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Introduction

*The International Tax Revolution, 2008–2023**

The past decade has witnessed the creation of a new International Tax Regime (ITR). The original ITR was created a century ago by the League of Nations based on a compromise reached in 1923. Until the 1980s, it functioned well by preventing most instances of double taxation and double non-taxation by allocating cross-border income between home and host jurisdictions.

However, since the advent of globalization in the 1980s and digitalization in the 1990s, the original ITR has ceased to function as intended. The main problem is the increased mobility of capital related to increased intangibility and digitalization, in conjunction with a relaxation of capital controls and increased tax competition.

These developments posed a problem for countries that wished to leave their financial borders open to reap the benefits of globalization. Countries were faced with a difficult choice if they wished to continue to participate in an open, globalized financial economy. They could either refuse to engage in cutthroat tax competition and face the risk of capital fleeing their borders, or they could give in, engage in tax competition, and lose tax revenue as they slashed rates to placate corporations. The outcome was a significant fall in tax revenues that threatened the social safety net of the modern welfare state.

The challenging trilemma faced by countries of open borders in the globalized economy, tax competition among countries, and financially supporting the welfare state became unsustainable following the financial crisis of 2008–09, after which many countries were forced to implement harsh austerity measures. These governments subjected their populations to austerity while parliamentary hearings, leaks, and media reports revealed that rich individuals and large corporations were paying little tax on cross-border income. The result over the past decade has been the creation of a new ITR designed to curb both tax evasion by the rich and tax competition by countries.

* This chapter draws heavily from a previous piece written by the first author. Reuven S. Avi-Yonah, *International Taxation, Globalization, and the Economic Digital Divide*, 26 J. Int'l Econ. L. 101 (2023).

The key question going forward is how the new ITR will deal with inter-nation equity – that is, the division of tax revenues among states. Here, we will first provide an overview of the decline and fall of the original ITR from 1980 to 2009, then the creation of the new ITR from 2010 on, and finally the implications of the new ITR for inter-nation equity (especially between developed and developing countries).

I.1 GLOBALIZATION AND THE DECLINE OF THE INTERNATIONAL TAX REGIME, 1980–2009

Before the 1980s, the ITR functioned as an adequate protective device against tax competition, therefore protecting tax revenues and the social safety net. The old ITR was based on two principles: the benefits principle, and the single tax principle. The benefits principle is that active (business) income should be taxed primarily in the *source jurisdiction* and passive (investment) income should be taxed primarily in the *residence jurisdiction*. The single tax principle is that the goal of the ITR is to prevent both double taxation and double non-taxation. Therefore, the secondary taxing jurisdiction (residence for active income and source for passive income) should impose a tax in a situation where the primary taxing jurisdiction does not do so.

Prior to the 1980s, residence jurisdictions were able to impose tax on most passive income because exchange controls made it difficult to invest offshore, and because source jurisdictions imposed withholding taxes on such income. Active income was in turn taxed by source jurisdictions because it was less mobile and Controlled Foreign Corporation (CFC) rules imposed residence-based tax on the income in cases where it was mobile and escaped source-based taxation.

This situation changed in the 1980s and 1990s. Globalization led most countries to relax their exchange controls, and portfolio investments overseas became more common. In addition, starting with the United States in 1984, most members of the Organisation for Economic Co-operation and Development (OECD) unilaterally abolished withholding taxes on outbound interest payments, thereby aiding and abetting tax evasion by residents of other OECD members. For active income, the increased mobility of multinational enterprises (MNEs or multinationals) led source jurisdictions to offer targeted tax holidays, and the fear of tax competition for the headquarters of those MNEs led residence jurisdictions to relax their CFC rules. Neither the residence jurisdiction of the MNEs nor the production jurisdiction typically taxed the MNEs' income on a current basis. The only jurisdiction that was not subject to this sort of tax competition was the *market jurisdiction*. However, after the creation of the internet and the rise of the digital economy in the 1990s, it became possible for MNEs to earn billions in income from market jurisdictions without being subject to tax because they lacked a permanent establishment (PE) in a market.

In the first decade of the twenty-first century, things only got worse. On the passive income front, it became possible to avoid withholding taxes not just on interest (because of unilateral abolition), royalties (because of the tax treaties, which abolish withholding), and capital gains (because of the source rules, which provide for residence taxation) but also on portfolio dividends because of the rise of derivatives, which enabled portfolio investors to receive the economic equivalent of dividends without being subject to withholding taxes. It also became clear that limits on the exchange of financial information meant that, in most cases, *residence jurisdictions* could not effectively tax foreign source portfolio income. In 2005, Joseph Guttentag (the former Treasury Deputy Assistant Secretary for international tax affairs) and the first author estimated that the United States was losing $50 billion a year to such tax evasion, and that most other countries were in worse shape because their shadow economies were larger.[1]

On the active income front, the decade from 1998 to 2008 saw the enactment of Check the Box and Internal Revenue Code (IRC) section 954(c)(6), which cause US tax authorities to become incapable of using the CFC rules to enforce residence-based taxation of US-based multinationals. Deferral, which is categorized as a tax expenditure in the United States, exploded from less than $20 billion in the mid-1990s to the second largest tax expenditure in the US budget, worth $1.348 trillion from 2017 to 2026.[2]

This was justified in the name of preserving the competitiveness of US-based MNEs, but it resulted in shifting of massive amounts of income from the United States to low-taxed jurisdictions. By 2017, US MNEs had close to $3 trillion in profits "trapped" in low-taxed, offshore jurisdictions. Ireland, Luxembourg, and other jurisdictions enacted low-tax regimes designed to attract such active income, as well as the headquarters of multinationals.[3] Over thirty US-based MNEs "inverted" to Ireland and other low-taxed jurisdictions, primarily to reduce their US tax rate on US source income and to enable the distribution of low-taxed foreign-sourced income to shareholders.

Thus, a decade after the OECD first tried to tackle international tax competition, the problem had gotten significantly worse. Both the individual income tax (designed primarily to preserve progressivity) and the corporate income tax (designed primarily to regulate MNEs) were under tremendous pressure. The decline in revenues and the inability of most jurisdictions to raise consumption taxes (because the consumption tax rates were already prohibitively high) placed the social safety net under severe financial pressure. This pressure became too much for the system to bear following the financial crisis of 2008.

1 Reuven S. Avi-Yonah & Joseph Guttentag, *Closing the International Tax Gap*, in Bridging the Tax Gap: Addressing the Crisis in Federal Tax Administration 99 (Max B. Sawicky ed. 2005).

2 US Treasury, *Tax Expenditure Budget* (2017).

3 *See* Edward Kleinbard, *Stateless Income*, 11 Fla. Tax Rev. 699 (2011) and Edward Kleinbard, *The Lessons of Stateless Income*, 65 Tax L. Rev. 99 (2011).

I.2 THE CREATION OF THE NEW INTERNATIONAL TAX REGIME, 2010–2023

The financial crisis and the Great Recession that followed led to millions losing their jobs and their homes. In Europe, governments reacted to this pressure by imposing harsh austerity measures not seen for some time in these countries. While the Obama administration made no such cuts, the size of the US fiscal stimulus in response to the crisis was limited. While the banks were saved, millions of Americans suffered a decade of slow growth and high unemployment.[4]

The political reaction on both sides of the Atlantic was dramatic. It led to Brexit and the election of right-wing populists across the western world including Donald Trump in the United States. With this new political turn came the prospect of serious limits to globalization in the form of immigration restrictions, tariffs, and exchange controls. The nation state was reasserting itself against globalization, and one of the instruments it used was taxation. In the United States, the focus on taxation was limited to the first couple of years after the crisis because the Republican takeover of the House of Representatives in 2010 meant that no tax measures would be enacted before the 2017 Tax Cuts and Jobs Act (TCJA). In the United States, the "Double Irish Dutch Sandwich," which allows large corporations to shift profits to low- or no-tax jurisdictions, was once featured as a tax avoidance technique in detail in 2010 on the *NBC Nightly News*, but the topic faded thereafter. In contrast to the United States, in Europe, austerity meant a continued political focus on taxing both the rich and MNEs. European taxes became a front-page matter for the period after 2008. Such political momentum brought a series of developments that led to a significant enhancement in the ability of the ITR to capture cross-border income.

On the passive income front, the UBS scandal of 2006–08 led directly to the enactment of the US Foreign Account Tax Compliance Act (FATCA) in 2010. The UBS hearing before the Senate Permanent Committee on Investigations (PSI) revealed that UBS sent bankers directly to the United States to solicit rich individuals to set up shell companies in the Cayman Islands and then reinvest the money through UBS into the United States. UBS claimed that even though it was a "qualified intermediary" (QI) and knew who the real owner of the shell was, it was justified under the QI regulations in relying on a form W8-BEN that stated that the owner of the income was the Caymans shell and that it was foreign.[5]

[4] Reuven S. Avi-Yonah & Orli K. Avi-Yonah, *Be Careful What You Wish For? Reducing Inequality in the Twenty-First Century*, 116 Mich. L. Rev. 1001 (2018).

[5] Reuven S. Avi-Yonah, *Testimony on Banking Secrecy Practices and Wealthy American Taxpayers*, US House Committee on Ways and Means, Subcommittee on Select Revenue Measures (Mar. 31, 2009); Reuven S. Avi-Yonah, *Testimony for Hearing on Offshore Tax Evasion*, US Senate Finance Committee (May 3, 2007); Reuven S. Avi-Yonah, *Testimony for Hearing on Offshore Transactions*, US Senate Permanent Subcommittee on Investigations (Aug. 1, 2006).

The FATCA imposes a 30 percent withholding tax on the US income of any foreign financial institution (FFI) that knows or has reason to know it holds accounts of US residents or citizens and does not reveal such information to the Internal Revenue Service (IRS). Because FFIs are frequently prohibited from directly revealing financial information to the IRS, the Obama administration negotiated over 100 intergovernmental agreements (IGAs) that enable the FFIs to turn over the information to its own government, which then exchanges it with the IRS under tax treaties and tax information exchange agreements (TIEAs). Many of the IGAs are reciprocal, so that the United States is also obligated (at least on paper) to exchange this same information about foreign residents. This bilateral diplomatic initiative has enabled the United States and other countries to enforce rules against previously shady FFIs.

The IGAs in turn made countries develop a Common Reporting Standard (CRS) for the automatic exchange of financial information. The OECD negotiated a Multilateral Agreement on Administrative Cooperation in Tax Matters (MAATM), which relies on the CRS to provide for automatic exchange without the ability to rely on bank secrecy or dual criminality provisions. Most countries in the world, and all OECD members except the United States, have ratified the MAATM.[6]

It is now much more difficult to evade income taxation due to these new regulations and reporting rules. An evader must worry that, in almost every country, information about her income may be collected and transmitted to her residence jurisdiction. In addition, the evader must worry that the information may be leaked by a whistleblower (as in the Panama Papers and the Paradise Papers). We would estimate that the FATCA alone led to a significant decrease in the international tax gap in the United States, well below the $50 billion estimated in 2005.

On the active income front, there have also been dramatic developments in the last decade. First, there was the OECD Base Erosion and Profit Shifting (BEPS 1.0) project (2013–15), which was led by the G20 and resulted in fifteen action steps designed to enhance both source-based and residence-based taxation of active income. For example, BEPS 1.0 Action 2 bars a deduction for payments to hybrid entities, thereby eliminating the tax avoidance impact of Check the Box.

BEPS 1.0 was introduced in the EU as the Anti-Tax Avoidance Directive II (ATAD II). ATAD II generally came into effect in January 2019 and, requires all EU members to adopt strict CFC rules (generally requiring residence-based taxation if the effective tax rate of the source jurisdiction is below 50 percent of the tax rate in the residence jurisdiction).[7] This measure, in addition to the enactment of BEPS 1.0 Action 2, means that it is now much harder to shift profits artificially out of EU

6 Reuven S. Avi-Yonah, *And Yet It Moves: Taxation and Labor Mobility in the Twenty-First Century*, 67 Tax L. Rev. 169 (2014); Reuven S. Avi-Yonah & Gil Savir, *IGAs vs. MAATM: Has Tax Bilateralism Outlived Its Usefulness?* 66 CCH Global Tax Weekly 11 (Feb. 13, 2014).

7 *See* Council Directive (EU) 2017/952 of May 29, 2017 (ATAD II), applying the anti-hybrid rules to third countries.

member states.[8] Another important measure in BEPS 1.0 and ATAD II is the primary purpose test (PPT), which requires that all tax treaties incorporate language that the treaty will not apply to transactions if the primary purpose of the transaction was tax avoidance.[9]

Until 2017, it could be argued that the United States was falling behind in terms of combating tax avoidance, because it took the position that it was already compliant with BEPS 1.0, rejected the PPT, and did not sign the MAATM. The passage of the 2017 TCJA dramatically changed this. The TCJA includes three measures that significantly increase taxation of US-based as well as foreign-based MNEs: the transition tax, the Global Intangible Low-Taxed Income (GILTI), and the Base Erosion and Anti-Abuse Tax (BEAT). First, the TCJA imposed a one-time, hefty transition tax on $3 trillion of past, accumulated, foreign earnings of US-based MNEs. Second, while the TCJA provided for an exemption for certain future dividends from CFCs to their US parents, this exemption is strictly limited to a deemed 10 percent return on tangible property, which for most US-based MNEs is close to zero (as they rely heavily on intangibles). For any amount that exceeds this deemed return, TCJA imposes a current minimum tax of 10.5 percent (13.125 percent if foreign tax credits are included) on the worldwide earnings of the MNE. Third, the TCJA imposes an alternative minimum tax of 10 percent on both US- and foreign-based MNEs by disregarding interest, royalty, and some other payments from the United States to the related foreign entity.

These developments (BEPS 1.0, ATAD II of the EU, and the TCJA of the United States) resulted in both US-based and foreign MNEs being subjected to significantly higher levels of tax on cross-border active income than they were before 2018.[10]

For example, the structure used by most US-based MNEs before 2017 for their foreign operations was to have a top-level CFC in a low-tax jurisdiction, with lower-tier CFCs in high-tax jurisdictions. The parent would transfer intellectual property to the top-tier CFC via a cost sharing agreement, and the top-tier CFC would, in turn, license the IP to the lower-tier CFCs. The key to this structure under Check the Box was only the top CFC would be treated as a corporation, while all the lower CFCs would be treated as disregarded entities by tax authorities (i.e., treated as branches of the top CFC). While for foreign tax purposes deductible royalties from the lower CFCs to the top CFC would be effective in shifting profits to the low-tax jurisdiction of the top CFC (and not subject to withholding under treaties and EU Directives), for US tax purposes these royalties did not exist and did not trigger a deemed dividend to the US parent.

8 Another measure included in ATAD is a 30 percent of EBITDA limit on interest deductions, similar to IRC 163(j).

9 *See* Reuven S. Avi-Yonah & Gianluca Mazzoni, *BEPS, ATAP and the New Tax Dialogue: A Transatlantic Competition?* 46 Intertax 885 (2018).

10 *See* Kimberly A. Clausing, *Profit Shifting before and after the Tax Cuts and Jobs Act*, 73 Nat'l Tax J. 1233 (2020).

This structure does not work anymore due to the new reforms. Under BEPS 1.0 Action 2, as implemented by the EU's ATAD II, the royalties from the lower CFCs to the top CFC are not deductible because they are directed to a hybrid entity. Second, the cost sharing payments from the US parent to the top CFC would be subject to the BEAT minimum tax. Finally, the top CFC as well as all the disregarded entities below would be subject to the GILTI minimum tax (10.5 percent or 13.125 percent with foreign tax credits) on a current basis. The result is US-based MNEs need to restructure their foreign operations and are likely to be subject to a significantly higher worldwide effective tax rate than before 2018, even though both Check the Box and IRC section 954(c)(6) have only been indirectly affected by the TCJA.

Despite these achievements, BEPS 1.0 has some limits. Specifically, no consensus was reached about taxing the digital economy (i.e., primarily the US tech giants). In addition, transfer pricing was not meaningfully reformed. The PE threshold and arm's-length standard (ALS) remained in place despite both being obsolete in a modern, digital economy. In addition, relatively few of the BEPS 1.0 actions were minimum standards that had been adopted by all participants.

The political pressure to do something about BEPS 1.0 in the EU and in the developing world has not subsided, manifesting in the quick rise and fast adoption of digital services taxes (DSTs) and equalizations levies (ELs) designed to bypass the treaty limits on taxing the digital economy. This in turn has led the OECD and G20, working with over 100 countries, to propose BEPS 2.0, which was finalized in principle in October 2021.[11]

BEPS 2.0 consists of two pillars: Pillar One and Pillar Two. Pillar One is designed to address the problem of taxing corporate income at source in accordance with the benefits principle (BP). Pillar One allows source jurisdictions to tax a limited amount of income without regard to the PE and ALS limits, and to tax an additional amount in the market jurisdiction subject to the PE and ALS limits.

The main innovation in Pillar One is Amount A, which represents 25 percent of residual profit (defined as profit more than 10 percent of revenue) of in-scope MNEs (MNEs with revenues over 20 billion euros and a pretax profit margin of 10 percent). Amount A will be allocated to market jurisdictions with nexus (at least 1 million euros in revenue), using a revenue-based allocation key – that is, a single factor sales formula.

Amount A eliminates the two features of the international tax regime that have long been identified as obsolete: The requirement that MNEs have a permanent establishment (PE) in a source jurisdiction and the ALS for calculating the amount of income attributable to the PE. The PE requirement is obsolete in a world in which MNEs can earn billions in a market jurisdiction with no physical presence. The ALS is unworkable for the residual profits of MNEs (defined here as profits

[11] OECD, Statement on a Two-Pillar Solution to Address the Tax Challenges Arising from the Digitalisation of the Economy (Oct. 8, 2021) (the "Statement").

above 10 percent) because there are typically no comparable transactions. In other words, a formula, not the ALS, is the best way to allocate the residual profits. The PE requirement and ALS were both introduced into the international tax regime at an early stage, primarily through the work of Mitchell Carroll in the 1930s. It is time for both to go to make way for reforms that ensure large MNEs like Amazon, Apple, Meta, and Google pay tax in the source country they derive profits from.

Amount A is fully consistent with the benefits principle. It can be argued that a residence country should also get a share as typically the algorithms that underlie the business model were developed there; this is reflected by the fact that 75 percent of the residual profit is not taxed in the market jurisdiction and therefore should be taxed in other jurisdictions based on Pillar Two. The allocation of income to these jurisdictions is based on payroll and tangible assets (depreciation).

Pillar Two directly implements the single tax principle (STP) by ensuring a minimal tax in the residence jurisdiction if the source country tax is insufficient, and, if that is not enough, by ensuring a minimal tax in the source jurisdiction. In addition, residence or source jurisdictions can adopt a Qualified Domestic Minimum Top-Up Tax (QDMTT) to prevent the application of minimum taxes by other jurisdictions. The STP was envisaged in the original League of Nations 1923 report and the tax treaty model from 1927. But the STP was first implemented in the 1960s, and then gradually accepted (with some retreat such as the US portfolio interest exemption in 1984 and Check the Box in 1997) and implemented in BEPS 1.0 (2013–15) and the TCJA's BEAT and GILTI (2017).

Pillar Two consists of the Income Inclusion Rule (IIR), the Undertaxed Profits Rule (UTPR), and the QDMTT. The IIR reflects the ability of residence countries to implement the STP by taxing their MNEs on a residence basis. Since 95 percent of large MNEs are resident in G20 countries, this is expected to be highly effective. The UTPR is designed to enable residual source taxation when residence taxation is ineffective. The QDMTT enables both residence and source jurisdictions to turn off the other rules on domestic income by imposing their own minimum tax. The agreed-upon minimum tax rate of 15 percent is low, but it was the best that could be expected given the size of the coalition of countries. The G20 can be expected to use a higher rate for the IIR. The substance carve-out is unfortunate (since it allows for some double non-taxation in violation of the STP) but it is quite limited.

Together with the CRS regime that implements the STP for individuals, Pillar Two will ensure that the STP will apply to large MNEs as well.

1.3 THE NEW INTERNATIONAL TAX REGIME AND INTER-NATION EQUITY

A key question regarding the new ITR is how it will apply to inter-nation equity. Specifically, how will the new ITR apply to and affect developing countries?

The answer is clear; the new ITR will help developing countries curb massive tax evasion by their rich residents. As documented by recent leaks in the Panama Papers, the Paradise Papers, and the Pandora Papers, rich individuals in the developing world use tax havens to hide their investment income in developed countries from the tax administrations in their home countries. Although it does not go far enough, the CRS should significantly limit this strategy. Despite CRS and MAATM, we do not think the solution can depend entirely on the exchange of information and residence-based taxation rules. There are too many residence countries that would need to cooperate effectively, and there will always be non-cooperative tax havens hoping to attract evaders. But the key point is that portfolio investments are limited to a small number of large jurisdictions. If the United States and the EU could cooperate to reinstitute withholding taxes on interest, a large part of the issue could be solved.[12]

Regarding BEPS 2.0 and the two pillars, the answer is more complicated. Pillar One shifts some of the tax revenue from where goods and services are produced to where they are consumed. This will help large developing countries like China and India but not smaller developing countries that do not have large national markets. However, Pillar One is unlikely to harm developing countries because they will remain able to tax MNEs based on the location of production.

Pillar Two is potentially more problematic because it eliminates the ability of developing countries to engage in tax competition by setting the global minimum corporate tax rate at 15 percent, and by giving primacy to the IIR, which is based on residence. Despite this, developing countries should still be able to tax MNEs based on their local production activities and adopt the QDMTT.

The deeper issue is that Pillar Two limits developing countries' autonomy by restricting their ability to engage in tax competition. The standard advice by economists to small open economies is that they should refrain from taxing foreign investors, because such investors cannot be made to bear the burden of any tax imposed by the capital importing country. This attracts foreign capital and the tax will necessarily be shifted to less mobile factors in the host country, such as labor and/or land, and it is more efficient to tax those factors directly.

While this advice is valid when applied to portfolio investment, it is less valid regarding foreign direct investors (FDI) for two reasons. First, the standard advice does not apply if a foreign tax credit (FTC) is available in the home country of the investor, which frequently would be the case for FDI. Second, the standard advice assumes that the host country is small. Extensive literature on multinationals suggests that typically they exist to earn economic rents (or supernormal returns). The host country is no longer "small" in the economic sense. There is a reason for the investor to be there and not elsewhere. Therefore, any tax imposed on such rents

[12] Reuven S. Avi-Yonah, *What Goes around Comes around: Why the USA Is Responsible for Capital Flight (and What It Can Do about It)*, 13 Haifa L. Rev. 321 (2019).

will not necessarily drive the investor to leave even if it is unable to shift the burden of the tax to less mobile factors.

This argument defending the host country taxation holds in the case of rents that are linked to location specific factors, such as natural resources or a large market. But what if the rents can be earned in many potential locations? In this case, the host country will not be able to tax the rents if the multinational can credibly threaten to go elsewhere. This situation, which is probably the most common, would require coordinated action to enable all host countries to tax the rent earned within their borders. This is precisely what Pillar Two does.

This point relates to another prevalent argument: Host countries need to offer tax incentives to be competitive. Extensive literature has demonstrated that taxes do play a crucial role in determining the location of investment. But these studies emphasize that tax incentives are crucial *given the availability of such incentives elsewhere*. It can be argued that, given the need for tax revenues, developing countries would in general prefer to refrain from granting tax incentives, only if they could be assured that no other developing country would be able to engage in tax competition.

Thus, restricting the ability of developing countries to engage in tax competition does not truly restrict their autonomy, nor does it counter their interests. Whenever competition from other countries drives the tax incentives, eliminating the competition does not hurt the developing country, and may aid its revenue raising efforts (assuming it can attract investment on other grounds, which is typically the case).

* * *

The following chapters will develop these themes in greater detail. Chapter 1 will describe the old ITR as it functioned before the recent globalization. Chapter 2 will show how globalization and digitalization undermined the old ITR in the period between 1980 and 2008. Chapter 3 will discuss the impact of the financial crisis of 2008 and the development of the Common Reporting Standard (CRS) for Automatic Exchange of Information (AEoI). Chapter 4 will evaluate the OECD's Base Erosion and Profit Shifting project (BEPS 1.0). Chapter 5 will discuss Pillar One of BEPS 2.0 (the digital economy), and Chapter 6 will analyze Pillar Two (the global minimum tax). Chapter 7 will discuss where the new ITR might be heading in the future. Chapter 8 concludes by exploring the extent to which the new ITR constitutes a revolution or paradigm shift and what were the origins of the new ITR.