did not. The stakeholders therefore agreed on minimum standards for four Actions (nos. 5, 6, 13 and 14) which can be implemented quickly. The Inclusive Framework Group monitors the implementation with the help of peer review procedures.

The OECD recommends the implementation of six other Actions (nos. 2, 4, 7, 8, 9 and 10) in order to achieve more transparency and a level playing field in the area of taxation. It uses monitoring procedures to review the implementation. In addition, these Actions include measures which may be regarded as "best practice" (Actions 3 and 12). While the Actions 7 and 8–10 touch upon bilateral or international law, the participating countries can implement the remainder of the recommended measures (Actions 2 and 4) by unilateral amendments to their national legislation.

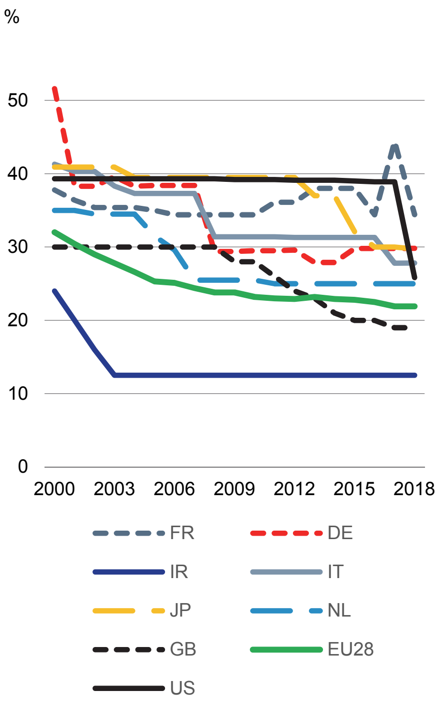
The BEPS Package also includes operative measures to supplement the tax law recommendations. In June 2017, 77 countries signed the Multilateral Convention to Implement Tax Treaty Related Measures to Prevent Base Erosion and Profit Shifting (Action 15). The Multilateral instrument (MLI) entered into force on 1 July 2018. It serves as a platform for the implementation of BEPS-related measures and enables the participating countries to directly include BEPS measures and (tax) law amendments in double taxation agreements. This removes the need of further, time-consuming bilateral negotiations. The focus is on the obligatory measures.

8 See OECD (2019). Addressing the Tax Challenge of the Digitalisation of the Economy – Public Consolidation Document, p. 6 et seq.
9 Evers, M. Th. et al. (2016). Country-by-Country Reporting: Tension between Transparency and Tax Planning. Discussion Paper No. 17-008. Centre for European Economic Research.

Harmonised tax rules and increased transparency intensify international tax competition

The BEPS Package has directed the attention at additional weaknesses of the existing international taxation system.[10] Even experts involved in the project believe that international tax competition is likely to have intensified.

Declining corporate tax rates 9



Source: OECD

One sign of this tax competition is that corporate tax rates continue to decline. If national governments have less scope to set rules for determining the tax base, tax rates (which are not the subject of harmonisation efforts) will become more important in the global competition for investment and innovation, particularly as the harmonisation efforts make national tax rules more transparent, too. In any case, incentive effects suggest that companies tend to shift investments if they have fewer opportunities to shift book profits. The trend towards lower corporate tax rates is therefore likely to continue. In fact, the International Monetary Fund is already criticising the lack of measures against tax competition, which, according to the IMF, is above all to the detriment of developing countries.[11]

These aspects ultimately raise the question of the advantages and disadvantages of international tax competition. We will only touch upon either briefly here. One of the advantages is that tax competition may have a disciplining effect on national fiscal policies: governments are required to efficiently provide public goods and create a favourable environment for entrepreneurial activities. The disadvantages, particularly in emerging markets and developing countries, are that governments may not have sufficient funds at their disposal for an adequate supply of such goods, for example educational institutions. Moreover, there is the tricky issue of the potential uptrend in tax burdens on less mobile factors, including SMEs which are only doing business in their home regions. As a result, tax competition is likely to come increasingly into the focus of the international community.

Digitalisation has compounded these problems. In addition, the recommendations adopted in 2015 are directed only at some of these new challenges. In fact, the current debate shows just how controversial the existing rules are. It seems that the discussion about potential solutions has only just begun.

Two difficult issues remain

Two key challenges for the digital economy remain:

— First, despite the new rules outlined above, multinational companies with highly digital business models still have opportunities to shift profits (from the market or their home country) into low-tax countries, in particular by transferring intangible assets (connected with specific entrepreneurial activities which establish a certain level of physical activity in the low-tax jurisdiction, e.g. functions like risk management, financing or sales planning, or functions relating to the development, enhancement, maintenance, protection and use of intangibles). With regard to these company-specific services, the arm’s length principle is meeting its limits, as it is very difficult to determine suitable (external) market prices for such activities. Therefore, regardless of international efforts to ensure a “fairer” tax allocation, companies may still create or maintain permanent establishments which actually conduct sweeping and successful business activities, but generate

[10] Schreiber, Ulrich et al. (2018). Nach der US-Steuerreform 2018: Unternehmensbesteuerung in Deutschland im Steuerwettbewerb. Arbeitspapiere Universität Mannheim. Fakultät für Betriebswirtschaftslehre.

[11] International Monetary Fund (2019). IMF Policy Paper. Corporate Taxation in the Global Economy. March 2019.

only low taxable income in that country, since profits are shifted to low-tax countries where only limited activities are located.

— Second, there is the core issue of the (international) allocation of taxation rights on digital business models. (The BEPS initiative's Action 1 Report refers to these issues as the "broader direct tax challenges.") Given the peculiarities mentioned above, in particular the lack of physical presence (scale without mass) and the (suspected) contributions of users to value creation, the existing rules often do not provide a nexus for taxation, albeit it is deemed necessary. That is why many protagonists call for new rules.

Digitalisation: A special part of the BEPS Package with considerable disruptive potential

These issues are what Action 1 (Digital Economy) of the BEPS initiative is about. The international community has established the Task Force on the Digital Economy (TFDE), a sub-committee of the Inclusive Framework on BEPS, in order to find solutions to these problems. The committees presented an interim report in spring 2018.[12] The final report, including proposals for a solution and recommendations for action, is to be prepared by next year. The TFDE has provided a detailed analysis and outlined potential solutions in its interim report and another, recently released report. However, it is not clear yet whether and when the stakeholders involved will arrive at the necessary consensus.

The current TFDE discussions focus on developing new rules to (better) capture digital business models. The primary aim is to give governments (new) rights to tax "locally" generated profits of multinational companies which rely on digital business models, i.e. to tackle the "nexus issue" and to provide concomitant rules on profit allocation. The TFDE has bundled the remaining challenges of digitalisation (the "unresolved BEPS issues", i.e, those outlined at the bottom of p. 8) in a second field.

All in all, the key question is whether the current international system of corporate taxation is still suitable for the digital age. And this question becomes all the more urgent as the solutions for capturing digital business models are quite controversial. If the current rules, including potential modifications, prove to be unfit for the future, disruption (the core term of the digitalisation debate) may take place in international tax policy, too. Some of the far-reaching new rules currently being discussed are certainly disruptive enough to revolutionise the current corporate tax system.

Modification proposals for existing rules

The working group has presented three proposals for the main field, i.e. the capturing of digital business models (the "broader tax challenges"). In principle, all three of them foresee a (partial) shift in taxation rights to the sales markets (market countries). However, no details have been thrashed out yet. In fact, the OECD plans to determine the specific features in cooperation with the participating countries and other stakeholders and started a consultation process on this issue some time ago (see footnote on p. 11). According to the OECD (as already mentioned), the goal is not to make tax rules for an isolated part of the economy (which could not be ring-fenced consistently). As digitalisation spreads, it is necessary to develop sweeping rules which can, in principle, apply to all digital business models – including companies whose core business is not in the digital economy.

[12] See OECD (2018). Tax Challenges Arising from Digitalisation – Interim Report 2018.

We will only outline the proposals in this study. They are based on the following basic ideas and core elements:[13]

i. Active user contribution. Instead of physical presence, "active user participation" is to serve as the basis for a right of taxation. The users' country of residence is to be given a right of taxation, regardless of whether the company maintains a permanent establishment in that country or not. This proposal targets highly digitalised business models, such as social media platforms, search engines or online marketplaces, which generate (valuable) data from user interaction. Values created on the basis of these user data, for example by analysing them and/or selling them to third parties (e.g. for advertising purposes), shall serve as a nexus for taxation.

ii. Marketing intangibles. The nexus for taxation is value creation on the basis of assets which are directed at the relevant market, such as brands and trade names, customer lists and client data or image campaigns. The concept assumes that brands and campaigns become valuable because of customers' appreciation in the relevant country. In the case of user data, the link to national value creation is more evident. According to the OECD, one advantage of this approach is its wider scope, which goes beyond purely digital business models (on which the first proposal focuses) and also covers situations in which user contributions are not immediately obvious. It addresses both the 'scale without mass' problem and the growing importance of intangible assets.

iii. Significant economic presence. A significant economic presence is thought to exist if there are factors indicating that a company regularly interacts with a country via digital technology and other automated means. A major relevant factor is the regular generation of revenues or profits from doing so. In order to establish a nexus for taxation, additional criteria need to be met beyond, such as the existence of a (local) user base and – consequently – a certain volume of data flows, billing in local currency, a website in the local language, responsibility for final (goods) deliveries to customers and/or after-sales services and sustained marketing and sales promotion activities. The criteria are therefore based on both sales and value creation. However, more detailed definitions of transactions and thresholds have not been provided yet. This proposal aims to create a transparent, easy to handle procedure, which is suitable for developing countries in particular.

The first two approaches in particular are to apply only to those non-routine profits which are not (separately) captured by the existing provisions. In addition to new principles for allocating taxation rights, the proposals also include mechanisms for the international allocation of the tax base, i.e. the taxable non-routine profits (see box). This is obviously necessary because many digital business models are used in many countries at once. Nevertheless, the proposals become even more complex as a result. Above all, the different countries may argue about the allocation, as it will certainly lead to winners and losers. The business community has therefore called for clear rules and arbitration mechanisms in order to prevent companies suffering from such disputes.[14]

For the 'significant economic presence' model methods based on a fractional (formulary) appointment are discussed for the allocation of the tax base. This base could be determined, e.g., by a simple calculation, i.e. a multiplication of the revenues in the relevant country with the global profit rate of the given company. The final allocation of the tax base might then be refined with the help of an additional metric (an allocation key) which takes into account revenues, assets and employees. Since under present rules multinationals determine their

Potential approaches for allocating the tax base to the participating countries 10

The OECD proposes a tiered procedure regarding the taxation of user contributions.

– First, it is necessary to determine the non-routine profit, i.e. the residual (difference) between total profits and profits from routine activities, which are determined by current rules.

– Second, it is necessary to determine which share of these profits was created by user contributions. This can be done on the basis of user numbers, or simply on the basis of a pre-agreed percentage.

– Third, this share of the profits is allocated to the individual countries on the basis of an agreed allocation key, for example revenues.

The OECD proposes two methods for allocating profits from the use of marketing intangibles.

– The first is a relatively direct approach, which is based on the existing rules, as profits from the use of marketing intangibles can, in principle, be determined by transfer prices. In that case, the relevant intangibles need to be determined first. Then, their contribution to profits has to be determined on the basis of two assumptions: 1) that current rules continue to apply; 2) that marketing intangibles are allocated to the market jurisdiction. Based on the difference between the two amounts, taxable profits will then be allocated to the market jurisdiction.

– As a second option, the OECD proposes a tiered procedure similar to that for user contribution. The non-routine profit would reflect profits derived from the use of marketing intangibles. The share of profits to be allocated to different countries might be determined on the basis of expenses (for the creation and maintenance of these assets) or on the basis of a fixed percentage.

[13] See OECD (2019). Addressing the Tax Challenge of the Digitalisation of the Economy, op. cit.
[14] BDI (Federation of German Industries e.V., ed.) (2019). OECD Consultation "Addressing the Challenges of the Digitalization of the Economy". Position paper.

(taxable) profits separately in each country where they run a permanent establishment, this proposal might form the basis for a far-reaching amendment (and not just minor modifications) of international tax legislation (see p. 12).

Major points of criticism about OECD proposals

While the OECD regards its proposals as a basis for discussion, the involved countries and other stakeholders are still arguing about whether digitalisation requires new rules at all. Many stakeholders do not think so. They believe that the numerous other measures of the BEPS Package are sufficient to reach the goals, in particular a fair allocation of the tax base. To some extent, this reflects considerable reluctance about the proposals, which was expressed, for example, during a public consultation hearing organised by the OECD in mid-March in Paris.[15]

Overall, the OECD wants to make sure that taxation takes place in the jurisdiction where value creation occurs. The individual proposals provide different concepts for the taxation of value creation, which cannot be captured by traditional approaches. However, there are some problems with these approaches, particularly with the concept of putting a tax on user contributions. This was the proposal which met with the loudest criticism at the Paris conference, above all from business representatives.

The goal of establishing new taxation rules for internet-based social media, search engines and online marketplaces runs counter to the OECD's often repeated intention of not allowing isolated solutions for the 'digital economy'. However, the OECD's intention is quite justified. A taxation approach which only applies to a small number of business models would lead to competitive distortions and definition problems. Which user activities make which contributions to the profits of digital entrepreneurial activity? Is it necessary that users become active, for example by evaluating goods or services, or is the (passive) use of a portal, which may nevertheless yield data, sufficient? Which expenses may the multinational company offset against its revenues?

These problems will become more significant as more and more products become part of the digital network. In fact, operative digitalisation along the value chain is increasingly becoming an elementary entrepreneurial strategy in the industry. In Germany, this phenomenon is called "industry 4.0". Online communication and interaction with end users is gaining importance. An analysis of the resultant data may provide companies with valuable insights for their marketing procedures or the improvement of their after-sales services and their products as such. Moreover, data from export customers may be gained and analysed abroad.

The Federation of German Industries points out that car producers already use such strategies: data on the use of sold vehicles help them to determine which and how many replacement parts may be needed in a given market. This information may be included in related delivery agreements between producers and local service providers. While it is unclear to what extent such agreements would be subject to taxation under the BEPS approach, the related definition questions will certainly gain importance as digitalisation progresses.

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[15] Numerous government representatives, academics and business representatives attended the international conference. Please see the OECD website for videos of the conference and related documents: https://www.oecd.org/tax/beps/public-consultation-tax-challenges-of-digitalisation-13-14-march-2019.htm. The following paragraphs are based on: The BEPS Monitoring Group (2019). Submission to the Inclusive Framework Public Consultation on Addressing the Tax Challenges of the Digitalisation of the Economy. The Paris event was not the first of its kind. Rather, the BEPS initiative and in particular the work concerning Action 1 are characterised by efforts to ensure a significant involvement of the stakeholders.

Proposal of the European Commission concerning the corporate taxation of a 'significant digital presence' 11

The European Commission has developed its own definition of a 'significant digital presence', which is similar to the TFDE's proposal. The Commission presented a proposal for a Directive* in March 2018, jointly with the proposal for a digital services tax (see p. 2). The digital permanent establishment is intended to reflect the 'digital footprint' of a company in a tax jurisdiction, cover different types of business models and exclude minor cases.

According to the proposal, a digital permanent establishment is assumed to exist if a company automatically provides services to the users via the internet or via an electronic network and if these services meet one of the following criteria:

– revenues in a tax jurisdiction (Member State) exceed EUR 7 m p.a.

– the number of users in a Member State exceeds 100,000 in a year,

– more than 3,000 contracts for the services are concluded each year.

The allocation of the (taxable) revenues to the digital permanent establishment is not yet determined in detail. However, it is to follow international standards (authorised OECD approach, AOA) as far as possible. For this purpose, the functions of the permanent establishment are analysed and key staff functions, assets (inputs) and risks are allocated to it. During this process, significant activities are taken into account, for example services which the fictitious permanent establishment provides via a website. These activities include, among others, contributions to the development, extension, maintenance, protection and use of company intangibles. Any business transactions between the (fictitious) permanent establishment and other parts of the company shall be assessed according to the arm's length principle.

If this procedure cannot be used, the tax revenues could be allocated based on a fractional appointment method, i.e. in line with a key, which takes into account research, development and marketing expenditure, the number of users and the data collected in the relevant Member State.

* European Commission (2018). Proposal for a Council Directive laying down rules relating to the corporate taxation of a significant digital presence. Brussels, 21 March, 2018.

In addition, there are systematic problems. Does the concept of "user contributions to value creation" make sense at all? In fact, users' contributions to value creation might be regarded as input, for which the users are remunerated by the free provision of digital services. The value of this input might be captured by transfer prices. However, the TFDE rejects this view. It ultimately implies that users would need to pay (income) tax for using digital services. For this simple reason, such a concept is unrealistic from a political vantage point – never mention the related administrative problems.

The broader, marketing-related approach avoids some of the definition problems, as it aims at the taxation of numerous business models, not only highly digitalised businesses. However, it leads to other basic definition and valuation problems, as patents and the related value creation (patent or licence fees) are to be taxed pursuant to the traditional method (by transfer prices). The OECD argues that these contributions to value creation and profits are less prone to shifts, as they are usually linked to a physical presence in the relevant countries. Still, the value of marketing activities seems, to some extent, to be dependent on the (technical) value of the products. And, above all, user data can be exploited not only for better marketing, but also for innovations concerning the design and quality of the relevant product.

Generally speaking, well-known experts and institutions such as the International Monetary Fund believe that the OECD's approach of "taxing profits wherever value creation takes place" is questionable.[16] They point out that entrepreneurial value creation is a highly complex endeavour in multinational companies.[17] While many departments and factors, including financing, R&D, management and marketing, contribute to it, it is impossible to determine their individual contributions or to attribute them to a specific location if a company's activities are spread across different countries. If, however, taxation rights were allocated to a specific location, the factors listed above might be misallocated.

If one of two first proposals is implemented, international tax law will become even more complex. This would make life considerably more difficult for national tax offices, particularly in emerging markets and developing countries, and for companies. The business community is afraid of rising administrative costs if more countries get the right to levy taxes on entrepreneurial value creation.

Some experts believe that supplementing the definition of permanent establishment by a 'significant economic presence' is the best way to go about the further development of international tax law.[18] This approach covers all relevant aspects, namely value creation and sales, for profit generation. However, the proposal is still in a very early stage, and it is uncertain whether and how the relevant working group (the TFDE) will continue to refine it. While pessimists fear that the international tax landscape might be fragmented even further and become excessively difficult to navigate, as major definition problems for individual business models might arise (after all, a homepage in a given language might already serve as a nexus for national taxation), the model's supporters regard it as a first step towards creating a uniform international corporate taxation base. Still, this goal is still very far away.

The European Commission has presented a concept for a more narrowly defined 'significant digital presence', which is limited to digital business models (see box). However, the Commission's proposal has been subject to the same points of criticism as the OECD's. In fact, the criticism is even more justified in some instances, as the EC's proposal focuses on regional measures for the EU.

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[16] International Monetary Fund (2019). Op. cit, p. 18 et seq. Devereux, Michael P. and John Vella (2017). Implications of Digitalization for International Corporate Tax Reform. In: International Monetary Fund (ed.) (2017). Digital Revolutions in Public Finance. P. 91 et seq.

[17] Devereux, Michael P. and John Vella (2017). Op cit., p. 97.

[18] The BEPS Monitoring Group (2019). Op. cit, p. 12.

A corporate tax revolution instead of a reform?

Several supporters of the new approaches want to revamp the current international corporate taxation system as a whole.[19] They believe that it does not make sense to artificially split multinationals into (fictitious) permanent establishments, determine the value creation of each establishment and use that figure as a basis for taxation. Rather, they think, multinationals should be treated as a unit, particularly since their shareholders ultimately bear the entrepreneurial risk. For this reason, it seems illogical to allocate these risks (or some of these risks) to individual permanent establishments. Overall, the idea of independent permanent establishments leads to major theoretical and practical problems.

From the critics' vantage point, these problems are particularly evident with regard to the arms' length principle and to transfer prices.[20] As explained above, transfer prices are often difficult to determine and controversial. This entails high costs for both companies and tax administrations. And the critics go farther. They believe that internal transactions cannot be compared to market transactions, as companies usually have good entrepreneurial reasons for not making the relevant transactions on the market (i.e. not outsourcing the activities). That is why the critics are calling for a new system which does not rely on the complex, expensive transfer price system any more.

Digitalisation has made the weaknesses of the current system even more obvious, as it has become even more difficult to determine transfer prices for activities related to the processing of large data sets, for example.[21] In addition, cross-border business and/or profit shifting have become easier for companies.

As an alternative, the critics propose a uniform approach for the taxation of multinational companies. They suggest that total profit should be determined in the company's country of domicile with the help of a uniform corporate tax base. The resultant tax revenue is then to be allocated to all jurisdictions where the company does business in line with pre-set quotas.[22]

Allocation keys which reflect revenue-generating economic activities should be based on three factors, namely

— Labour, i.e. the number of a company's local employees

— Capital, i.e. the existing assets

— Sales in the relevant jurisdiction.

Depending on the degree of digitalisation, the factors may be weighted differently to develop specific allocation keys for individual industries.

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[19] Devereux, Michael P. and John Vella (2017). Op. cit.

[20] There is a second set of problems, with which we will not deal in more detail here, namely the relationship between corporate financing and taxation. This refers to the definitions of borrowed capital and equity, for example. The critics claim that one and the same financing instrument may be treated differently in different jurisdictions and that this may result in double taxation or double non-taxation. In addition, companies may select certain financing instruments or establish financing companies in order to reduce and/or shift profits. From the critics' vantage point, the BEPS efforts to restrict such options are quite difficult and time-consuming and do not lead to the desired result.

[21] Marcel Olbert and Christoph Sprengel (2019) take a different stance. Op. cit. They believe that entrepreneurial activities related to data mining, such as the collection, analysis and interpretation of data, may be captured by transfer prices, as companies may choose to outsource such activities. Consequently, these two authors call for a (careful) further development of the current system and not for fundamental restructuring.

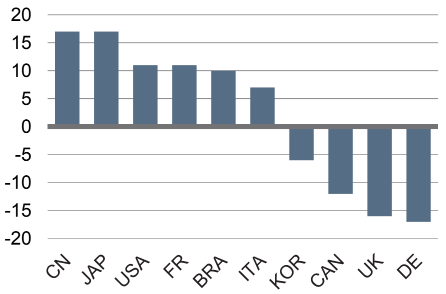
[22] Other proposals, such as the Destination Based Cash Flow Tax, are outside the scope of this study.

This proposal is largely in line with the European Commission's efforts to create a Common Consolidated Corporate Tax Base (CCCTB) in the EU.[23] The CCCTB will enable companies with permanent establishments in several Member States to deal with their (EU) tax matters in one single Member State on the basis of a uniform, EU-wide set of rules. Depending on the allocation key, this will remove incentives to shift profits by transferring intangibles within the EU. However, incentives to shift investments to Member States with low tax rates will remain in place.

A comparable project at the global level would be desirable, as a larger number of participating jurisdictions will lead to considerably bigger advantages. However, the international community would evidently need to agree on the details of the tax base and, in particular, the allocation key. These are highly sensitive issues with far-reaching effects on the global allocation of tax revenues. We therefore doubt that the international community can reach agreement on such a concept in the foreseeable future.

Winners & losers of a corporate tax reform in the G20 12

Percentage of the relevant national tax base*, %



* selected countries, assumption that the reform follows the EU Commission's plans for a Common Consolidated Tax Base (CCCTB)

Source: German Economic Institute (IW)

Germany may lose in case of fundamental reforms

Calculations by the German Economic Institute show just how much the international distribution of tax revenues may change if a new system is introduced.[24] Germany in particular would lose a significant share (17%) of the (hypothetical) corporate tax base if the tax base was redistributed within the G20 in line with the EC's proposals. This is largely due to the fact that profits of large export-oriented companies might be taxed abroad to a much larger extent than so far if exports (via sales) are a factor in the tax base allocation.

Minimum tax(es) to supplement the international tax system

A global common tax base is probably a project for the far future, particularly since the allocation of the tax base is a highly sensitive issue. There is also another problem, namely intensified international tax competition, which many stakeholders regard as increasingly urgent. That is why the OECD and the TFDE have proposed supplementary measures. Apart from a digital tax (pursuant to uniform international rules), minimum tax concepts have got considerable attention. The German and the French governments in particular support such measures, and the US seem open to the idea, too. The intention of these concepts is to make sure that the tax burden on corporate profits does not fall below a certain (politically defined) level.[25]

There are two variants of a minimum tax, which may coexist. The first variant (the income inclusion rule) will give a company's residence country a better grip on revenues generated abroad, whereas the second relies on measures to counteract the shifting of profits abroad in order to reduce the tax burden (i.e. it aims at higher taxation in the country where the revenues are generated, the market country). Several countries, among them the US, have already introduced taxes to this effect. Therefore, all efforts to establish common international standards also aim to prevent a jungle of different rules. This applies to discussions about global rules for a (purely sales-based) digital tax, too.

The first, outward-looking variant of the minimum tax is actually a kind of an expanded, independent approach in the framework of controlled foreign

[23] See Bräuninger, Dieter (2018). German corporate taxes: Growing need for action. Deutsche Bank Research. Germany Monitor.
[24] Hentze, Tobias (2019). The challenge of moving to a Common Consolidated Tax Base ... Op. cit.
[25] Becker, Johannes and Joachim Englisch (2019). The German Proposal for an Effective Minimum Tax on MNE Profits. In the internet: https://www.taxjustice.net/2019/01/15/the-german-proposal-for-an-effective-minimum-tax-on-multinationals-profits/

The Global Intangible Low-Taxed Income rule (GILTI) in the US* 13

The new rule aims to counteract the shifting of intangibles abroad by introducing a (partial) US tax on any profits of foreign subsidiaries of US companies which exceed a pre-set minimum return. GILTI does not target specific (digital) business models, but is levied regardless of the actual business activities of the foreign subsidiaries.

The tax is based on the total revenues of the subsidiary/the subsidiaries (regardless of whether these revenues were generated via intangibles) minus routine profits. For calculation purposes, routine profits are assumed to amount to 10% of the subsidiary's/subsidiaries' tangible corporate assets (Qualified Business Asset Investment, QBAI) – excluding receivables and inventories – minus interest payments. This deduction ensures that companies cannot increase their routine profits by a leveraged purchase of tangibles and thus reduce the tax base.

50% of the calculated tax base are subject to US tax and taxed at the corporate tax rate of 21%. Up to 80% of taxes paid abroad may be deducted from the tax debt. Ultimately, the minimum tax is levied only if foreign taxes on profits (or, in the case of several subsidiaries, the weighted median of these taxes) amount to less than 13.125%.

Base Erosion and Anti-Abuse Tax (BEAT)* 14

BEAT is to prevent companies which do business in the US from reducing their profits by making payments to parent (or affiliated) companies abroad. To this purpose, such payments are included in the corporate tax base and taxed if, pursuant to specific rules, they reduce the company's profits (such payments are labelled Base Erosion Payments, BEPs). The tax rate on potential value creation in the US is currently 10%.

In simplified terms, the BEAT-modified corporate tax burden is calculated as follows: Any corporate tax-deductible payments to parent or affiliated companies are re-added to the tax base, except for payments for goods purchases, certain services and, under certain circumstances, interest service payments. This extended tax base is subject to a tax rate of 10%. If the calculated amount exceeds the corporate tax debt pursuant to the normal tax rate (21%) before the re-added payments, the company has to pay the amount calculated under the BEAT rules. If it does not, the tax debt will remain unchanged.

BEAT only applies to multinationals with a three-year average sales volume of at least USD 500 m p.a. and their subsidiaries (criterion: stake of at least 25%), provided that payments to affiliated companies amount to at least 3% of total corporate expenses.

* See Becker, Johannes and Joachim Englisch (2018). BEAT the GILTI – Gewinner und Verlierer der außensteuerlichen Sonderregime der US-Steuer-reform. In: ifo-Schnelldienst 4/2018, p. 9 et seq.

company rules (CFC rules). The tax is levied on profits generated by foreign permanent establishments of domestic companies which are not taxed abroad or only subject to marginal taxes. Tax payments abroad may usually be offset against the tax debt. Without such a tax (an appropriate income inclusion rule), domestic tax authorities can only levy taxes on reflows of passive income (such as dividend payments) of foreign subsidiaries. Overall, this variant may therefore increase the tax revenues of the company's home country. It does not, however, prevent subsidiaries of foreign companies from shifting their profits abroad.

Action 3 of the BEPS Package focuses on CFC rules (see p. 6), but does not provide minimum standards. Some kind of CFC rules have been part of German tax law for a long time now. At the EU level, the Anti-Tax Avoidance Directive I provides minimum standards (in line with the BEPS recommendations); German law is currently being amended accordingly.

An international set of rules would be a major step forward and counteract the trend towards a patchwork of national rules. Isolated national frameworks do not only increase the administrative burden for companies, which need to comply with them, but may also hamper useful investment abroad, particularly if the rules appear excessive. This is a point of criticism about the German rules, which are regarded as restrictive and to some extent obsolete.

However, income inclusion rules (outward-looking minimum taxes) such as GILTI ('Global Intangible Low-Taxed Income') in the US (see box) are highly complex concepts. It is therefore a challenge to establish a common framework at the international level. The involved parties would have to reach consensus on numerous complex details and controversial issues. Which types of foreign revenues and profit from which types of economic activities are to be subject to taxation? How and to what extent will foreign taxes be deductible?

The second minimum tax variant (higher taxation in the country where profits are generated) aims to reduce any incentives to shift profits abroad by making payments to foreign subsidiaries (above all interest and licence fees). To this purpose, a cap on the tax deductibility of such payments may be introduced and/or a source tax on such payments may be levied. (In return, domestic creditors and licence holders might be refunded all source taxes paid by their foreign borrowers and licensees. This would prevent double taxation.) The Base Erosion and Anti-Abuse Tax (BEAT) adopted in the US at the end of 2017 is based on the first approach (see box). The Act's list of payments and expenditure is quite extensive and includes, for example, certain interest payments and license fees, overhead expenses, payments for certain services and write-downs on newly acquired assets.

This illustrates one of the problems of a minimum tax based on domestic activities. It is difficult to draw up a list of the corporate expenses which are taken into account and will necessarily be arbitrary to some extent.

Overall, minimum taxes are indeed an effective tool to counteract inappropriate incentives for profit shifting. However, they are complex and difficult to handle for both companies and tax offices. The trend towards such approaches at the national level is a good argument to intensify coordination efforts at the international level. Moreover, national minimum taxes might result in a problematic double taxation of profits – and this is certainly an even more convincing argument for uniform rules and a coordinated international procedure. However, any potential recommendations for a minimum tax are 'soft law', just like all other BEPS measures. Individual governments cannot be obliged to implement them. While the international community can put some pressure on its members, it might cause problems if the German government or the EU acted quickly and took measures which might be to the disadvantage of Germany as a corporate location.

Conclusion

The trend towards digitalisation has increased the urgency of efforts to remedy the weaknesses of the current international corporate tax system. The international community is working on solutions which are to be presented by (end-)2020. Two main options are being discussed. The first consists of modifications and supplements to the existing rules. While this is the most promising way towards achieving progress, it has its price. The implementation of additional BEPS measures will make international tax law even more complex. It might become more contradictory and even less transparent, particularly if new, revenues-based taxation rights and related profit allocation mechanisms were created. Administrative costs for companies and tax offices would rise. In addition, the risk of a double taxation of entrepreneurial activity is increasing, particularly if the planned or discussed solutions are not introduced in all countries around the world. The parties involved should pay particular attention to these problems during their search for a consensus.

The second, more revolutionary alternative is to introduce a new set of international corporate tax rules. Proposals to this effect include the creation of a global corporate tax base and an allocation of the tax revenues according to certain metrics, which take into account local employment, capital use and sales. Such a system would be highly transparent, consistent, neutral (concerning the regional distribution of intangibles) and efficient, particularly with regard to administrative costs. However, it would lead to a major redistribution of aggregate global corporate tax revenues towards the sales markets. It is therefore relatively improbable that the international community will agree on such a sweeping revamp of the system.

An agreement on some type of minimum tax seems more likely. The German government appears to be backing the right horse in this context. However, it will take some time for the international community to agree on new rules, and even more to implement them. Moreover, even consensus-based minimum tax rules will probably have only a limited effect on international tax competition. This means that Germany, as a high-tax country, should quickly implement any necessary reductions in corporate tax burdens.

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