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International taxation: Centuries-old rules of the game and the need for change

Toward redesigning International Tax Architecture

In the aftermath of World War I, the world was undergoing major changes on all fronts, with a new configuration of the political spectrum.

Economically, enterprises were beginning to expand beyond the borders of their home countries into other jurisdictions, called source countries. The advent of multinational enterprises posed challenges for tax administrations, as the assets and profits of a single company could be taxed more than once, in two or more countries where it has a presence.

The need to equalize taxing rights among the various jurisdictions led to the compromise of the 1920s[1]. Under this compromise, sponsored by the League of Nations, the forerunner of the United Nations, home countries, or source countries, were given primary taxing rights on active business income, such as corporate income tax, and residence countries were given primary taxing rights on passive income, such as dividends, royalties and interest.

Since that time, the International Tax System has become more complex (in 2013, the number of Double Taxation Treaties exceeded 3,000) but two trends were to be confirmed.

While the countries of residence, often high-income countries, taxed the liabilities of their companies and became richer, the source countries, mostly lacking investment and foreign exchange, reduced their effective tax rates. In the highly competitive arena of comparative advantage, it was essential for them to become more attractive, even if this attractiveness often took the form of tax advantages improperly offered to foreign direct investment (FDI)[2].

The race to the bottom that developing countries have engaged in and the loopholes in the international tax system have allowed multinationals, as well as the wealthy, to transfer or hide their profits where they will pay the least amount of tax possible. Practices such as tax evasion and fraud, if not illegal, at least unfair to the countries that create this economic wealth, have intensified over the years. The Pandora Papers, Panama Papers, OpenLux, based on the leakage of confidential documents, illustrate the extent of illicit financial flows[3], which cause Africa, for example, to lose between 30 and 60 billion dollars each year.

[1] Sadowsky, Marilyne, L'histoire du droit fiscal international (16 mars 2021). OUP Handbook of International Tax Law (F. Haase, G. Kofler eds., Oxford University Press 2021 à paraître)

[2] Bilan des incitations aux investissements en Tunisie | Observatoire Tunisien de l'Economie (economie-tunisie.org)

[3] Les 13 leaks politiques et financiers des 40 dernières années | Les Echos Start

The increasing digitalization of the economy has further complicated the situation, raising new challenges for tax administrations around the world. How can a tax authority in an African country, in this case Tunisia, tax a digital platform that makes huge profits in this country without being physically present? How to prove its digital presence? How to determine the value of these profits? At what rate should they be taxed? Is it even possible to tax this platform if it is protected by the tax stability clause in the non-double taxation agreement between its country of residence and its «host» country?

To answer these questions and so many others, it was necessary to think about new rules that are adapted to the immateriality of the digital economy and its elusive nature. With this in mind, in 2016 the Organization for Economic Cooperation and Development (OECD)[4] established the OECD/G20 Inclusive Framework on Tax Base Erosion and Profit Shifting, with a special focus on the digital economy.

[4] A propos de l'OCDE - OCDE (oecd.org)

Last October, the OECD/G20 Inclusive Framework endorsed a Two-Pillar Solution to Address the tax Challenges Arising from the Digitalisation of the Economy.

Pillar One establishes a new taxation right to companies that sell goods and services digitally in the countries where their users or consumers are physically located. Pillar Two ensures that all global profits of multinational companies will be taxed at a minimum effective tax rate of 15%.

Pillar Two should undermine the logic of tax competition, as explained by the International Institute for Sustainable Development. The aim is to make the most damaging tax practices ineffective: countries that, through tax incentives for example, reduce their effective tax rate below 15% would simply transfer the difference to the high-income countries of residence.

However, this initiative is viewed with suspicion by many developing countries because of onerous conditions that may undermine the stated fundamental objective of providing an inclusive and equitable framework.