ARTICLE

JUNE 2022

Contact Us

Americas
+1.212.553.1658
clientservices@moodys.com

Europe
+44.20.7772.5454
clientservices.emea@moodys.com

Asia (Excluding Japan)
+85 2 2916 1121
clientservices.asia@moodys.com

Japan
+81 3 5408 4100
clientservices.japan@moodys.com

WILL CHANGING INTERNATIONAL TAX RULES COMBAT TAX LOSSES BY COUNTRIES?

By: Maqbool Lalljee
Moody's Analytics Global Tax & Transfer Pricing Solutions – Industry Practice Lead

INTRODUCTION

Globalization and the digitization of the economy over the past 10 years have seen large amounts of corporate tax being lost by tax administrations:

•The Organization for Economic Co-operation and Development (OECD) estimates that between $100 to $240 billion dollars is being lost annually from tax avoidance.[1]

•The State of Tax Justice Report of 2021, on the other hand, estimates the amount to be over $483 billion lost through tax havens annually. Of this, around $312 billion dollars is lost through cross border tax abuse by multinationals (aggressive tax avoidance) and $171 billion dollars is lost through off-shore tax evasion – hidden assets and income streams offshore – by wealthy individuals.[2]

To address such huge losses annually, G20 countries are using the work of the OECD in a vigorous campaign to change the basis of corporate taxation rules. We will discuss the impact of these rule changes, which are likely to apply from 2024, once local legislations are in place. Although an overwhelming majority of tax jurisdictions have joined the plan to reform the international taxation rules (OECD 2021), some questions remain:

•Would these changes stop profit-shifting?

•What impact, if any, would there be on corporate tax evasion?

•How could our data support tax and transfer pricing analyses?

NEW RULES FOR THE CORPORATE TAXATION REGIME

Tax rules for international corporate taxation were put in place about a century ago, based on domestic tax law and international treaties. These rules distinguish features "between residence and source, between active and passive income and its basis of separate accounting."[3]

In the twenty-first century, however, the business models of large companies, especially multinationals, have changed from having a physical presence in tax jurisdictions to conducting large-scale business in countries with little or no physical presence. Since the early 1990s, it has become easier for multinationals to shift profit to low- or zero-tax jurisdictions, mainly through the increasing use and exploitation of intangible assets.

To address the global tax avoidance issue and recoup some of this lost tax, in 2013 the OCED and G20 countries embarked on a mission to equip governments with domestic and international rules through the OCED's Base Erosion Profit Shifting Project (BEPS). This initiative culminated in the new Two-Pillar plan to reform the basis of international corporate taxation rules and ensure that multinationals pay a fair share of tax wherever they operate (Tax Justice 2021).

THE TWO-PILLAR SOLUTION IN A NUTSHELL

• **Pillar 1** offers market jurisdictions new taxing rights over multinationals with over $20 billion dollars annual Operating Revenue (OPRE), whether or not they have a physical presence in their jurisdictions. Twenty-five percent of the residual profits of the largest 100 "in-scope" multinationals would be reallocated to tax jurisdictions where their users and customers are located; this is referred to as **Amount A**. There is also an **Amount B**, which is a fixed allocation of profit-to-market jurisdictions, using an arm's-length principle to arrive at an in-country baseline for marketing and distribution activities (OCED 2021). The "high-level" view shown in Figure 1 was developed using Orbis data only, depicting a multinational that falls within the parameters of analysis.

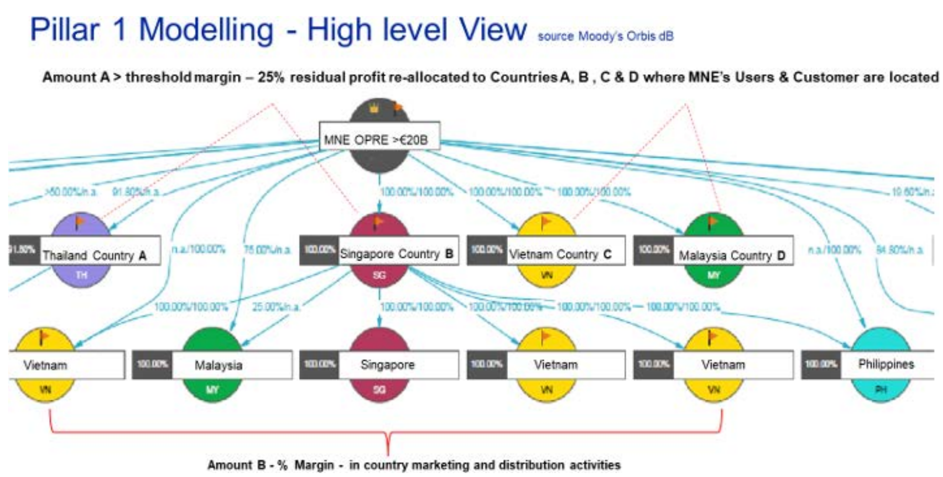

Figure 1. High-level view of Pillar 1 modeling using Orbis data

•**Pillar 2's** scope is to extend beyond the traditionally "digital" businesses to capture multinationals with an annual OPRE of greater than 750 million euros and those that have a foreign entity present in their group structure. The aim is to ensure that these "in-scope" multinationals pay at least **a minimum global tax of 15%**. The tax rules here are highly complex, consisting of: (a) two interlocking domestic rules and (b) a treaty-based rule (OECD 2021). Suffice to say that it would be challenging for multinationals to provide – and for tax administrations to check and monitor – the data and information needed for accurate calculations with myriad adjustments. The "high-level" view (with appropriate selection parameters) shown in Figure 2 uses Orbis data only. It shows for comparative purposes the global estimated effective corporate tax rate (at accounting period December 31, 2020) and the global minimum tax rate post-Pillar 2 implementation.

ARTICLE
JUNE 2022

Contact Us

Americas
+1.212.553.1658
clientservices@moodys.com

Europe
+44.20.7772.5454
clientservices.emea@moodys.com

Asia (Excluding Japan)
+85 2 2916 1121
clientservices.asia@moodys.com

Japan
+81 3 5408 4100
clientservices.japan@moodys.com

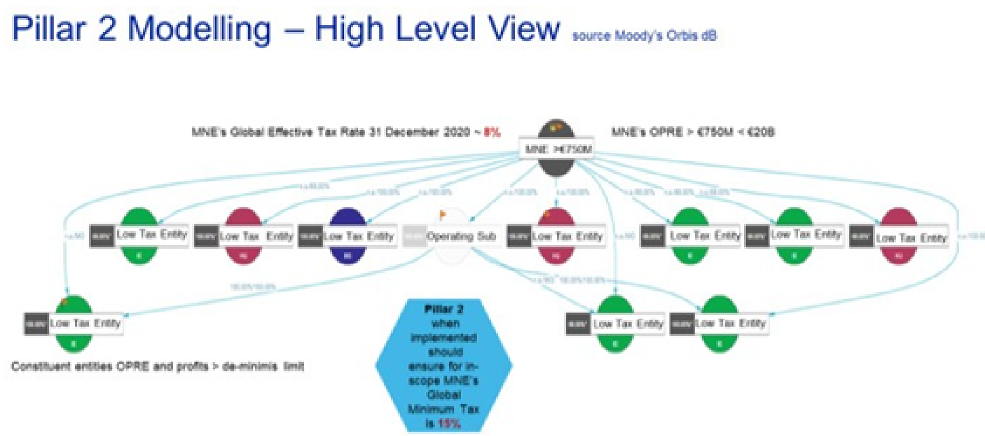

Figure 2. High-level view of Pillar 2 modeling using Orbis data only

Pillars 1 and 2 exclude companies in extractive industries, shipping, regulated financial services, and pension funds for two reasons: profits are not part of the perceived problem because sources are aligned to place of operations, and not all taxes in these industries arise under the corporate tax regime.

WOULD THESE CHANGES STOP PROFIT-SHIFTING?

OECD publications estimate that the Pillar 1 and 2 rules will come into effect early 2023. From Pillar 1 rules on taxing rights, more than $125 billion dollars of profit are expected to be reallocated to market jurisdictions each year. From Pillar 2, the global minimum tax rate of 15% is estimated to raise around $150 billion dollars in additional global tax revenues annually (OECD 2021). These figures remain transient and have more than doubled from the amounts cited in the OECD's 2020 Impact Assessment. [4]

Work continues at a frantic pace to bottom out calculations on Pillars 1 and 2 by the end of 2022; to get full consensus from the current 141 Inclusive Framework Members (IFMs)[5]; and to develop model legislation, a multilateral instrument, and detailed guidance.

The impact on jurisdictional reallocation of profits has been worked out by the OECD Secretariat and shared with IFMs. Due to lack of consensus among IFMs, the findings have not been made public (BEPS 2020). After countries like Ireland argued that the Pillar 2 scheme would deter foreign direct investment, the OECD/G20 reached agreement allowing for low-tax jurisdictions to keep their current low rates for businesses with revenue below 750 million euros annually.[6] For Ireland, this means that over 160,000 businesses employing approximately 1.8 million people will see no change to their corporation tax rate of 12.5% (Government of Ireland 2021). Globally, this would mean that at least 1 million businesses in jurisdictions below the 15% corporate tax rate would see no change in rate. Corporates below the 750 million euros annual OPRE threshold that have an entity overseas amount to several million globally.[7] All of these businesses are below the limit for Country-by-Country Reporting (CBCR) data exchange requirements.[8] This would mean that existing tax avoidance and evasion among small and medium-size business will still be there, despite the tightening of local anti-avoidance legislations in some jurisdictions and substance testing for permanent establishments.[9]

ARTICLE

JUNE 2022

Contact Us

Americas
+1.212.553.1658
clientservices@moodys.com

Europe
+44.20.7772.5454
clientservices.emea@moodys.com

Asia (Excluding Japan)
+85 2 2916 1121
clientservices.asia@moodys.com

Japan
+81 3 5408 4100
clientservices.japan@moodys.com

The proposed rule changes would allow tax administrations to make better use of their limited specialist resources to inquire into less complex businesses. What this means, however, is that the need for Moody's ownership and financial data is greater than ever, as administrations will be performing in-depth risk assessment work at a notch lower than before, without the insights of CBCR data. The new paradigm would also require tax administrations to undertake risk assessment reviews in those multinationals that would be impacted by the rule changes, to ensure that their operations adhere to – and remain within the parameters of the new rules. True understanding of where "aggressive tax avoidance" has found a home will only come to light two or three years after the rule changes.

WHAT IMPACT, IF ANY, WOULD THERE BE ON CORPORATE TAX E ASION?

The work of Pillars 1 and 2 aims to change the basis of corporate taxation rules, primarily those applying to trading activities. These rules don't fully apply to certain exempt entities, pension funds, most asset-holding companies of investment funds and real estate investment funds.[10] In fact, the classical "complex secretive structure" diagrammed using Orbis data (Figure 3) would escape scrutiny under the proposed Pillar 1 and 2 rules.

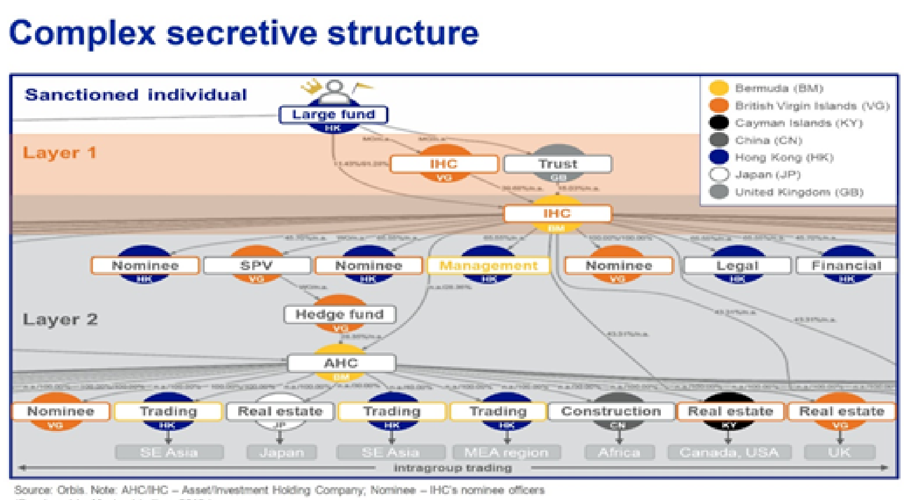

Figure 3. Example of a "complex secretive structure" using Orbis data

For high-net-worth individuals, the possible ill-gotten untaxed gains flowing through entities layered in "tax havens" would escape scrutiny. This is because the regulatory requirements in such jurisdictions are low, facilitating the flow of financing through normalized trading. Identifying tax evasion in such scenarios becomes very difficult without data linked to global ownership, as is available in Orbis. The new proposed corporate tax rules miss this area. Here, tax and customs administrations' efforts would need to be supplemented through our online access tools and data feeds to blend with the authorities' own primary source data and information to develop high-risk neural networks and predictive analytical models.

ARTICLE
JUNE 2022

Contact Us

Americas
+1.212.553.1658
clientservices@moodys.com

Europe
+44.20.7772.5454
clientservices.emea@moodys.com

Asia (Excluding Japan)
+85 2 2916 1121
clientservices.asia@moodys.com

Japan
+81 3 5408 4100
clientservices.japan@moodys.com

HOW COULD OUR DATA SUPPORT TAX AND TRANSFER PRICING ANALYSES?

Our data is already playing a significant role in the current work for the Two Pillars rule changes. We are one of only two commercial data vendors providing data for blending with various OECD and CBCR datasets for very complex analysis undertaken by the OECD teams.[11] With the granularity it provides, our Global Ownership data is essential for direct and indirect ownership calculations. Our vast financial firm-level dataset is heavily used for jurisdiction- and sector-level analysis for the Two Pillars work. Going forward once the new rules are embedded through local tax legislation, our data will play a crucial role for tax administrations to monitor and test the allocations of profits by multinationals. Tax and customs administrations' work on risk assessment and identification of international cross-border risks will increase considerably to recoup tax losses suffered through the pandemic.

The proposed rule changes will free up resources and allow tax examiners to devote more attention to closing the tax gap around the large number of medium-size businesses and the tax not paid by high-net-worth individuals from their multiple business activities. The Amount B provision of Pillar 1 may reduce the need for tax consultants and administrations to undertake and challenge transfer pricing benchmarks in low-risk areas. An example of that would be for limited risk distributors, fixed returns may be calculated for such in-country activities.

CONCLUSIONS

•New Pillar 1 and 2 rules will be a significant shift in the way we want to tax large multinationals in the twenty-first century, to neutralize the effect of profit shift and reallocate tax to the jurisdictions where the income is earned.

•In trying to achieve rule changes in 2023, and the fairness in international taxation, considerable work is still needed on both the political and technical fronts.

•The system must be attractive for members and the technical models must work in real trading work environments.

•Ireland and other low-tax jurisdictions were able to extract a compromise to tax businesses below EUR 750 OPRE at their lower rates of tax (Government of Ireland 2021). This allows many of these low-tax jurisdictions to attract FDI and go about their normal business as before.

•Although the imposition of new rules would not eliminate tax avoidance or evasion, it may make tax avoidance less aggressive. The task to recover some $483 million dollars annually still remains short of the mark as the current estimates of the impact of Pillars 1 and 2 will be around an additional $275 million dollars redistribution of tax annually.

ARTICLE
JUNE 2022

Contact Us

Americas
+1.212.553.1658
clientservices@moodys.com

Europe
+44.20.7772.5454
clientservices.emea@moodys.com

Asia (Excluding Japan)
+85 2 2916 1121
clientservices.asia@moodys.com

Japan
+81 3 5408 4100
clientservices.japan@moodys.com

•Many emerging jurisdictions are increasingly willing and able to mount effective investigations. We are and can help advance established and emerging tax administrations alike. According to McKinsey Research, "Tax authorities are in the eye of the storm of these global forces…and data are becoming the currency of tomorrow."[13] Several tax authorities have embraced analytics to transform how they conduct examinations and debt collections, using analytics to create early warning systems and practice extreme modeling, while others are still working to get beyond the basics.

REFERENCES

1. OECD/G20 Base Erosion and Profit Shifting Project, "Two-Pillar Solution to Address the Tax Challenges Arising from the Digitalisation of the Economy," October 2021; hereafter cited in text as "OECD 2021."

2. The State of Tax Justice, November 2021; hereafter cited in text as "Tax Justice 2021."

3. Michael P. Devereaux et al., Taxing Profit in a Global Economy (Oxford University Press, 2021).

4. "Tax Challenges Arising from Digitalisation – Economic Impact Assessment: Inclusive Framework on BEPS," October 2020; hereafter cited in text as "BEPS 2020."

5. Members of the OECD/G20 Inclusive Framework on BEPS (https://www.oecd.org/tax/beps/inclu�sive-framework-on-beps-composition.pdf).

6. Government of Ireland, "Ireland joins OECD International Tax agreement," October 2021 (www.gov.ie/en/press-release/59812-ireland-joins-oecd-international-tax-agreement); hereafter cited in text as "Government of Ireland 2021."

7. Moody's Orbis – modelling – population, March 2022.

8. https://www.oecd.org/tax/beps/beps-actions/action13/

9. https://www.oecd.org/tax/beps/additional-guidance-attribution-of-profits-to-a-permanent-establish�ment-under-beps-action7.htm

10. "Tax Challenges Arising from Digitalisation – Reports on Pillar One and Two Blueprints," 2020.

11. "Tax Challenges Arising from the Digitalisation of the Economy: UPDATE ON THE ECONOMIC ANAL�YSIS & IMPACT ASSESSMENT WEBCAST," February 13, 2020.

12. "Transfer Pricing Guidance on Financial Transactions: Inclusive Framework on BEPS: Actions 4, 8-10," February 2020.

13. "Four innovations reshaping tax administration," McKinsey Research, January 2018.

Additional terms for Australia only: Any publication into Australia of this document is pursuant to the Australian Financial Services License of MOODY'S affiliate, Moody's Investors Service Pty Limited ABN 61 003 399 657AFSL 336969 and/or Moody's Analytics Australia Pty Ltd ABN 94 105 136 972 AFSL 383569 (as applicable). This document is intended to be provided only to "wholesale clients" within the meaning of section 761G of the Corporations Act 2001. By continuing to access this document from within Australia, you represent to MOODY'S that you are, or are accessing the document as a representative of, a "wholesale client" and that neither you nor the entity you represent will directly or indirectly disseminate this document or its contents to "retail clients" within the meaning of section 761G of the Corporations Act 2001. MOODY'S credit rating is an opinion as to the creditworthiness of a debt obligation of the issuer, not on the equity securities of the issuer or any form of security that is available to retail investors.Additional terms for Japan only: Moody's Japan K.K. ("MJKK") is a wholly-owned credit rating agency subsidiary of Moody's Group Japan G.K., which is wholly-owned by Moody's Overseas Holdings Inc., a wholly-owned subsidiary of MCO. Moody's SF Japan K.K. ("MSFJ") is a wholly-owned credit rating agency subsidiary of MJKK. MSFJ is not a Nationally Recognized Statistical Rating Organization ("NRSRO"). Therefore, credit ratings assigned by MSFJ are Non-NRSRO Credit Ratings. Non-NRSRO Credit Ratings are assigned by an entity that is not a NRSRO and, consequently, the rated obligation will not qualify for certain types of treatment under U.S. laws. MJKK and MSFJ are credit rating agencies registered with the Japan Financial Services Agency and their registration numbers are FSA Commissioner (Ratings) No. 2 and 3 respectively.

MJKK or MSFJ (as applicable) hereby disclose that most issuers of debt securities (including corporate and municipal bonds, debentures, notes and commercial paper) and preferred stock rated by MJKK or MSFJ (as applicable) have, prior to assignment of any credit rating, agreed to pay to MJKK or MSFJ (as applicable) for credit ratings opinions and services rendered by it fees ranging from JPY100,000 to approximately JPY550,000,000.

MJKK and MSFJ also maintain policies and procedures to address Japanese regulatory requirements.