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Van Dyk, Tertia

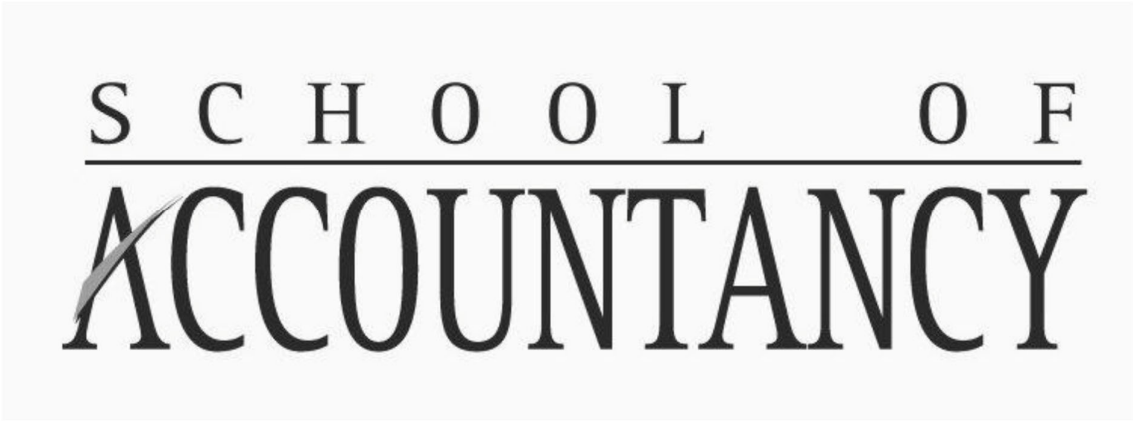
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University of the Witwatersrand, Johannesburg

Research report submitted to the Faculty of Commerce, Law and Management in partial fulfilment of the requirements for the degree of Master of Commerce in the field of Taxation

An analysis of whether the Two-Pillar Solution is an equitable solution for developing countries in addressing tax challenges of a digital economy

Applicant: Tertia van Dyk

Student number: 479 549

Supervisor: Professor Roy Blumenthal

Degree: Master of Commerce (specialising in Taxation)

Date: Johannesburg, 2022

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Abstract

The purpose of this research report is to determine whether key elements of the Organisation for Economic Co-operation and Development (OECD) Two-Pillar Solution are equitable to developing countries. The key principles contained in the Two-Pillar Solution will be critically discussed to determine whether these rules are designed in a manner that:

I. Allows for appropriate and acceptable tax competition for developing countries to fairly compete with larger economies; and
II. Ensures that multinational enterprises pay adequate tax in the developing countries where they operate, extract value and generate profits.

The report seeks to understand who the key role players are, what base erosion and profit shifting (BEPS) challenges have arisen caused by the digitalisation of the global economy, and how the OECD Two-Pillar Solution seeks to address these challenges. This analysis is conducted through the lens of developing countries, which are vulnerable to inequitable allocation of taxing rights. The report seeks to assess whether the key elements of the Two-Pillar Solution are consistent with existing international tax rules that govern the allocation of taxing rights and, in some instances, challenges whether the existing rules on international tax are equitable to developing countries in the first place. The role of tax policy and tax competition from the perspective of developing countries will be discussed. Finally, the effectiveness of alternative mechanisms to address tax abuse will be assessed, including digital services tax and controlled foreign company rules, will be examined.

Key Words: Multinational enterprises, base erosion and profit shifting, BEPS, inclusive framework, Global Anti-Base Erosion Model, developing countries, tax incentives, controlled foreign company rules, effective tax rate, low-taxed income, G20, digital services tax, Organisation for Economic Co-Operation and Development

Declaration

I declare that this research report is my own unaided work. It is submitted for the degree of Master of Commerce in the University of the Witwatersrand, Johannesburg. It has not been submitted before for any other degree or examination in any other university.

Tertia van Dyk

Tertia van Dyk

31 January 2023

Chapter 1: Introduction

Background

The rapid advancement of technology means that the global economy is increasingly becoming more digitalised which has disrupted traditional business models. Companies no longer require physical presence in a country as a pre-requisite to derive value and generate revenues. This has challenged existing international tax rules and the resultant shortcomings are exploited by multinational companies to avoid paying tax. The combination of factors including avoidance of permanent establishment status, lack of clarity over source rules for digital products and services, countries which enable tax abuse and the opportunity to exploit existing rules for allocating taxing rights has enabled digital multinational companies to devise legally permissible tax avoidance schemes that have resulted in the loss of tax revenues through the shifting of profits to tax havens.

To combat base erosion and profit shifting, the OECD has proposed a Two-Pillar Solution to address the tax challenges arising from the digitalisation of the economy (the Two-Pillar Solution) – a product of the OECD/G20 Inclusive Framework on Base Erosion and Profit Shifting (the Inclusive Framework).

The key objectives of the Two-Pillar Solution are to:

I. Establish new sourcing rules for digital products
II. Ensure the that taxing rights are allocated to countries where multinationals derive profits and extract value
III. Ensure that multinational companies pay a minimum amount of tax on profits arising from each country of operation

Key principles of the Two-Pillar Solution were politically agreed upon by the G7, G20 and the OECD in July 2021. On 8 October 2021, Two-Pillar Solution was published, supported by majority of countries which are mainly developed, capital-exporting countries. Therefore, there is a risk that these principles disproportionately benefit capital exporting countries to the detriment of developing countries which use tax policies as an important tool to attract much needed foreign direct investment.

The paradox of this is that the Two-Pillar Solution was agreed upon by the ‘inclusive’ framework despite the exclusion of a vulnerable and important group of stakeholders.

Taxation is a controversial issue and the success of a system of taxation requires buy-in from the stakeholders who will be affected by the rules implemented. It is for this reason that a well-known economist, Adam Smith, devised four basic rules for proper tax policy, namely equity (the idea that people and organisations should pay tax in proportion to their income), certainty (the idea that taxes should be clear and transparent), convenience (the idea that the timing and method of paying taxes should be convenient) and economy (the idea that the cost of collecting taxes should be minimised).

This research report argues that lack of participation of developing countries means that their interests have not been considered in an equitable manner to result in balanced tax rules. The needs of developing countries cannot and should not be ignored when setting international tax policy.

The OECD is not an elected body and this research report illustrates that the balance of power is inappropriately skewed towards developed countries. This results in a self-interest threat to objectivity that cannot be ignored owing to the impact on developing countries.

The key issue relates to the allocation of taxing rights under the Two-Pillar Solution and whether an equitable solution for developing countries has been achieved.

This report does not focus on the administrative aspects, but rather the key principles of the Two-Pillar Solution.

Research Question

The purpose of this research report is to determine whether the fundamental principles of the Two-Pillar Solution contained in the OECD/G20 Inclusive Framework on BEPS are designed in manner that is equitable to developing countries.

Sub-Questions

In order to answer the main research question the following sub-questions will be addressed:

a. What is a developing country and what are their tax policies?
   This requires an understanding of what factors differentiate developing countries from developed countries. Further, an understanding of how the tax policies of developing economies differ from developed economies.
b. To what extent did developing countries participate in the development of the Two-Pillar Solution?

This requires an understanding of the various role players, including the OECD, G20 and G7, their membership composition and objectives. Assessing the balance of power between developed and developing countries is required.

c. What are the tax challenges that the Two-Pillar Solution seeks to address?

   This will require an investigation into various issues such as the impact of digitalisation on traditional business models, the use of tax havens by multinational companies and other BEPS mechanisms identified by the OECD. Further, understanding the extent to which existing international tax laws do not adequately address these tax challenges is required to give justification for the Two-Pillar Solution.

d. How will the Two-Pillar Solution address these tax challenges and what is the impact on developing countries?

   To answer this question, an analysis of the fundamental principles of Pillar One and Pillar Two is required. The fundamental principles of the Two-Pillar Solution must be evaluated against the stated objectives and existing international tax norms and standards. The assessment of the basis for allocating taxing rights between developed and developing countries is a key aspect of the evaluation.

e. Are anti-tax-avoidance measures such as including CFC rules and digital services taxes effective in addressing the tax challenges identified?

   This will require a gap analysis between CFC and digital services taxes and the rules contained in the Two-Pillar Solution (in other words, why does existing CFC rules and Digital Services Taxes not address the tax challenges?).

Chapter Outline

Chapter 2 outlines who the key players are, including the G7, G20 and OECD. It interrogates the membership composition of these role players, whether there is a balance of power and whether these role players should have the mandate to impose global tax rules.

Chapter 3 discusses the role of tax policy in developed and developing countries and how tax incentives used as a tool to attract foreign direct investment should not be equated to tax havens that enable the abuse of global tax systems.

Chapter 4 outlines the tax challenges arising from the digitalisation of the economy. Key international tax rules including nexus through permanent establishment and source rules are discussed, as well as the shortcomings of these existing rules.

Chapter 5 provides a brief overview of the Two-Pillar Solution, its objectives and how the framework seeks to address the tax challenges identified by the OECD.

Chapter 6 outlines and analyses the key provisions of pillar one through the lens of a developing country. Existing sources rules and new source rules, allocation of taxing rights and the scope the rules are outlined. Finally, the impact on enacted Digital Services Taxes imposed by some countries is outlined in terms of the provisions.

Chapter 7 outlines the key provisions of Pillar Two, namely the GloBE rules, including the objectives. The global minimum tax rules.

Chapter 8 explores alternative mechanisms to address the tax challenges identified by the OECD, in specific, the existing CFC regime.

Chapter 9 concludes on the overall impact of the Two-Pillar Solution on developing countries, including key issues identified in the analyses.

Chapter 2: Who are the key role players?

The purpose of this chapter is to obtain an understanding of who the key role players are in the devise of the Two-Pillar Solution, namely OECD, the Group of Seven and the Group of Twenty. It is necessary for any international forum or organisation that seeks to influence or set rules of international taxation to have adequate representation of both developed and developing countries so that an appropriate balance of power is maintained. This chapter will critically analyse the composition of the membership of the key role players and provide a view on where developing countries are adequately represented, evidencing a balance of power. Finally, this chapter will challenge whether it is appropriate for these role players to set international tax rules.

The Organisation for Economic Co-Operation and Development

The OECD is an international organisation that currently consists of 38 member countries[1] which collaborate to establish international standards and policies to address social, economic and environmental challenges (OECD 2021a).

The objectives of OECD are as follows (OECD n.d.):

I. To collect and analyse data to inform and influence economic, social and environmental policies of its member states and partners
II. To facilitate discussions and consultation on policy options and common rules
III. To set international standards in collaboration with its member countries and policy guidance for policy makers
IV. To provide support in the implementation of policies and international agreements
V. Peer review amongst its member countries to assess policies and suggest improvements.

A brief history of the OECD

The OECD, headquartered in Paris France, was established in September 1961 when it superseded its predecessor, the Organisation for European Economic Co-operation (OEEC) (OECD 2020a).

The OEEC was formed on 16 April 1948 (OECD 2019a) as a channel to administer aid to Europe for its reconstruction after World War II in accordance with the Marshall Plan (OECD 2020a). The

[1] Refer to annexure 1 for full membership of the OECD.

Marshall Plan, also known as the European Recovery Program, was an initiative of the United States of America (USA) to provide financial assistance to Western Europe for the reconstruction of cities, industries and infrastructure that were damaged during the war, to remove trade barriers between Western European countries and promote commerce between European countries and the USA (History.com Editors 2020). The plan was named after George Catlett Marshall, the United States Secretary of State in 1947, who proposed the plan for the economic recovery of Europe for which he was awarded the Nobel Peace Prize in 1953 (History.com Editors 2020).

The OEEC originally had 18 participants, namely: Austria, Belgium, Denmark, France, Greece, Iceland, Ireland, Italy, Luxembourg, Netherlands, Norway, Portugal, Sweden, Switzerland, Turkey, United Kingdom, Western Germany and the Free Territory of Trieste (OECD 2019a).

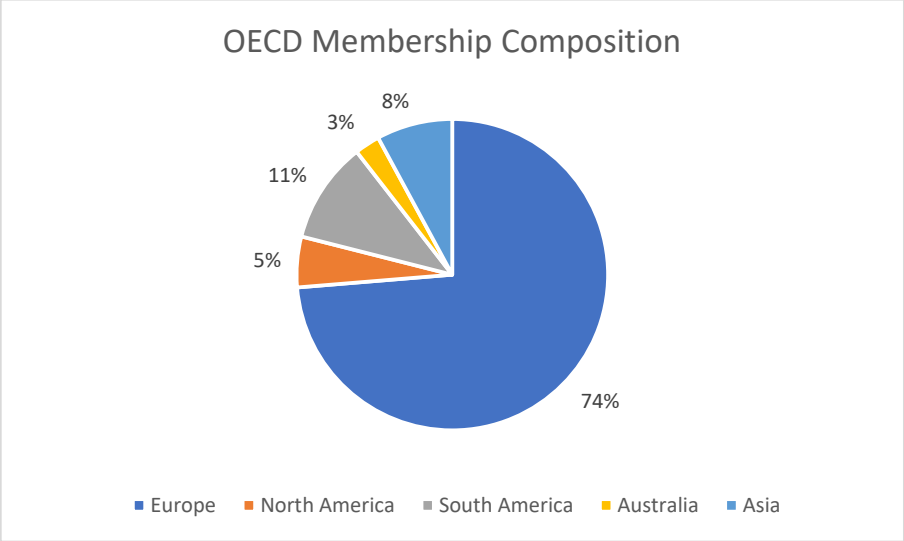
In September 1961, the OEEC was superseded by the OECD in include not only its European founder countries, but also the United States of America and Canada (OECD 2019a).

The significance of the history of the OECD is to demonstrate that the organisation was established primarily to serve the interests of European and North American countries. That is not to say that the organisation has not evolved beyond its original mandate, but merely to recognise the risk that dialogue, decision-making and policy recommendations put forward by the OECD are highly likely to be in the best interests of these countries for whose benefit the organisation was formed in the first place.

Membership composition of the OECD

The membership of the OECD by continent consists of 28 European countries (representing 74% of its membership), both North American countries (representing 5% of its membership), four South American countries (representing 11% of its membership), three Asian countries (representing 8% of the membership) and Australia (representing 3% of its membership).

Below is a graphical illustration of the membership of the current OECD membership by region:



The combined representation of North America and Europe, in whose interests the organisation was established represents 79% of overall membership today. There is not one African member country, home to many of the poorest countries in the world such as Burundi, South Sudan, Somalia and Malawi (Bajpai 2021) with the lowest per capita income.

The composition of the membership of the OECD is significant in assessing the balance of power and the extent to which a country or group of countries interests are adequately represented in a forum that seeks to play a significant role in influencing global tax policy, amongst other objectives.

The balance between 'developed' versus 'developing' countries in the membership of the OECD is a significant factor when assessing the fairness of the rules that the OECD seeks to implement under the proposed Two-Pillar Solution. Therefore, this concept will be discussed further.

What is a developing country?

The World Economic Outlook (WEO) classifies countries into two major groups, namely advanced economies and emerging and developing economies (International Monetary Fund [IMF] 2012).

There are various methodologies used to classify countries, two approaches will be discussed namely the criteria applied by the International Monetary Fund (IMF) and the United Nations (UN).

The IMF utilises three main criteria to classify the economies of the world, namely (Advocates for International Development Lawyers 2013; Worlddata.info 2022; IMF 2022b):

i. Per capita income level, which is a measure of the average income per person in a specific country (Corporate Finance Institute [CFI] 2021a)
ii. Diversification of exports and
iii. Degree of integration into the global financial system

The United Nations utilises a metric known as the Human Development Index (HDI) to determine whether a country is a developed or developing country (World Population Review 2022) which considers the following dimensions:

i. Long and healthy life, measured with reference to life expectancy at birth
ii. Knowledge (or education), measured with reference to expected years of schooling for children and mean years of schooling for adults
iii. A decent standard of living, measured by gross national income per capita (United Nations Development Programme 2022)

A developing country is generally characterised by having a standard of living, income, economic and industrial development that remains below average (Worlddata.info 2022).

The list of countries considered to be developing countries as defined includes Central America and the entire South American and African continents (Worlddata.info 2022). According to the International Monetary Fund, there are 152 developing countries[2] with a population of approximately 6.62 billion, representing about 85.20% of the world total population (Worlddata.info 2022).

The population of developing countries makes up approximately 85% of the world population and yet there are only six OECD member countries which are considered developing countries namely Chile, Columbia, Costa Rica, Mexico, Poland and Turkey.

According to the United Nations, developed economies (used interchangeably with countries) consist mainly of countries that form part of the European Union and other countries including Iceland, Switzerland, Norway, Australia, Canada, Japan, New Zealand, United States of America. In terms of the UN country classification, there is sub-group of 'advanced economies' referred to as 'major developed countries' which is based on the membership of the G7 (United Nations 2014).

The majority of OECD member countries are developed countries with above average basic economic country conditions. The notable absence of African countries and adequate

[2] Refer to annexure 2 for a full list of developing countries.

representation of developing countries is of concern considering the role the OECD has assumed in setting global tax standards.

Group of Twenty and Group of Seven

The Group of Twenty (G20) and the Group of Seven (G7) are key role players owing to their relationship with the OECD and their contribution and influence over the global tax reform proposed under the Two-Pillar Solution.

What is the Group of Seven?

Established in 1975 the G7, originally the Group of Eight (G8) before Russia was removed, is an informal forum consisting of the world's leading industrial countries namely Canada, France, Germany, Italy, Japan, the United Kingdom and the United States of America (European Commission n.d.).

The United Nations also refers to the G7 as 'major developed economies' in terms of its country classification (the United Nations 2014).

Annual summits are held between its member countries to determine multilateral political responses to global challenges (European Commission n.d.).

According to the European Commission, the courses of action taken by the G7 are not legally binding but exert strong political influence, therefore political direction has a ripple effect across other international organisations and institutions (European Commission n.d.).

The G7 finance ministers held discussions in June 2021 to agree on key elements of the global tax reform contained in the OECD Two-Pillar Solution (KPMG in Ireland 2021; Milliken 2021). Therefore, it can be reasonably inferred that G7 exerted significant political influence over the global minimum tax provisions provided for under the Two-Pillar. This brings into question the extent of influence that the G20 had over the key elements of the global tax reform and whether the nature of its participation was merely to ratify the decisions politically agreed upon by the G7.

The significance of this is to demonstrate the risk that key elements of the global minimum tax reform agreed by the G7 may be in the best interests of these advanced nations caused by the balance of power being skewed towards the most advanced economies in the world.

What is the Group of Twenty?

Established in 1999, the Group of Twenty (G20) is an international forum for economic co-operation on key issues of global financial stability (Zamfir 2021).

At inception, the forum consisted of the finance ministers and central bank governors of the G20 countries which collaborated to discuss the response to the global financial crises that occurred from 1997 to 1999 (G20 2021). The forum has evolved to include heads of state of the member countries as well as international and regional organisations who participate in the forum (G20 2021).

The membership of G20 consists of 19 countries and the European Union[3], which is an economic and political union consisting of 27 European member countries. Furthermore, 7 of the 19 countries are G7 members and three of the G7 members' (France, Germany and Italy) representation is reinforced through their EU membership. The presence of the European Union (EU) and the G7 shifts the balance of power in favour of developed European countries within the G20.

Notably absent is the under-representation of African countries as South Africa is the only African member country. Overall, developing countries are not sufficiently represented in this group.

Although the G20 members contribute to the majority of world GDP and international trade (the G20 members account for more than 80% of world gross domestic product and 75% of global trade) this does not mean that the forum is balanced in its membership composition but rather highlights the imbalance in the global economic participation between developed and developing countries (G20 2021). The inadequate representation of developing countries in the G20, a partner to the OECD in the development of the Two-Pillar Solution and other global tax standards, is a key risk to the developing countries. International tax policies should enable developing countries to improve their participation in the global economy and empower developing countries to migrate from developing to developed status. It is for this reason that the impact of the Two-Pillar Solution on developing countries should be thoroughly considered.

The significance of highlighting the composition of the OECD, G7 and G20 is that they have assumed the role of influencing significant global tax reform without adequate collaboration with developing countries, especially African countries. There is a heightened risk that key elements of the Two-Pillar Solution may have been designed without adequate consideration for the interests of developing countries. The impact could be far reaching and may not have been adequately considered.

[3] Refer to annexure 3 for full membership of the G20.

This brings into question whether the OECD, G7 and G20 are the appropriate forums to set global tax reform standards objectively and free of political interference and immoderate influence.

Chapter 3: Tax Policy Considerations for Developing Countries

In order to assess the impact of the Two-Pillar Solution on developing countries, an understanding of the role of tax policy in developing countries is an important factor. This chapter discuss the key challenges facing developing countries and the role of tax incentives. This chapter addresses the need to distinguish between a tax haven which enables tax abuse and the legitimate use of tax incentives by all countries to meet their fiscal needs.

According to the IMF an ideal system of taxation is characterised by the following (Tanzi & Zee 2001):

1. An ideal tax system should raise essential revenue without the need for excessive borrowing by government
2. An ideal tax system should not discourage economic activity
3. An ideal tax system should not deviate too much from tax systems in other countries

The Role of Tax Incentives in Developed and Developing Countries

Developing countries face a number of unique challenges in achieving ideal tax systems such as uneven distribution of wealth and income and informal economic sectors which has a direct impact on the composition of tax revenue and the design of tax mechanisms (Tanzi & Zee 2001).

The tax policies of developing countries are materially different to developed nations owing to factors such as political power, wage income disparities and the sophistication of tax administration. For example, developed countries derive more personal income tax than corporate tax when compared to developing countries (Tanzi & Zee 2001).

Tax incentives are justified when used to promote industries that will have a positive impact in the rest of the economy and to meet the development needs of the country, however, other factors such as natural resources, political stability, infrastructure, a skilled labour workforce and a transparent regulatory environment are also important in attracting foreign investment (Tanzi & Zee 2001).

Almost all countries use tax incentives. In developed countries, tax incentives are usually in the form of investment tax credits, accelerated depreciation and favourable tax treatment for research and development expenditure (United Nations 2018). Developed countries also adopt tax rules that favour export activities and seek to provide their resident companies a competitive advantage in the global economy.

Developing countries use tax incentives to attract foreign direct investment and grow domestic industries using tax holidays, regional investment incentives, special economic zones and reinvestment incentives (United Nations 2018).

It is clear from the differences in the type of incentives offered by developing and developed countries indicates that developed countries are typically capital-exporting countries and intellectual property is highly like to be owned by companies who are tax resident in developed countries.

The use of tax incentives is not illegal, nor should it be concluded that it results in unfair tax competition as there are bona fide reasons for the use of tax incentives by both developed and developing countries. However, the issue lies where multinational companies expand to a tax haven when there is no substantial economic nexus for being there and the sole reason for their tax residency in that country is to evade tax and conceal information material to tax authorities.

Which countries are enablers of tax abuse?

The Corporate Tax Haven Index evaluates each country's tax and financial systems to evaluate the world's greatest enablers of global corporate tax abuse (Tax Justice Network 2021). The top 25 countries according to the Corporate Tax Haven Index of 2021 is as follows: 1) British Virgin Islands, 2) Cayman Islands, 3) Bermuda, 4) Netherlands, 5) Switzerland, 6) Luxembourg, 7) Hong Kong, 8) Jersey 9) Singapore, 10) United Arab Emirates, 11) Ireland, 12) Bahamas, 13) United Kingdom, 14) Cyprus, 15) Mauritius, 16) Belgium, 17) Guernsey, 18) France, 19) China, 20) Isle of Man, 21) Malta, 22) Spain 23) Germany, 24) Hungary, 25) United States of America.

According to the Corporate Tax Haven Index of 2021, the top 25 'enablers of corporate tax abuse' is made up mainly of developed countries, rather than developing countries. The significance of this is that OECD Model Tax Convention already favours developed nations and developed nations, through the OECD, G7 and G20 have a great deal of power and influence over the rules contained in the Two-Pillar Solution. Therefore, there is a risk that the rules contained in the Two-Pillar Solution could be disadvantageous for developing countries, whilst not addressing the base erosion and profit shifting concerns that appear to be enabled by the international tax rules and policies that are in favour of developed countries in the first place.

Chapter 4: What are the tax challenges brought about by the digitalisation of the economy?

The purpose of this chapter is to obtain an understanding of the tax challenges that arise owing to the globalisation and digitalisation of the economy that the OECD Two-Pillar Solution seeks to address. This requires an understanding of how globalisation and digitalisation has changed traditional brick-and-mortar business models. The existing international tax principles for the allocation of taxing rights will be examined, including how these principles are applied to digital business models and the how the resulting gap in international tax laws are exploited by some multinational companies through legally permissible tax planning.

Globalisation

Globalisation, in the economic sense, refers to the integration of economies around the world through the movement of goods, services and capital across international borders (IMF 2008).

Globalisation provides many benefits to businesses, such as access to new geographical markets (which translates to new customers), new products, technology, innovation and competitive labour markets. This enables businesses to achieve scale, efficiency and diversification which translates to improved profitability. Therefore, there are bona fide commercial incentives for businesses to expand their operations across multiple countries.

Multinational companies operate in multiple countries, which generally gives rise to the obligation to pay tax in each of the countries in which they operate. Owing to the increasing integration of global economies and differing rules of taxation across various countries, international tax law (which is concerned with the interface between the domestic tax laws of countries (de Koker, 2010) and the allocation of taxing rights between countries when a transaction occurs cross-border is becoming increasingly important (Engel 2021).

An effective system of tax, domestic or international, should not discourage economic activity (Tanzi & Zee 2001). In the context of globalisation, tax rules should not discourage businesses from expanding their operations internationally for bona fide commercial reasons.

Tax avoidance versus tax evasion

Owing to the increasing extent of globalisation, multinational companies are concerned with how their tax affairs are structured to balance compliance with domestic law and minimising the tax liability across all global operations. Multinational companies are entitled to structure their tax affairs in a manner that exploits the tax regimes of the countries in which they operate to their best advantage, within the parameters of the law, to reduce the tax payable whilst making

full disclosure of material information to tax authorities (Musviba n.d.). This is referred to as tax avoidance and can be achieved through various mechanisms such as utilising tax deductions, changing one's business structure or establishing an offshore company in a tax haven (Deloitte 2022).

A tax haven is a country or jurisdiction that offers certain tax benefits such as lower tax rates, credit mechanisms or deductions resulting in limited or no tax being levied on certain profits (Deloitte 2022). Tax havens generally have less onerous exchange control, labour, equity and other requirements than other countries, resulting in overall ease of doing business (Deloitte 2022). Tax havens may be legally utilised in tax planning if profits are properly attributable to the tax haven and sufficient economic substance is maintained to justify their tax residency in that country (Deloitte 2022).

In contrast to tax avoidance, tax evasion refers to the use of illegal means employed to dodge paying tax (Musviba n.d.). Multinational companies could utilise tax havens illegally to evade tax. This is usually achieved by establishing shell companies with no economic activity in tax havens to conceal profits and benefit from lower tax rates in the tax haven, rather than paying tax in the true country of tax residency (Deloitte 2022). This diversion of business profits to low or no tax countries results in base erosion and profit shifting, thereby allowing multinational companies to avoid paying their fair share of taxes and results in the loss of tax revenues in the countries from which business profits are diverted.

Digitalisation

The digital economy is 'the global network of economic and social activities that are enabled by platforms such as the Internet, mobile and sensor networks'. The digital economy is driven by the rapid advancement in technology and access to technology equipment (such as smartphones and laptops) and the internet (Hadzhieva 2016).

The rapid advancement of technology means that the global economy is increasingly becoming more digitalised which has disrupted traditional business models. New business models arising from digitalisation include e-commerce, app stores, online advertising, cloud computing, participative networked platforms, high speed trading and online payment services (Davis Tax Committee 2013).

The main tax challenges arising from digitalisation are that:

I. There is no tax nexus (connection) to permit allocation of taxing rights to the countries from which revenue is derived (Hadzhieva 2016) and

II. Existing source rules and principles are not suited to digital business models

Nexus through permanent establishment

Digitalisation enables businesses to sell goods and services to customers situated anywhere in the world with little or no physical presence in the countries where customers are consuming those goods and services. The intangible nature of digital products and services and intellectual property means that companies do not have to conduct their business in the same country where their consumers are located. In other words, digitalisation allows companies to be physically removed from the location where economic activity takes place (Hadzhieva 2016).

The lack of physical presence in the countries where revenue is derived means that companies can avoid having a permanent establishment in that country and avoid the tax net of that country (Hadzhieva 2016). This presents a challenge for existing tax rules which are designed for traditional brick-and-mortar businesses.

Under existing international tax rules, cross border transactions may be subject to tax in either the source country or the country of residence (van der Zwan, 2020).

The source country may tax the income on the basis that the income was derived from this country, using its resources. This is referred to as source-based taxation as the nexus (connection) lies between the source country and the income (de Koker, 2010). The source of income can be determined by identifying what the originating cause (the activities undertaken to earn the income) of the income is and where that originating cause is located (*Commissioner for Inland Revenue vs Lever Bros & Unilever Ltd* (1946) as cited in van der Zwan, 2020).

The country of residence may tax income on the basis that residents of a country are subject to tax on world-wide income (van der Zwan, 2020). The nexus lies between the country of residence and the company as the taxpayer. The tax residency of a company is mainly determined with reference to the place of incorporation and the place of effective management (OECD, 2017).

Both the country of residence and the source country may tax income, therefore, there is a need to allocate taxing rights between countries to avoid double taxation. This allocation is done through a tax treaty.

A tax treaty is an agreement between two or more countries, whose main objective is to allocate taxing rights between the country of residence of the taxpayer and the country of source where the income arises, thereby avoiding 'juridical double taxation' (which is occurs when two or

more countries impose tax on the same person, in respect of the same amount) (van der Zwan, 2020). There are two main tax treaties, namely The OECD Model Convention on Income and on Capital 2017 (The OECD Model Convention) and The United Nations Model Double Taxation Convention between Developed and Developing Countries (The UN Model Convention) (van der Zwan, 2020). Generally, these two conventions allocate taxing rights in a similar manner, with a few exceptions.

OECD Model Convention allocates the unlimited right of taxation of business profits to a source country if the business is carried on through a permanent establishment located in the source country and this unlimited right of taxation applies to the profits attributable to that permanent establishment only (OECD 2017).

Because the first right of taxation of business profits is generally granted to the source country, it is generally expected that the country of residence grants relief from double taxation where there is an overlap (de Koker, 2010).

Where a company does not carry on business through a permanent establishment in a foreign country, the source country has no taxing rights under the OECD Model Convention and, consequently, the country of residence will enjoy the full taxing rights in respect of the cross-border income earned.

In terms of the OECD Model Tax Convention on Income and on Capital, permanent establishment means a fixed place of business through which the business of a company is carried on (OECD 2017). It is a test of physical presence in a country, therefore, source countries do not automatically have taxing rights if a multinational company conducts operations and derives income in that country.

Even prior to the digitalisation of the economy, the requirement of the physical presence means that source countries are not adequately empowered to impose corporate income taxes on multinational companies who directly benefit from the infrastructure and other resources in source countries but are able to escape the tax net by limiting their physical presence to the 'bare bones' such the physical presence test is not met.

This has resulting in multinational companies exploiting the default allocation of taxing rights to the country of residence by establishing tax residency in tax havens. A common tax avoidance mechanism employed by some multinational companies entails holding intangible assets such as patents, trademarks and copyrights (which are material revenue-generating assets for digital multinational companies) in shell companies registered in tax havens. A shell company is a

company that does not have actual business operations; it exists only on paper (CFI 2021b). The intangible assets are then licenced to other group companies located across various countries (Bloomberg Tax 2022). Sales and licensing fees generated from the intangible assets will then be attributable to the tax haven and at worst, licensing fees may be subject to royalties withholding tax at a rate much lower than the corporate tax rate in those other countries (Bloomberg Tax 2022).

According to the OECD Model Convention, royalties may only be taxed in the country of residence of the person who owns the intellectual property from which the royalty arises. The OECD Model Convention defines royalties as 'the consideration for the use of, or the right to use, any copyright of literary, artistic or scientific work including cinematograph films, any patent, trademark, design or model, plan, secret formula or process, or for information concerning industrial, commercial or scientific experience'. The source country only has the right of taxation if the intellectual property owner carries on business in the source country through a permanent establishment (OECD 2017).

The OECD refers to tax planning strategies that exploit gaps and mismatches in tax rules to artificially shift profits to low or no-tax locations where there is little or no economic activity or to erode tax bases through deductible payments such as interest or royalties as 'base erosion and profit shifting' (BEPS) (OECD 2022a). Not all BEPS schemes are illegal (OECD 2022)[1], however, they undermine the fairness of the international tax system as multinational companies are able to extract value from countries without adequately contributing to much needed tax revenue required to develop key infrastructure and provide goods and services necessary to enable commerce in the first place.

Schemes employed by digital companies have resulted in significant loss of tax revenues, prompting the European Union and its member countries to conduct investigations. Some of the findings include (Hadzhieva 2016):

- The investigation of Google Incorporated for tax evasion in Italy between 2009 and 2013, totalling 250 million euros.
- The investigation of Apple, launched in March 2015, for diverting profits through Ireland resulting in a tax saving of 897 million euros.
- The investigation into Alphabet (the parent company of Google Incorporated) for tax losses incurred by the UK tax authorities since 2005. A settlement was reached whereby Google voluntarily paid 130 million pounds to compensate for the tax losses.

According to the European Union, Google employed a scheme dubbed the 'Double Irish Scheme' or 'Double Irish and a Dutch Sandwich' which resulted in Google paying effective tax of 2.4% across the countries in which it operates despite those countries having an average statutory corporate tax rate of 20% (Hadzhieva 2016). Google Ireland, registered in Ireland, held the license for search and advertising technology (the intellectual property). When users located in Europe, the Middle East and Africa place a search advertisement on Google, they pay licensing fees (royalties) to Google Ireland. Owing to the allocation of taxing rights under the OECD Model Convention, the licensing fees paid were not taxable in the source countries (being the country the intellectual property is utilised) located in Europe, the Middle East and Africa, but rather in Google Ireland being the country of residence of the person that owns the intellectual property. Google avoided paying any withholding and corporate tax in those countries. According to Ireland's tax laws, the country of residence is the country where effective managements occurs even if the company is incorporated in Ireland. Google registered a company called Google Ireland Holdings in Ireland and which had its effective management located in Bermuda. Bermuda imposes no taxes on business profits, income, dividends, or capital gains and has no requirement to distribute dividends (PWC 2022). In terms of Ireland's tax laws, the business profits of Google Ireland were taxable in Bermuda where effective management occurred. However, the royalties were subject to withholding tax in Ireland, since no double tax agreement existed between Ireland and Bermuda. In order to avoid withholding taxes on royalties in Ireland, Google Ireland made payments to Google Holdings, who then made payments to Google Netherlands, a shell company, to exploit the tax exemptions on passive income earned in a foreign country and the double tax agreements with tax havens such as Bermuda. Google was able to achieve double non-taxation through the avoidance of the United States and the Irish income tax, which impose corporate income tax at a rate of 35% and 12,5% respectively.

Gap in source rules

The source of income can be determined by identifying what the originating cause (the activities undertaken to earn the income) of the income is and where that originating cause is located (*Commissioner for Inland Revenue vs Lever Bros & Unilever Ltd* (1946) as cited in van der Zwan, 2020).

However, it is not always clear which activities result in the income-generation for digital products and services. Is it where the intellectual property is developed, in other words, where research and development activities take place or where those services are consumed?

According to the OECD, profits associated with the use of intangible assets should not be divorced from value creation (OECD 2013). The term value creation is not defined by the OECD.

The methodologies applied in determining the fair value of intangible assets may provide insight on the factors that drive the value of intellectual property. Fair value is defined as the 'price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date (an exit price)' (International Reporting Financial Standards Foundation 2022).

There are three principal methodologies for valuing intellectual property, namely (World Intellectual Property Organisation [WIPO] n.d.):

a. Income method, based on the present value of the amount of economic income that it is expected to generate
b. Market comparable, based on the price of a similar asset in the market
c. Cost method, based on the cost of a similar or exact intangible asset

The value of intellectual property is mainly driven by the ability of the assets to generate future economic benefits and the ability to restrict competitors from accessing those future economic benefits (WIPO n.d.).

The market and cost methods are not appropriate or possible when intellectual property is unique in nature, which is often the case for digital companies. The income method is the most used method of valuation and is determined by the ability of the intellectual property to generate future cash flows, which a function of the consumption of the intellectual property by the users or consumers.

The value of intellectual property developed by digital companies would vary depending on the target market based on factors such as purchasing power, market size and access to telecommunication equipment and infrastructure.

A company could expend resources developing intellectual property and still not monetise it, with no recourse to sell the asset. Therefore, value creation cannot be separated from the consumption of intellectual property, which should in turn inform the source of the income.

According to the Davis Tax Committee, source rules for digital good or services could be based on where the recipient who pays for the digital goods or services is based at the time of supply to align with the OECD's recommendation to base the source rules on the 'payor principle' similar to royalties (Davis Tax Committee 2013).

In summary the key tax challenges arising from the digitalisation of the economy relate to the allocation of taxing rights in the absence of physical presence in a country from which revenues are generated and the absence of clear source rules and principles for digital goods and services.

It is important that domestic and international tax law is adapted to accommodate changing business models so that services are effectively taxed and to ensure that balance is maintained between the taxing powers of various countries (de Koker, 2010). Statute and regulation are cornerstones of tax law, therefore, changes to tax models must be based on the foundation of existing statutory principles and doctrines (de Koker, 2010). This Two-Pillar Solution will be assessed against these criteria in the following chapter.

Chapter 5: What is the Two-Pillar Solution and how does it address the tax challenges arising from the digitalisation of the economy?

The purpose of this chapter is to obtain an understanding of the Two-Pillar Solution and how it addresses the tax challenges arising from the digitalisation of the economy.

What gave rise to the Two-Pillar Solution?

The OECD Two-Pillar Solution is a derivative of the OECD/G20 Inclusive Framework on Base Erosion and Profit Shifting (the Inclusive Framework) to address the tax challenges arising from the digitalisation of the economy (OECD, 2021d).

Prior to the proposal of the Two-Pillar Solution, the OECD introduced a 15-point action plan (in 2013) to assist governments with domestic and international rules and instruments to address tax avoidance that ensure that profits are taxed where income-generating activities take place and where value is created (OECD, 2019b).

In summary the 15-point action plan consisted of the following initiatives to combat BEPS:

Action 1: Address the tax challenges arising from the digitalisation of the economy

This action aims to develop a solution to the tax challenges arising from rapid digital transformation that existing international tax rules do not effectively address.

Some countries have since introduced a unilateral tax on digital services, referred to as Digital Services Tax, which is a tax on selected gross revenue streams of large digital companies (Asen & Bunn, 2021).

During October 2021, the OECD finalised and released the Two-Pillar Solution in response to Action 1.

Action 2: Neutralising the effects of hybrid mismatch arrangements

This action aims to neutralise efforts by companies who employ aggressive tax planning schemes to exploit differences in the tax treatment of an entity or instrument between different countries to achieve double non-taxation and long-term taxation deferral.

Action 3: Designing effective Controlled Foreign Company Rules

This action aims to develop recommendations to strengthen existing Controlled Foreign Company (CFC) rules to disincentivise companies from shifting profits from their market countries into foreign subsidiaries to exploit low tax rates (OECD, 2019b).

Action 4: Limitation on interest deductions

This action aims to combat base erosion using interest expense to achieve excessive deductions or to finance the production of exempt or deferred income by establishing rules to link interest deductions to the level of economic activity in the country (OECD, 2019b).

Action 5: Countering harmful tax practices

This action aims to counter harmful tax practices of countries by conducting assessments of preferential tax regimes, implement compulsory transparency requirements between countries, and introducing substance requirements (OECD, 2019b).

Action 6: Prevention of tax treaty abuse

This action is concerned with the development of tax treaty provisions and recommendations to prevent the granting of treaty benefits inappropriately (Patel, 2015).

Action 7: Prevention of artificial avoidance of permanent establishment status

This action aims to prevent the avoidance by companies of having a taxable presence in a country under tax treaties by amending the definition of 'permanent establishment' under Article 7 of the OECD Model Tax Convention (OECD, 2019b).

Actions 8 -10: Alignment of transfer pricing outcomes with value creation

These actions aim to strengthen existing transfer pricing standards to result in better alignment with value created by the multinational groups (OECD, 2019b).

Action 11: BEPS data analysis

This action aims to collect and analyse tax avoidance mechanisms and the effectiveness of BEPS measures in combating these mechanisms.

Action 12: Mandatory disclosure rules

This action requires taxpayers and advisors to disclose aggressive tax planning arrangements to tax authorities (OECD, 2019b).

Action 13: Country-by-country reporting

This action requires all large multinational companies to prepare country-by-country reports reflecting income, profit, taxes paid and economic activity for each country of operations (OECD, 2019b).

Action 14: Improving the effectiveness of dispute resolution mechanisms

This action is concerned with improving the effectiveness and timeliness of resolution of tax disputes between countries (OECD, 2019b).

Action 15: Developing multilateral instruments

This action aims to develop a multilateral instrument to close loopholes in international tax treaties in line with certain BEPS recommendations (OECD, 2019b).

According to the OECD, despite the introduction of the 15-point BEPS action plan, existing international tax rules still allow multinational companies to generate income in a country without paying their fair share of tax in that country. A key issue that remains is the ability of multinational companies that rely on intellectual property to shift profits to low-tax countries, which is exacerbated by 'unhealthy tax competition' (OECD, 2021b).

The Two-Pillar Solution was introduced to address the tax challenges that arise from the digitalisation of the economy. It consists of:

1. **Pillar One** of The Two-Pillar Solution addresses allocation of taxing rights of business profits of multinational companies in response to the digitalisation of the economy, which the existing rules of international taxation do not adequately address (OECD, 2021c).
2. **Pillar Two** seeks to impose a minimum tax of 15% on large multinational companies to limit unfair tax competition and ensure that multinational companies pay their fair share of tax (OECD, 2021b).

Chapter 6: Pillar One

There are two key issues that Pillar One seeks to address, namely:

I. The absence of clear source rules for revenue generated from digital goods and services and
II. The lack of physical presence of digital companies that results in tax avoidance under existing international tax rules.

The source of digital goods and services and physical presence

Under existing international tax rules, the right of taxation of business profits lies with the source country only if a multinational company conducts its operations through a permanent establishment located in the source country.

The source country is identified by determining what the income-producing activities of the business are and establishing where these activities are conducted.

The income generating activities can be determined with reference to where the key income generating assets are located. The key income generating assets for digital companies such as Facebook, Google, Netflix, Apple and the other companies alike consists of intellectual property, including patents, trademarks and copyrights. The innovation of these digital companies is embodied in their intellectual property. The intangible nature of intellectual property and the human capital investment required to develop it means that physical presence of a multinational company is not required in a country, but rather, they require the ability to connect digitally to exchange information and ideas. This can be done from anywhere in the world.

The location of income producing activities is complicated by the intangible nature of digital commerce. The originating cause of income derived by digital companies is the digital services. However, the location where the services are rendered does not necessarily correlate with the location where digital services are consumed.

This results in ambiguity around the source of digital goods and services; even multinational companies consume resources and public goods of countries where their services are consumed, such as telecommunication infrastructure and service providers.

The implication of the digital business model is that countries from which multinational digital companies generate income lose taxing rights, because digital companies do not require physical presence in a country, thereby limiting the ability of countries to impose source-based

taxation on business profits. Consequently, this means that multinational digital companies are more likely to be subject to residence-based taxation rather than source-based taxation. Digital multinational companies are then able to select tax residency based on the countries that have the most favourable tax rules and incentives for digital multinational companies, which are usually tax havens.

Where digital companies earn royalty income on intellectual property, the allocation of taxing rights under the OECD Model Tax Convention favours the country of residence (which is usually a developed country), which has the exclusive right of taxation unless the royalties arise through a permanent establishment in the source country (OECD, 2017). In this case, the source country (which is generally the country of residence of the person paying the royalty or the country where the intellectual property is utilised) is allocated the first right of taxation. Digital companies are able to benefit from establishing residency in low-tax countries where royalty income is taxed caused by the exclusive right of taxation afforded by the OECD Model Tax Convention. In contrast, the UN Model Convention affords the source country, which is often a developing country, greater taxing rights (van der Zwan, 2020).

The irony of this tax efficient structure is that it is founded on the very principles of international taxation that favoured developed countries. Most digital companies listed on the Forbes list of the top 100 digital companies (Forbes 2022) are situated in developed countries, therefore, the risk of base erosion owing to the diversion of profits to tax havens through schemes such as the 'Double Irish and A Dutch Sandwich' lies exponentially more with developed countries in comparison with developing countries. Perhaps more focus should be placed on tightening economic substance rules for tax havens and improve the equitable allocation of taxing rights under the OECD Model Tax Convention.

Objective of Pillar One

The main objective of Pillar One is to focus on redistributing the allocation of taxing rights over business profits to market countries whether or not there is a physical presence (OECD, 2021b). Market countries are where users and customers are located. This is achieved through 'Amount A' which is discussed in further detail below.

Pillar One also aims to standardise the remuneration of related party distributors that perform 'baseline marketing and distribution activities' in a manner that is aligned with the arms-length principles (OECD, 2021c). This adjustment to the taxable income of related-party distributors is referred to as Amount B. The OECD anticipates that the basis for determining Amount B could

be return on sales plus a fixed return for each geographic location and industry (OECD, 2021c). The rules and principles for Amount B are being developed by the OECD and will be completed by the end of 2022 (OECD, 2021b). Therefore, this will not be discussed in further detail.

What are the new source rules?

Pillar One establishes a new revenue sourcing rule for in-scope multinational companies. Revenue is sourced to the end market country where goods and services are used or consumed. To facilitate the application of this principle, detailed source rules for specific categories of transactions will be developed. In applying these source rules, the multinational company must use a reliable method based on facts and circumstances (OECD, 2021b).

The new source rule introduces a new standard to the allocation of taxing rights over business profits such that taxing rights should not require the physical presence of a company, as long as profits are sourced from the country that seeks to impose tax. The establishment of new revenue sourcing rules provides clarity in the age of digital services, where the source of revenue is not clear owing to the virtual nature of e-commerce.

This is a step in the right direction as it elevates the substance-over-form principle that even though a multinational company does not have a permanent establishment in a country, it does not mean that source countries should lose their taxing right over profits generated in that source country. It acknowledges that source countries are entitled to impose tax on foreign companies that generate income from that country on the basis that those multinational companies benefit from public goods and services, and that the users and customers of digital products and services cannot be separated from the digital products and services themselves in determining value.

Which multinational companies are in-scope?

Multinational companies with a global turnover over €20 billion and a profit margin above 10% will be allocated to qualifying market countries (OECD, 2021b). The intention of the OECD is to reduce the turnover threshold from €20 billion to €10 billion contingent upon successful implementation, with a review beginning seven years after the date that the agreement becomes effective.

Multinational companies within the extractive and regulated financial services industry are specifically excluded from Pillar One rules.

It is estimated that fewer than 80 multinational companies will fall within the scope of Amount A (Navarro, 2021).

The scope of Amount A does not only cover digital multinational companies but any multinational company that meets the revenue and profitability thresholds. This goes beyond the scope of tax challenges of the digitalisation of the economy that BEPS Action 1 seeks to address.

Further, the use of revenue thresholds excludes a large number of the multinational companies, which consume resources of market countries such as telecommunication infrastructure without contributing to the tax base of the market country. This opportunity cost has a greater impact on developing countries which require tax revenues to build infrastructure and meet other sustainable development goals.

The rationale for applying the provision of Pillar One to just a few multinational companies is not an equitable and consistent application of tax principles. As long as a multinational consumes resources in a market country and derives value from that market country, it should be liable for taxation.

Perhaps the fact that most top countries are located in major developed countries has something to do with this rationale, as developed countries only need to tax a small number of high tax value multinationals to generate high tax revenues.

How are taxing rights allocated to qualifying market countries?

A market country will qualify for taxing rights of Amount A if they meet the requirements of the new 'special purpose nexus rule'. In terms of this special purpose nexus rule, a market country is allocated taxing rights for the business profits of in-scope multinational companies only if that multinational company generates at least one million euros in the that country. The threshold will be reduced to €250 000 if the market country has a GDP lower than 40 billion euros.

In terms of the OECD Model Tax Convention, business profits are taxed first at the source country provided that those profits are attributable to a permanent establishment. Therefore, the new sourcing rule allows for a nexus to be established, forming the basis for allocating taxing rights to market countries.

The existing OECD Model Tax Convention imposes no further qualifying requirements to afford source countries taxing rights over business profits. Contrary to this existing international tax standard, the special purpose nexus rule imposes qualifying criteria (over and above the nexus established from the new source rules) to permit the taxing rights over business profits through Amount A.

The imposition of the special nexus rule may result in a material loss of tax revenues for developing countries. The concept of materiality is relative. From the perspective of developing countries, the opportunity costs of much needed tax revenues forgone caused by the requirement for market countries to generate a minimum amount of revenue may appear to be immaterial to developing countries.

Further, one could argue that the revenue threshold imposed by the special nexus rule is discriminatory as it favours countries with greater populations, per capita income and economic activity. This is often not the case for developing countries and especially the poorest nations in the world, which have low levels of economic participation.

A fixed revenue threshold does not consider the revenue generating capacity of countries, particularly smaller countries. This creates a global economic environment that inhibits the ability of smaller countries, such as Madagascar, which is also among the poorest nations in the world, to meet sustainability goals owing to the limitation on the ability to generate tax revenues.

On the other hand, multinational companies can exploit small market countries to increase their consolidated global profits. Smaller market countries are highly likely to be profitable to digital companies which have low investment requirements, as the intellectual property costs are sunk costs and any additional revenue generates improves profitability. However, digital multinationals are enabled to extract value and pay their fair share of taxes merely because the market country is small relative to developed countries. This would be highly inequitable and detrimental to developing markets.

Under existing international tax norms and standards, source countries are entitled to tax full profits derived from a source country. Article 7 of the OECD Model Tax Convention does not provide for any limitation on the amount of business profits, so long as they are derived from the source country imposing the corporate income tax (OECD 2017). In contrast to this principle, Pillar One allocates taxing rights over a portion of business profits of large, profitable multinational companies through the allocation of Amount A.

Amount A is 25% of the residual consolidated profit of an in-scope multinational company. Residual profit means profit in excess of 10% of revenue.

Financial accounting principles, for example International Financial Reporting Standards (IFRS) or Generally Accepted Accounting Principles (GAAP), will form the basis for determining the amount of profit taxable under Amount A. Any losses will be carried forward.

Once the quantum of Amount A has been determined, this must be allocated to all qualifying market (source) countries based on the proportionate share of revenue contributed by each qualifying market country.

The mechanisms available to resident countries to relieve in-scope multinational companies for the double taxation of profits allocated to market countries are the income exemptions or tax credits.

The limitation on taxable business profits to 25% of residual profit is not consistent with the objective to ensure that a fair share of tax is paid in the countries where profit is generated and merely preserves existing international tax rules. This modest reallocation of taxing rights means that multinational companies are still able to benefit from the gap in international tax rules because the increase in the tax burden is minimal (Navarro, 2021).

The opportunity cost of market countries not being entitled to tax 100% of business profits generated from the source country has a far greater impact on developing countries, which require tax revenue to build and maintain public infrastructure and services to enable commerce and sustainable economic growth.

Further, one could argue that the design of Amount A allows for multinational companies to utilise key telecommunication and other public infrastructure and services in market countries to generate income without paying adequate compensation. There is a likelihood that this could result in losses for the economies of market countries, where the cost of enabling e-commerce outweighs the benefit derived through tax revenues.

The rationale for allocating only a portion of business profits is not clear and not consistent with international taxing standards. It negates the impact of establishing clear source rules in the first place.

One could speculate that the quantity of Amount A should be low enough so that it leaves room for the global minimum tax regime to generate meaningful additional tax revenue for developed countries, where the largest digital companies in the world are tax resident. The global minimum tax regime will be explored in the next chapter.

The OECD expects rules in relation to Amount A to come into effect in 2023.

Digital Services Taxes

Pillar One requires countries to remove all digital services taxes and other similar measures with respect to all companies. Pillar One requires that no newly enacted digital services taxes may be

imposed on any company until the earlier of 31 December 2022 or the effective date of the Multilateral Convention.

The aim of digital services tax is to allocate taxing rights over the income of technology-based multinational companies to the market countries to whom they sell their products, collect data from and target advertising to, regardless of their physical presence in the market country (Morris & Brown, 2022).

Digital services tax is not a corporate income tax, online sales tax or value-added tax (which is an indirect tax on the consumption of goods and services in the economy (South African Revenue Service, 2022). It is generally a tax on the gross on various digital revenue streams such as online sales, digital advertising, data usage, e-commerce, streaming and downloading (Morris & Brown, 2022).

A few African countries have implemented direct digital services tax that applies to non-residents with no physical presence in their countries:

- Effective 1 January 2021, Kenya introduced digital services tax at a rate of 1.5% on income generated through a digital marketplace (a platform that enables the direct interaction between buyers and sellers of goods and services through electronic means).
- Effective 1 January 2020, Tunisia introduced a digital services tax at a rate of 3% on gross income from the sale of computer appliances and digital services.
- Effective 1 January 2019, Zimbabwe introduced a digital services tax at a rate of 5% on gross income from satellite broadcasting services and e-commerce companies providing goods and services to persons who reside in Zimbabwe (Deloitte, 2020a).

Some European countries have also introduced digital services taxes including France, Italy, Australia, the United Kingdom, Turkey and Spain (Deloitte, 2020b).

African countries, and other developing countries, are deprived not only of corporate income tax, but also of various other taxes including employment taxes, environmental taxes, and property and land taxes caused by the lack of physically present technology-based multinational companies in African countries and other developing countries (Magwape, 2021). Instead, multinational companies establish only strategic regional offices, which limited the tax residency, resulting in significant reduction of tax obligations across the continent.

Digital services taxes addresses the issue of tax avoidance by multinational companies owing to the lack of physical presence and allows full taxing rights on income generated from market countries (unlike Pillar One that limits taxing rights and the amount).

The potential gains from digital services taxes presents a sustainable source of tax revenue for developing countries as the digital economy will only grow as technology penetrates developing economies, and with the rapid advancement of technology.

The African Tax Administration Forum (ATAF) has developed a proposal on digital services taxes that meets the needs of African countries. This is known as the Suggested Approach to Drafting Digital Services Taxes (the Suggested Approach).

Chapter 7: Pillar Two

The key issue that Pillar Two seeks to address is the tax avoidance of multinational companies by establishing tax residency in tax havens and diverting profits to tax havens where no substantial economic activities take place, which is enabled by the business model of digital companies.

Pillar Two proposes that multinational companies should pay a minimum level of tax on the income arising in each country where they operate (OECD, 2021f). This is achieved through the introduction of a global minimum tax at a rate of 15% on corporate income, which limits international tax competition (OECD, 2021b).

Introduction of GloBE rules

Pillar Two introduces a new set of international tax rules, referred to as Global Anti-Base Erosion (GloBE) rules, which is intended to ensure that multinational companies pay a minimum level of corporate income tax in each country in which income arises (OECD, 2021e). The GloBE rules consist of two rules, namely the 'Income Inclusion' rule and the 'Under Taxed Payments' rule

Scope of GloBE rules

The GloBE rules apply to multinational companies that have generated consolidated group revenue in excess of €750 million in at least two of the four years preceding the financial year under review (OECD, 2021e).

The consolidated group revenue means the consolidated revenue in the financial statements of the ultimate parent entity of the multinational group (OECD, 2021e). Group revenue may not be reduced by any amount attributable to minority interests and excludes inter-group revenue that is eliminated upon consolidation of group revenue (EY, 2022).

The ultimate parent entity of a multinational group is not owned by any other entity and owns a controlling interest in any other entity within the multinational group (OECD, 2021d).

Each company, permanent establishment, trust or partnership or any other legal entity that forms part of an in-scope multinational group must apply the GloBE rules (OECD, 2021d). During March 2022, the OECD released Commentary to the Pillar Two Model Rules, which states that joint ventures and associates are not subject to the GloBE rules because the ultimate parent entity does not control these entities (EY, 2022). Control is generally evidenced by having a majority of voting and economic participation rights.

The following entities are not subject to the GloBE rules (OECD, 2021d):

a) Government entities

b) International organisations

c) Non-profit organisations

d) Pension funds

e) An investment fund that is an ultimate parent entity

f) Real estate investment vehicles that are ultimate parent entities

Even though the GloBE rules do not apply to the above-listed excluded entities, the rules can still apply to sub-groups controlled by excluded entities (EY 2022).

Similar to Pillar One, Pillar Two does not only cover digital multinational companies but any multinational company that meets the revenue and profitability thresholds. This goes beyond the scope of tax challenges of the digitalisation of the economy that BEPS Action 1 seeks to address.

As noted above, the use of revenue thresholds excludes smaller market countries from attaining their fair share of taxing rights. This opportunity cost has a greater impact on developing countries, which require tax revenues to build infrastructure and meet other sustainable development goals.

The use of a revenue threshold could be seen as discriminatory, since all companies should be subject to the same tax rules. Further, the design of the scope rules enables multinational companies that are similar in size with slightly less revenue to escape minimum global tax rules, which could be competitively disadvantageous to multinational companies which fall within the scope of the GloBE rules.

A real estate investment trust (REIT) is an investment fund or security that is listed on a stock exchange and invests in income-producing commercial real estate such as office and apartment buildings, warehouses, hospitals, shopping centres and hotels (Corporate Finance Institute, 2020). Globally, REITS received favourable special tax considerations.

The exclusion of investment funds and REITS will favour capital exporting countries, which are typically developed countries.

The rationale for subjecting only the top multinational companies to taxation in qualifying markets does not speak to the stated intention of the Pillar Two, which is to ensure that multinational companies pay a minimum amount of tax on all profits.

The rationale for including only a small portion of high tax-value multinational companies is not based on an objective selection and appears to be intended to generate incremental tax revenues rather than set objective rules of taxation that apply to all companies.

The scope of the GloBE rules is inextricably linked to the countries to which taxing rights are allocated. The scope requirements do achieve a consistent and equitable application of rules imposing tax.

What are the GloBE rules and how are they applied by in-scope multinational groups?

The GloBE rules impose a minimum tax at a rate of 15% on all in-scope multinational companies through a top-up tax to the extent that actual tax paid by the multinational company in a country falls below the global minimum tax rate.

GloBE rules consists of two rules that achieve this objective, namely the Income Inclusion Rule and the Under Taxed Payments Rule.

The Income Inclusion and Under Taxed Payments Rule impose a top-up tax using an effective tax rate test that is applied on a country-by-country basis to identify low-taxed entities within the multinational group (OECD, 2021d).

The GloBE rules requires that the effective tax rate is determined for each country on an annual basis, according to the formula below (OECD, 2021d):

Effective tax rate for a country =

Total adjusted covered taxes for all group entities operating in that country/

Total net profit or loss of all group entities operating in that country

The effective tax rate aggregates all group entities that operate in a country, akin to a country-specific consolidated effective tax rate. Put simply, the effective tax rate is the tax paid on income generated in that country.

The aim of computing the effective tax rate on a country-by-country basis is to isolate countries whose domestic tax rules do not impose adequate taxes as measured by the minimum tax rate.

Covered taxes are taxes on income and capital imposed by a country, irrespective of the manner in which they are levied (OECD 2014).

Adjusted covered taxes in respect of must take into account the following:

- Taxes on income or profits recorded in the financial statements of the group entity (both domestic and foreign taxes imposed on the company's profits are included, for example, taxes paid under controlled foreign company rules)
- Taxes on distribution or deemed distribution of profits to shareholders
- Taxes in place of corporate income tax
- Taxes levied with reference to retained earnings and corporate equity
- A deferred tax adjustment amount to address temporary differences

The tax base represents the income earned in country from all countries operating in that country and is determined with reference to the consolidated profit or loss for all group companies in that country, prior to any consolidation entries to eliminate inter-group transactions (Deloitte, 2021b). This is then adjusted to exclude the following:

- Tax expense
- Dividends
- Gains or losses from equity transactions (such as the sale of shares)
- Asymmetric foreign exchange gains or losses (Law Insider, n.d.)
- Disallowed expenses (such as bribes)
- The effect of prior period errors
- The effect of changes in accounting policies
- Intergroup financing charges that are not included in the income of the counterparty (Deloitte, 2021b)

Consistent with international tax norms and standards, the net profit or loss for each entity must include transfer pricing adjustments where inter-group transactions are not at arm's length.

The inclusion of all taxes, including passive income in the determination of the effective tax rate is directly impacted by the limitation on taxing rights imposed by the OECD Model Tax Convention. Royalties may not be taxed by source countries, and limited withholding taxes on interest and dividends may be imposed by source countries. This prejudices developing source countries compared to developed, capital exporting countries, which are allocated a greater proportion of taxing rights over passive income.

If a country's economy is not well-established or developed, there is a high likelihood that the economy of that country is reliant on a few sectors. Tax incentives in those countries may be designed to capitalise on those sectors, which countries are entitled to do. Each country may

design tax incentives unique to the resources and other advantages. Foreign companies which establish substantial economic nexus in those countries may be unfairly penalised when they are participating in the economy of that country on a fair and transparent basis.

This disempowers developing countries when competing for limited international capital resources. Although investors consider alternative factors when allocating capital to projects, the absence of attractive tax incentives reduces the cost-benefit ratio and may result in alternative investment options. Any loss to developing countries is not just a loss to their tax base, but also a loss of jobs, skilled labour, which impacts on upstream and downstream business that supply to or purchase from companies, to name a few factors.

The exclusion of investment entities from the scope of GloBE rules means that capital exporting countries (where investment entities are likely to be headquartered) do not have an incentive to align their tax policies with GloBE rules. This could be seen as discriminatory as developed countries could easily comply with GloBE rules as an investment qualifying criterion, and yet they do not have to align with this shift in global tax policy. This perpetuates the lack of participation in the global economy as it limits the ability of developing countries to compete with developed countries.

When a country's effective tax rate is above the minimum tax rate, a multinational group is not liable for top-up tax in respect of income generated in that country. Conversely, where the effective tax rate for a country is lower than the minimum tax rate imposed by the GloBE rules, this is considered a low tax country. Consequently, the ultimate parent entity is liable for top-up tax in respect on income arising from that country.

Once low tax countries have been identified, top-up tax in respect of each low-tax country must be computed. The top-up tax in respect of a low-taxed country is determined as follows:

Top-up tax payable for a low tax country =

Top-up tax percentage x (combined tax base of group entities located in the country less substance-based income exclusion).

The top-up tax percentage is the difference between the effective tax rate in the country and the minimum tax rate.

The combined tax base of a country is the same as determined for the purpose of the effective tax rate test.

The substance-based income exclusion is a relief mechanism for substantial activities undertaken in a country. The OECD has identified two factors that form the basis of the substance-based income exclusion, namely human resources and tangible assets. This mechanism provides shelter for industries heavily invested in tangible assets in connection to their operations, such as the extractives industry.

The substance-based income inclusion is determined as follows:

5% of payroll costs for eligible employees performing activities in that country

+

5% of the carrying value of tangible assets used located in that country

The issue with the substance-based income inclusion is that multinational companies with heavy investment in human resources and tangible assets (such as manufacturing and mining companies) would already have sufficient economic nexus to the source country as a permanent establishment, which would be easy to demonstrate. Those multinational companies would be liable for corporate income tax on the business profits generated from those countries. There is no risk of base erosion or profit shifting in this case, therefore the GloBE rule serve no purpose in addressing this risk.

Further, the basis of the substance-based income inclusion rule implies that only certain kinds of business activities are acceptable for investment outside of resident countries, namely industrial and related operations. This is based on the OECD's limited interpretation of what would benefit developing nations. There are a multitude of other sectors, such as information technology, professional services and media entertainment, that are capable stimulating job creation and sustainable economic development. The OECD tax rules and standards should observe and promote the sovereignty of developing countries to determine their own tax incentives according to their developmental and fiscal needs, as long as they comply with international standards and norms.

The percentages applied to payroll costs and book value of intangible assets are rather modest at just 5%. Further, the decreasing book value of tangible assets means that this benefit has a finite period, inconsistent with the long-term sustainable development needs of developing countries.

Once the top-up tax in respect of a low tax country has been determined, the ultimate parent entity must pay its proportionate share (based on an income apportionment basis) of top-up taxes in respect of each entity located in a low tax country.

Top-up tax of a constituent entity =

*country top-up tax **

(tax base of the group entity for the year less portion of the tax base attributable to minority shareholders)/

tax base of all group entities in the country.

The ultimate parent entity is not required to pay top-up tax in respect of constituent entities that have a net global loss.

The allocation of taxing rights under the global minimum tax rules to the ultimate parent entity is a significant issue in the design of the rules.

The source of the income is the country where operations are located and where income arises. Under the OECD Model Tax Convention, source countries have the first right to tax business profits if the operations are conducted through a permanent establishment located in the source country. Assuming that the permanent establishment requirement has been met, all of the business profits that arise in the source country should be taxed in the source country.

Pillar One rules eliminate the need for physical presence to account for the business model of digital companies and establish a nexus between the market country and the multinational company.

Based on the above two factors, any additional tax should follow the same country where profits are primarily taxed. Owing to the tax residency of the top 100 multinational companies in the world, developed countries (where the ultimate parent entity is most likely to be located) would be the biggest winners.

Developing countries are seldom enablers of tax abuse, as evidenced by the Corporate Tax Haven ranking. The rules are designed to divert potential tax revenues from developing countries to the country of the ultimate parent company, even though legitimate business operations are conducted in many developing countries.

This means that developing countries fall in the same bracket as countries which are notorious for perpetuating tax abuse. Perhaps greater focus should be placed on establishing, enforcing

and monitoring economic substance rules as the risk for BEPS lies with tax havens rather than most developing countries.

The ultimate parent entity is not required to pay top-up tax in respect of low-taxed constituent entities in its jurisdiction. The reason for this exclusion is not clear, but it appears to be biased in favour of developed countries.

The Under Taxed Payments Rule is not the primary GloBE rule, but rather acts as a backstop designed to address base erosion and profit shifting through payments made by group entities located in a low tax country to avoid paying taxes, as implied by the name (payments to under taxed group entities) (McKenzie 2021).

Under the Income Inclusion Rule, top-up tax is imposed on the ultimate parent entity to the extent of their ownership interest in a low taxed group entity. The Under Taxed Payments Rule is designed to disincentivise multinational groups from making any adjustments to take advantage of any top-up tax saved on profits attributable to minority owners (OECD, n.d. 'Under Taxed Payments Rule'; OECD, 2020b).

The Under Taxed Payments Rule applies in respect of low taxed group entities and applies only to the extent that the Income Inclusion Rule has not been applied. This means that the Under Taxed Payments Rule imposes a residual top-up tax to the extent that the Income Inclusion Rule did not result in a low tax group entity paying a minimum rate of tax.

The Under Taxed Payments Rule does not apply to investment entities (OECD, 2021d). Further, owing to the complexity and administrative burden of applying this rule, a multinational group may elect not to apply the Under Taxed Payments Rule on the basis that there are no low taxed group entities or that any low taxed group entities are under the control of another group entity that applies the Income Inclusion Rule (OECD, n.d. 'Under Taxed Payments Rule'; OECD, 2020b). In other words, the Under Taxed Payments Rule will not apply to a low taxed entity that is controlled by another group entity that applies the Income Inclusion Rule.

An example of when the Under Taxed Payments Rule would be applied is where the ultimate parent entity has an effective tax rate below the minimum rate but is excluded from the requirements of the Income Inclusion Rule. Unlike the Income Inclusion Rule, the Under Taxed Payments Rule applies to ultimate parent entities located in a low taxed country.

The application of the Under Taxed Payments Rule results in the denial of a deduction (or requirement to make a similar adjustment under domestic law) for group entities equal to an

amount that results in an additional cash expense equal to the residual top-up tax (OECD, 2021d).

The Under Taxed Payments Rule utilises the same principles as the Income Inclusion Rule with regards to determining top-up tax in respect of low taxed group companies.

The top-up tax is allocated only to entities that are subject to the Under Taxed Payments Rule based on an allocation key that considers:

a. Base-eroding inter-group payments that are subject to the Under Taxed Payments Rule; and
b. The low-taxed outcomes arising in the countries where that income is not subject to the income inclusion rule.

If a group entity makes a deductible payment to a low tax country, the top up tax allocated to that group entity is the proportion of deductible payments as a proportion of total deductible payments made by all group entities.

This allocation method is applied first and is designed to ensure that the most obvious method of profit shifting through deductible inter-group payments to low taxed group entities is curtailed.

If a group entity has inter-group expenditure, any remaining top-up tax is allocated on the entity's proportionate share of net inter-group expenditure incurred by all group entities.

The second allocation key addresses any conduit structures implemented by multinational groups that route inter-company transactions through entities that are not subject to the Under Taxed Payments Rule so that there are no direct deductible payments to low taxed group entities. This allocation method is based on net related part expenditure without the need to trace the destination of all inter-group payments. The second allocation key does not require the establishment of a connection between a deductible expenditure and a pool of low tax income. It aggregates any remaining low tax income and allocates it in proportion to net related party expenditures; therefore, it acts as a backstop to the first allocation method.

The top tax under the Under Taxed Payments Rule is allocated to the country where the group entity making the payments is located, because it is that country that suffers the tax revenue loss. This means that top-up tax may not be allocated to low tax countries, to prevent top-up tax being allocated away from high tax countries (where the profit shifting risks are greater) towards low tax countries (OECD, n.d. 'Under Taxed Payments Rule'; OECD, 2020b).

The top-up tax allocated forms the basis of the adjustment required. GloBE rules do not, however, prescribe the mechanism by which this adjustment must be made. This is a matter of domestic law implementation that is left to the countries that elect to implement this rule. The adjustment could be through a limitation or a denial of a deduction for payments made to related parties, or could be in the form of an additional tax.

The GloBE rules seek to ensure that large multinational companies are taxed up to the agreed minimum rate where the jurisdictions in which they operate have not exercised their primary taxing rights or the payment is otherwise subject to low levels of effective taxation.

Subject to tax rule

The subject to tax rule targets intergroup payments which take advantage of low nominal rates of taxation in the country of the payee. The subject to tax rule is a treaty-based rule, which may override treaty benefits in existing treaties in respect of certain payments where those payments are not subject to a minimum level of tax in the recipient country (Deloitte 2021a).

The key differences between the subject to tax rule and the GloBE rules are as follows:

- The subject to tax rule may apply irrespective of the size of the multinational group.
- The subject to tax rule only applies to certain levels of categories of related payments.
- The subject to tax rule does not reference the same calculation methodology or rate as generally applied under the GloBE rules, but rather it is applied on a payment-by-payment basis and is triggered where the full amount of a payment will not be subject to tax at a nominal rate of least 7.5% to 9%.

Where the subject to tax rule applies, treaty relief that would otherwise have been provided may be denied, with the maximum applicable withholding tax being 7.5% to 9%. The subject to tax rule applies before the GloBE rules and any tax collected under the subject to tax rule should be factored into the global minimum tax calculations used for the purposes of the GloBE rules.

It also is anticipated that the majority of countries requesting the introduction of the subject to tax rule applies will be developing countries. Accordingly, treaties entered into between larger economies are less likely to be affected by the rule, or may not be affected at all.

Chapter 8: Alternative solutions to address BEPS challenges

The purpose of this chapter is to propose an alternative mechanism to address BEPS challenges that are favourable to developing countries . This chapter will discuss the ability of the CFC regime to address diversion of profits to low-income countries purely for the purposes of avoiding taxation. The Davis Tax Committee noted that jurisdictions which do not adopt CFC rules are not able to address BEPS issues caused by the digital economy in a comprehensive manner (Davis Tax Committee, 2013). The implementation and strengthening of existing CFC rules are alternatives to Pillar Two which imposes a global minimum tax on in-scope multinational companies whilst maintaining maintain tax sovereignty.

Controlled Foreign Company Rules

Companies may expand their operations to a foreign country for bona fide commercial reasons. Domestic and international tax laws should not inhibit the ability of companies to expand their operations globally.

As previously noted, companies may divert profits generated in one country to shell companies in tax havens with favourable tax rules for the sole purpose of avoiding and reducing their tax obligation. This results in the loss of tax revenue in countries where companies are resident and where they operate and generate profit.

The controlled foreign company (CFC) rules address a tax avoidance scheme employed by multinational companies who establish a foreign subsidiary in a low tax country for the sole purpose of avoiding tax, in order to shift profits from the country of residence to the low tax country (OECD, 2019b).

CFC rules targets two main sets of income, which are most susceptible to BEPS (Davis Tax Committee, 2013).:

- Passive income, which includes dividends, interest, other financial instrument income, certain rental income and intellectual property income.
- Diversionary income (defined as income susceptible to transfer pricing), such as sales and services when these inter-group transactions lack meaningful economic nexus to the foreign country

The OECD has published recommendations for the design of effective CFC rules to prevent the inappropriate shifting of profits to foreign subsidiaries, which are contained in the OECD 2015 Action 3 Report (OECD, 2015). This is part of a 15-point action plant to address base erosion and

profit shifting adopted by the OECD and the G20 in September 2013, which is based on three key principles:

- Coherence in domestic rules that affect cross-border activities
- Reinforcing substance requirements in existing international standards
- Improving transparency and certainty

The OECD has identified six elements necessary for the effective CFC rules, namely (OECD, 2015):

1. Rules for defining a CFC
2. CFC exemption and threshold requirements
3. Definition of CFC income
4. Rules for computing income
5. Rules for attributing income and
6. Rules to prevent or eliminate double taxation

According to the OECD, CFC rules which were first enacted in 1962 have not adequately reflected changes in the international business environment and have design features that do not adequately address base erosion and profit shifting effectively (OECD, 2015). Some issues noted by the OECD and recommendations on how CFC rules can be strengthened, are discussed below.

CFC rules generally apply only to foreign companies controlled by shareholders resident in the country attempting to prevent against base erosion and profit shifting (OECD, 2019b). The OECD Action 3 report recommends the inclusion of partnerships, trusts and permanent establishments in the scope of the CFC definition (Davis Tax Committee, 2013).

Existing CFC rules generally apply after the application of provisions such as tax rate exemptions, anti-avoidance requirements and *de minimis* rules. The OECD Action 3 report recommends that CFC rules apply where controlled foreign companies are subject to effective tax rates that are meaningfully below the parent company's country (OECD, 2019b). The anti-avoidance rule under CFC regimes provides full relief for CFC where operations are established in foreign countries for sound business purposes and motives. For example, the United Kingdom applies the 'motive test' in terms of the Income and Corporation Taxes Act of 1988, which assesses whether:

- The main purpose of the transactions during the period was not a reduction in taxation in the United Kingdom.
- The main reason for the controlled foreign company's existence is not the diversion of profits away from the United Kingdom.

This principle is similar to the 'foreign business establishment' rule under section 9D (1) of the South African Income Tax Act of 1962 which provides full relief where the following factors can be proven:

- The existence of a physical structure in the foreign jurisdiction from which primary operations are conducted.
- The existence of suitable number of managerial and operational employees to conduct primary operations.
- The existence of suitable equipment in the foreign country required to conduct primary operations.
- The existence of suitable facilities in the foreign country required to conduct primary operations.
- The location of the business outside of South Africa for purposes other than the avoidance of South African taxation.

The motive test is highly subjective, rather than providing objective guidelines that can be consistently applied and measured across companies. This applies to the foreign business establishment test, as the measurement of 'suitability' is subjective, although more criteria are provided compared to the anti-avoidance requirement under the UK regime.

CFC rules need to be strengthened to ensure that substantial operations occur in the foreign country to justify the allocation of taxes to that country. This is supported by minimum substance requirements proposed by the OECD under BEPS Action 5.

Tax rate exemptions under CFC regimes provide relief when a foreign tax rate is higher than or closely approximates the tax rate of the country in which the parent company's shareholders are resident (OECD, 2019b). This means that CFC rules are designed to prevent the shifting of profits to low-tax countries. This is necessary to ensure that companies are not burdened with a higher liability for tax that would have been incurred had those operations been conducted in the parent company's country of residence.

Tax incentives have the effect of reducing the effective tax rate of companies. Many countries on the African continent employ tax incentive regimes, usually in mining, manufacturing and other brick-and-mortar businesses that are likely to fall outside of the scope of CFC rules owing to their being attributable to a permanent establishment (Davis Tax Committee, 2013).

However, financial centre regimes such as the Botswana International Services Centre and the Mauritius Global Business Company regime provide special tax incentives for regional treasury

operations and international companies (Davis Tax Committee, 2013). The Davis Tax Committee recommends that these regimes should be monitored and minimum substance rules should be enforced and monitored with respect to these regions (Davis Tax Committee, 2013).

CFC rules are effective in reversing the shifting of profits to low-income countries when it can be shown that the sole purpose of the foreign subsidiary is to shift profits and avoid paying tax in the true country of residence.

The OECD is able to clearly identify pitfalls in the design of the CFC regimes of countries and has recommended standards to improve the effectiveness of CFC rules in combating BEPS (Davis Tax Committee, 2013). Unlike Pillar Two, CFC rules allow countries to maintain tax sovereignty, and combat tax abuse whilst allowing for bona fide expansion of business operations to other foreign countries. CFC rules do not discriminate against companies on the basis of size, and allow countries to fully tax companies that fall within the CFC net on an equitable basis.

CFC rules do not create taxing rights; it is rather an anti-avoidance mechanism. The same cannot be said about the global minimum tax regime under Pillar Two that creates taxing rights for parent companies on a basis that is inconsistent with international tax rules.

Chapter 9: Conclusion

The allocation of taxing rights must be done in a manner that achieves equity and certainty. Developing countries are vulnerable to global economic and tax policy, and therefore should be adequately represented in any forum or institution that legislates global laws of taxation without exception.

The OECD is not an elected body, which means that the balance of power and representation is material considering that it seeks to be a global leader in setting tax standards. The research conducted demonstrates that the constitutions of the OECD, G20 and G7 are overwhelmingly representative of developed countries. Developing countries are not adequately represented and this brings into question the ability of these bodies to propose equitable, objective and balanced rules to address international tax challenges. An appropriate balance of power between developed and developing countries does not exist in the present form and presents a self-interested threat to objectivity so great that one could reasonably conclude that these role players should not be imposing global tax reforms.

Both developed and developing countries adapt their domestic tax policies according to serve the best interests of their economies. The use of tax incentives should not be equated with unhealthy tax competition. A key BEPS issue relates to the exploitation by multinational companies of tax havens which enable tax abuse through the lack of minimum substance requirements imposed by their domestic tax laws.

The introduction of source rules by Pillar One creates much needed certainty with regards to source rules over digital goods and services.

The global minimum tax rules (GloBE rules) ensure that only some of the largest multinational companies pay tax on the profits generated from the countries in which they operate. The application of revenue thresholds does not result in the equitable tax treatment of companies internationally.

The allocation of taxing rights under both the GloBE rules and Pillar One is problematic.

The special nexus rules under Pillar One are exclusionary to the detriment of developing countries and are not equitable when compared to countries where the largest multinational companies tend to be headquartered. In addition, the limitation of taxing rights to a modest portion of taxing rights defeats the stated objectives of Pillar One, which are to ensure that

multinational companies pay tax in the countries where they generate profits and extract value.

Allocation of taxing rights to the ultimate parent entity under the GloBE rules is not consistent with international tax rules. This basis for allocation should not be equated with the CFC regime. CFC rules do not create taxing rights – it is an anti-avoidance mechanism. Profits are only taxable in the headquarter country where it can be proven that the sole reason for foreign subsidiary is to avoid taxes. CFC rules do not penalise bona fide business operations established in foreign countries. In contrast, the GloBE rules do not provide for exclusions where multinational companies carry on bona fide business operations in a foreign country. A blanket allocation of taxing rights is afforded to the country of the ultimate parent as long as effective tax rate in a country is below the minimum rate of tax at 15%.

An acceptable mechanism to impose global minimum tax allocates taxing rights to source countries first and in full unless the source country elects otherwise.

Tax havens remain a key BEPS risk. However, a combination of other mechanisms such as the CFC regime, minimum substance rules, and monitoring efforts could address this risk whilst maintaining tax sovereignty and preserving international tax rules and principles for the allocation of taxing rights.

Annexure 1: Membership of the OECD

	Name of Country	Continent	Joining Date (also referred to as the date on which instruments of ratification were deposited)
1.	Australia	Australia	7 June 1971
2.	Austria	Europe	29 September 1961
3.	Belgium	Europe	13 September 1961
4.	Canada	North America	10 April 1961
5.	Chile	South America	7 May 2010
6.	Columbia	South America	28 April 2020
7.	Costa Rica	South America	25 May 2021
8.	Czech Republic	Europe	21 December 1995
9.	Denmark	Europe	30 May 1961
10.	Estonia	Europe	9 December 2010
11.	Finland	Europe	28 January 1969
12.	France	Europe	7 August 1961
13.	Germany	Europe	27 September 1961
14.	Greece	Europe	27 September 1961
15.	Hungary	Europe	7 May 1996
16.	Iceland	Europe	5 June 1961
17.	Ireland	Europe	17 August 1961
18.	Israel	Asia	7 September 2010
19.	Italy	Europe	29 March 1962
20.	Japan	Asia	28 April 1964
21.	Korea	Asia	12 December 1996
22.	Latvia	Europe	1 July 2016
23.	Lithuania	Europe	5 July 2018
24.	Luxembourg	Europe	7 December 1961
25.	Mexico	South America	18 May 1994
26.	Netherlands	Europe	13 November 1961
27.	New Zealand	Oceania	29 May 1973
28.	Norway	Europe	4 July 1961

29.	Poland	Europe	22 November 1996
30.	Portugal	Europe	4 August 1961
31.	Slovak Republic	Europe	14 December 2000
32.	Slovenia	Europe	21 July 2010
33.	Spain	Europe	3 August 1961
34.	Sweden	Europe	28 September 1961
35.	Switzerland	Europe	28 September 1961
36.	Turkey	Europe	2 August 1961
37.	United Kingdom	Europe	2 May 1961
38.	United States	North America	12 April 1961

Source: OECD (2022b)

Annexure 2: List of Developing Countries

Afghanistan	Albania	Algeria	Angola	Antigua and Barbuda
Argentina	Armenia	Aruba	Azerbaijan	Bahamas
Bahrain	Bangladesh	Barbados	Belarus	Belize
Benin	Bhutan	Bolivia	Bosnia and Herzegovina	Botswana
Brazil	Brunei	Bulgaria	Burkina Faso	Burma
Burundi	Cambodia	Cameroon	Cape Verde	Central African Republic
Chad	Chile	China	Colombia	Comoros
Costa Rica	Democratic Republic of the Congo	Djibouti	Dominica	Dominican Republic
East Timor	Ecuador	Egypt	El Salvador	Equatorial Guinea
Eritrea	Eswatini	Ethiopia	Federated States of Micronesia	Fiji
Gabon	Gambia	Georgia	Ghana	Grenada
Guatemala	Guinea	Guinea-Bissau	Guyana	Haiti
Honduras	India	Indonesia	Iran	Ivory Coast
Jamaica	Jordan	Kazakhstan	Kenya	Kiribati
Kosovo	Kuwait	Kyrgyzstan	Laos	Lebanon
Lesotho	Liberia	Libya	Madagascar	Malawi
Malaysia	Maldives	Mali	Marshall Islands	Mauritania
Mauritius	Mexico	Moldova	Mongolia	Montenegro
Morocco	Mozambique	Namibia	Nauru	Nepal
Nicaragua	Niger	Nigeria	North Macedonia	Oman
Pakistan	Palau	Panama	Papua New Guinea	Paraguay

Peru	Philippines	Poland	Qatar	Republic of the Congo
Romania	Russia	Rwanda	Saint Kitts and Nevis	Saint Lucia
Saint Vincent and the Grenadines	Samoa	Sao Tome and Principe	Saudi Arabia	Senegal
Serbia	Seychelles	Sierra Leone	Solomon Islands	Somalia
South Africa	South Sudan	Sri Lanka	Sudan	Suriname
Syria	Tajikistan	Tanzania	Thailand	Togo
Tonga	Trinidad and Tobago	Tunisia	Turkey	Turkmenistan
Tuvalu	Uganda	Ukraine	Uruguay	Uzbekistan
Vanuatu	Venezuela	Vietnam	Yemen	Zambia
Zimbabwe				

Source: WorldData.info (2022)

Annexure 3: Group of Twenty

	Name of Country
1.	Argentina
2.	Australia
3.	Brazil
4.	Canada
5.	China
6.	France
7.	Germany
8.	India
9.	Indonesia
10.	Italy
11.	Japan
12.	Korea, Republic of
13.	Mexico
14.	Russia
15.	Saudi Arabia
16.	South Africa
17.	Turkey
18.	United Kingdom
19.	United States
20.	European Union
21.	Spain is also invited as a permanent guest

Source: G20 (2021)

Annexure 4: Forbes Top 50 digital companies

	Name of Company	**Country**
1.	Apple	United States of America
2.	Microsoft	United States of America
3.	Samsung Electronics	South Korea
4.	Alphabet	United States of America
5.	AT&T	United States of America
6.	Amazon	United States of America
7.	Verizon Communications	United States of America
8.	China Mobile	Hong Kong
9.	Walt Disney	United States of America
10.	Facebook	United States of America
11.	Alibaba	China
12.	Intel	United States of America
13.	Softbank	Japan
14.	IBM	United States of America
15.	Tencent Holdings	China
16.	Nippon Telegraph & Tel	Japan
17.	Cisco Systems	United States of America
18.	Oracle	United States of America
19.	Deutsche Telekom	Germany
20.	Taiwan Semiconductor	Taiwan
21.	KDDI	Japan
22.	SAP	Germany
23.	Telefónica	Spain
24.	América Móvil	Mexico
25.	Hon Hai Precision	Taiwan
26.	Dell Technologies	United States of America
27.	Orange	France
28.	China Telekom	China
29.	SK Hynix	South Korea
30.	Accenture	Ireland

31.	Broadcom	United States of America
32.	Micron Technology	United States of America
33.	Qualcomm	United States of America
34.	PayPal	United States of America
35.	China Unicom	Hong Kong
36.	HP	United States of America
37.	BCE	Canada
38.	Tata Consultancy Services	India
39.	Automatic Data Processing	United States of America
40.	BT Group	United Kingdom
41.	Mitsubishi Electric	Japan
42.	Canon	Japan
43.	Booking Holdings	United States of America
44.	Saudi Telecom	Saudi Arabia
45.	JD.com	China
46.	Texas Instruments	United States of America
47.	Netflix	United States of America
48.	Philips	Netherlands
49.	Etisalat	United Arab Emirates
50.	Baidu	China

Source: Forbes Media (2022)

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