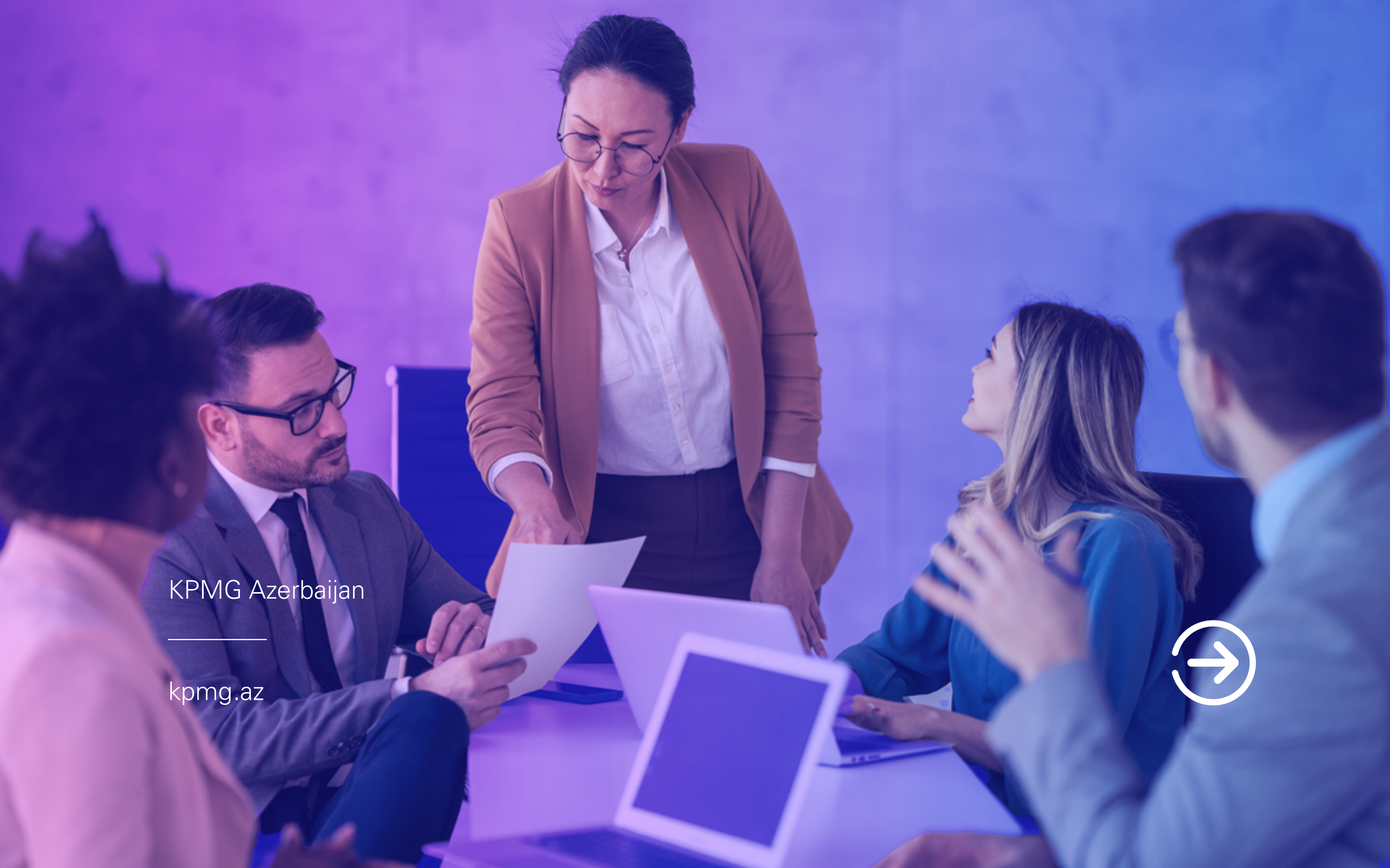
Global tax reboot:

Geopolitics, tax policy and society in flux



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Foreword

As chief tax officers manage complexity and change in tax, it's important to take in the big picture. Geopolitical events and social trends underway today have the potential to drive the tax policy decisions of governments and the business strategies of global companies into the future. Chief tax officers should understand these developments so they can anticipate — and even influence — the potential effects on the business.

KPMG member firm tax and legal professionals have identified three interconnected trends that are likely to reshape the global business landscape and creating uncertainty and risk:

- After decades of ongoing globalization, the international order is splintering and governments are now prioritizing safety and security over measures to promote prosperity and growth.
- International tax is a rare area where multilateral collaboration continues, with consensus being forged over fairer, more efficient tax rules. The consensus is fragile, however, and significant divisions over some of the rules still need to be bridged.
- Income inequality is worsening globally, leading to distrust of politicians and government, and fueling populist and protectionist attitudes.

To help businesses navigate these choppy waters, tax leaders should understand how geopolitical trends might play out, what threats might arise and how exposure can be mitigated. Many companies are taking steps to manage their exposure by scenario planning — considering what's likely, what alternatives are credible, what's unlikely and what's worst case — so they can chart their best course forward. Tax leaders have an important part in these endeavors to shed light on the tax angles of the strategic decisions being made.

The discussion in these pages seeks to provide an informative and insightful analysis of important geopolitical forces at work today and how they may transform the business environment and direction of tax policy in the years to come. Also highlighted are some important considerations for tax leaders as they work to position their teams for success in the new global reality.

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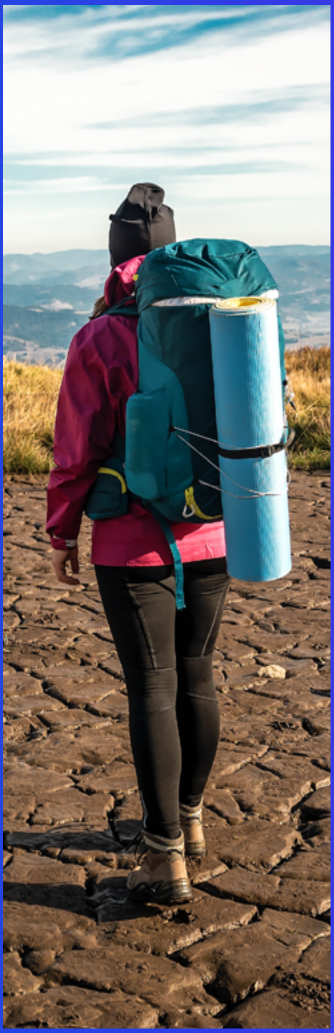
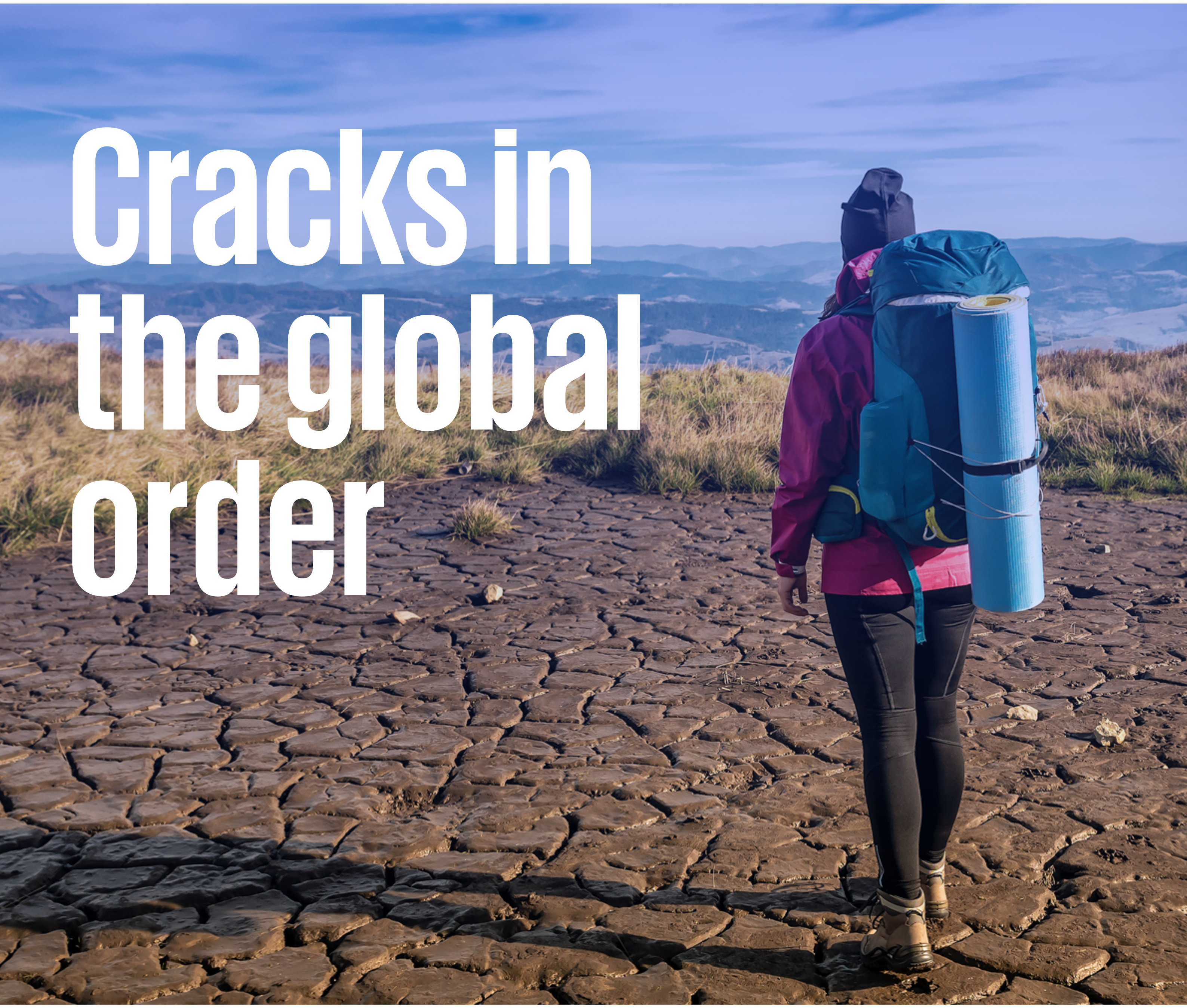


Cracks in the global order

From the pandemic, hyperinflation and extreme weather, to war in Ukraine and the Middle East, the world has been dealt multiple, overlapping crises in the past few years that are straining economies and opening cracks in the global order. Trends that were already underway before 2020 have picked up steam, with partisanship rising, inequality climbing, faith in institutions waning and global trade and capital flows continuing to splinter.

After decades marked by relative harmony and convergence, ongoing divergence and fragmentation are the hallmarks of geopolitics today. Moves toward global consistency on economic dimensions, such as trade, business values and technology standards, have slowed as political and diplomatic relationships veer in the opposite direction. With ongoing tensions between the world's biggest economic powers — China and the US — lesser powers have good reason to align their foreign relationships accordingly.

At the same time, less developed countries are expressing increasing frustration with global institutions and Western leadership after waiting in line for COVID vaccines, suffering immediate food and energy shortages due to the war in Ukraine, and enduring the impacts of climate change caused in large part by wealthier developed countries. Factors like these are leading developing nations to question whether global institutions and Western leadership truly represent everyone's interests.

There are signs that a new order will ultimately stabilize as traditional institutions for global cooperation adapt and new ones are created.

Companies today can no longer count on globalization to drive efficiency and savings as they have for the past decades. Instead, they are operating in a business environment with more cost and complexity than at any time in the past 30 or 40 years.

For example, the G20's step to bring in the African Union as a partner on par with the European Union shows how existing institutions might evolve toward more inclusive representation. As discussed later in this publication, multilateral cooperation on international tax continues to progress, even in the current unsettled environment.

5 factors driving geopolitical risk

Among the factors that are now converging to disrupt the global order, five forces in particular are creating the most pervasive risks:

- **Climate change and the energy transition** — Addressing climate change has become a top priority domestically for many countries. Despite ongoing challenges from powerful constituencies, the transition to clean energy is clearly underway. Climate change will continue to drive geopolitical tension between developed and developing countries over who should bear the burden of emissions reduction. Looking ahead, rising temperatures, sea levels and extreme weather events will probably displace huge populations, with the resulting migrations straining government resources and creating significant economic disruption.
- **Artificial intelligence** — In the past year, generative AI has caught the world's attention, for both its rich potential and its vast, uncharted risks. As discussed later in this publication, there seems no doubt that AI may produce untold discoveries that drive innovation, productivity and growth for global businesses. However, this depends on data that is of good quality and unbiased, and deployed with effective guardrails in place.
- **War in Ukraine and Israel-Hamas conflict** — With the war in Europe now into its second year and neither side gaining a decisive advantage, an end seems out of reach. It is also unknown how the eruption of Israel-Hamas conflict will be resolved. One way or the other, it seems that war will continue to stir volatility in global energy and commodity markets for some time to come.
- **China's domestic economy** — Following an unsustainable period of intense growth, China's domestic economy is undergoing a structural slowdown driven by inflated property and credit markets. While the government works to unlock new growth drivers with longer-term investments in emerging technologies, the pace of its response and depth of the slowdown may erode business and consumer confidence. While it remains to be seen whether conditions improve over time, China's economy will likely remain soft for the near term.
- **China's changing role in the world** — Strategic competition between China and the US seems likely to intensify. Even as the two countries work to keep their relationship stable, tensions will continue to simmer over trade, tariffs and export controls. China's domestic vulnerability on the economic front will likely diminish its appetite for escalating trade disputes any further.

Western companies operating in China will face new pressure and scrutiny from their governments over these investments, and this scrutiny may mount depending on the results of the 2024 US election. Another recent trend is seeing US and other Western governments take more interest in professional services firms and management consultants in China regarding the financing and advisory services they provide to Chinese state-owned enterprises.

Security takes top priority

In this unpredictable environment, some regimes are adopting more aggressive postures, and governments and businesses of democracies are learning that they need to alter their approach to foreign trade and investment in two key ways.

First, despite the growing importance of knowledge and digitalization in generating economic output, democratic nations have realized that it's equally vital to have physical control over the energy, raw material and resources needed to advance further into the digital sphere.

Second, in the past, some countries and territories could attract investment with their simpler rules and greater flexibility. Recent events have shown that these advantages can be vastly outweighed by the substantial risks of investing in such locations.

As a result, many countries are reorienting their economies around national security, rather than economic prosperity. They are also taking steps to secure vital supplies (e.g. vaccines and critical minerals) against emergencies and making strategic choices about how open to trade and investment they want their own economies to be.

As the global order reshuffles, China may become more important as a mediator in regional peace initiatives, especially where the US is unable. China's government has recently shown its capacity to fulfil this role, for example, by brokering the restored diplomatic relations between Saudi Arabia and Iran in April 2023.

Cooperation or competition?

The future of global tax

While geopolitical forces are disrupting international relations, corporate tax is a bright spot where multilateral consensus and cooperation are being won. The achievements of the Inclusive Framework on Base Erosion and Profit Shifting, led by the Organisation for Economic Co-operation and Development (OECD), are extraordinary, especially in view of the geopolitical volatility of the recent past.

According to an OECD tax report[1] issued ahead of the October 2023 summit of G20 finance ministers in Morocco:

- The Inclusive Framework now counts over 140 jurisdictions as members, collaborating as equals on a common approach for improving the global tax environment and to refraining from the adoption of measures, such as digital services tax (DST), that would be contrary to the agreed common approach.
- Following a July 2023 agreement among 138 members, the Inclusive Framework released the text of the multilateral convention (MLC) to establish new taxing rights for market jurisdictions in Amount A of Pillar One.
- The global minimum tax under Pillar Two is now a reality, with about 30 jurisdictions having legislated or in the process of legislating the rules from 2024.

Recent G20 summits are also setting a new tone of inclusiveness regarding developing countries. In February 2023,

[1] https://www.oecd.org/tax/oecd-secretary-general-tax-report-g20-finance-ministers-india-october-2023.pdf

for example, host country India took the lead in sponsoring the admission of the African Union.

Despite these victories, significant issues remain on the Inclusive Framework's agenda that could derail further success. Some developing nations do not think the framework is inclusive enough or that the two-pillar solution fully addresses their issues.

The tax treatment of incentives and how they can be deployed in developing countries under Pillar Two remains unresolved, as do some of the rules for sourcing revenues.

Earlier this year, 119 countries, including China and Singapore, voted in favor of expanding the United Nations' (UN) role in developing global tax principles, including work in areas that overlap with topics being tackled by the OECD. The resolution establishes an ad hoc international committee to draft terms of reference for developing a UN framework of international cooperation, to be finalized by August 2024.[2]

Some of the supporting jurisdictions believe the UN would be a more appropriate forum for this work as a counterweight to the OECD in the interests of developing countries, since any deal forged by the Inclusive Framework nations would be ultimately subject to the wealthier G20 countries' approval.

While the argument may have merit, another view sees it as more important to recognize the urgency of the reforms and use the momentum to build on what is already being accomplished at the OECD, rather getting distracted by which body is better placed to lead on international tax governance in the future.

What's next?

In July 2023, the Inclusive Framework issued an outcome statement[2] setting out its progress to date and allowing countries to move ahead with the reforms. Detailed text of the MLC to implement Pillar One was released in October 2023.

According to the OECD's statement, the MLC's text is largely complete except for a few specific issues to be resolved with a small number of countries. The goal was to finalize the MLC so it could be opened for signing in the northern summer of 2024.

It remains to be seen whether and when the MLC's text will be finalized and ratified by a sufficient proportion of Inclusive Framework members.

Ultimately, however, tax factors will become less important to investment decisions when the new global system is in place. Developing countries will no longer provide tax holidays for investment but may look to other measures to attract foreign investment. That is, instead of tax, capital allocation may increasingly be driven by the framework conditions in a jurisdiction — such as the quality of infrastructure, education standards and respect for rule of law — and greater economic efficiency would result.

There is currently not a global consensus on incentives. To accelerate the transition to renewables, the US has introduced tax credits for clean energy and other green investments. Like many other jurisdictions, the US also offers tax credits for research activities and a range of other general business activities. The Pillar Two rules treat some credits favorably. These include transferable credits, common tax equity structures, and certain refundable credits.

Non-refundable credits are treated less favorably. As a result, a multinational group that receives material nonrefundable tax credits in a jurisdiction, even one with a high-tax rate, could have an effective tax rate of less than Pillar Two's 15 percent threshold and incur top-up tax.

> Once the global minimum tax becomes a reality, countries will have limited ability to compete for foreign investment with non-refundable tax incentives. While other forms of incentive might be offered outside the tax system, mechanisms will be in place to prevent simply shifting tax support to other means.

2 https://webtv.un.org/en/asset/k1e/k1ed7roiks

The unfavorable treatment of the US's nonrefundable R&D credit is particularly controversial.

In fact, while Pillar Two is aimed primarily at eliminating tax benefits on profits earned in low-tax jurisdictions, according to an OECD report[3] released in November 2023, more than half of global profits now taxed below 15 percent are being earned in jurisdictions with high headline tax rates, such as the US and many Latin American countries, due to the generous incentives and concessions that these jurisdictions offer. According to the analysis, less than 28 percent of affected profits are located in low-or middle-income jurisdictions.

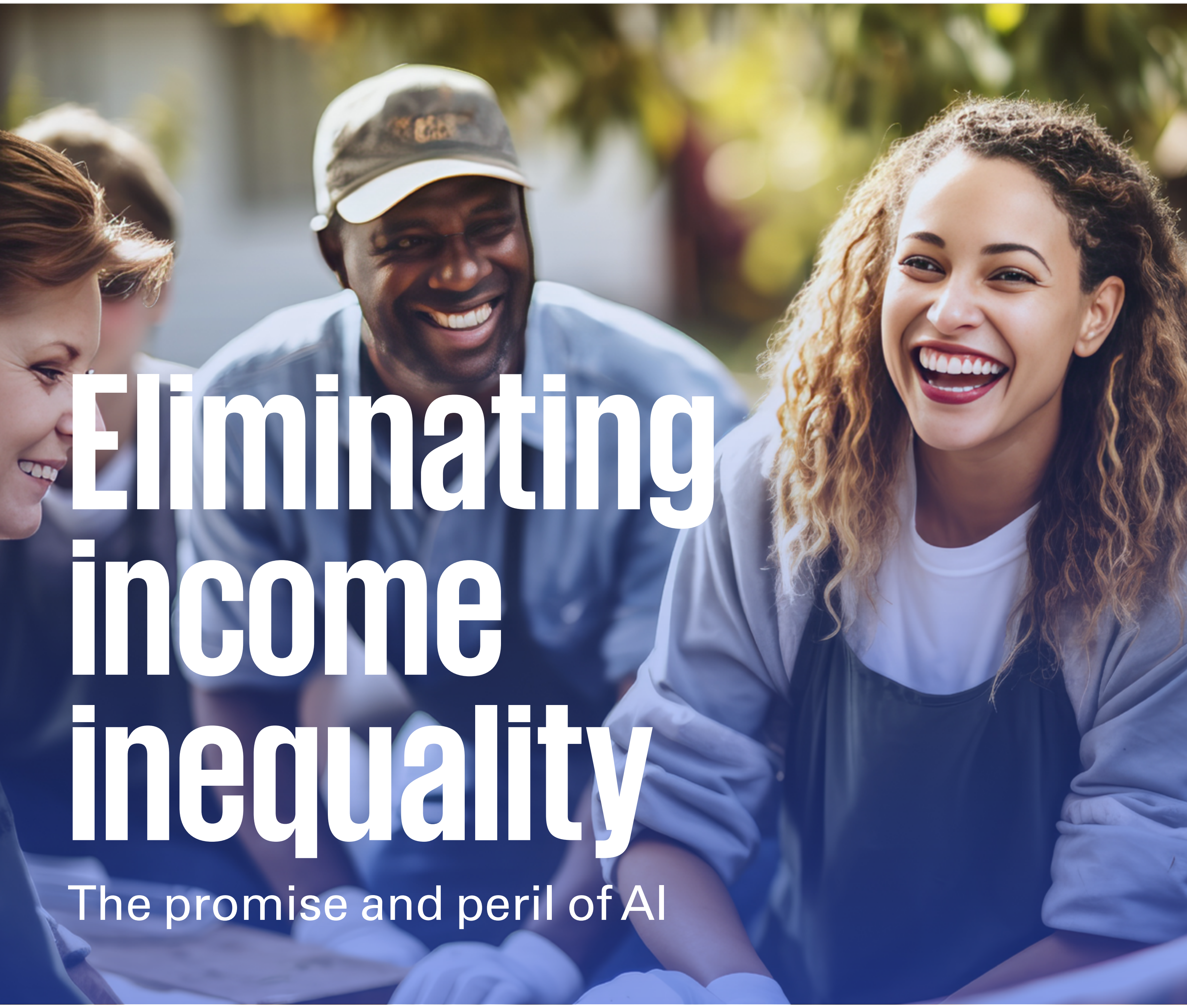
Many of these jurisdictions are considering what concessions they can offer without falling within the ambit of Pillar Two. Possible solutions may involve providing incentives for levies other than covered taxes (e.g. payroll tax holidays), as long as there is no direct corporate tax linkage. Other alternative may involve redesigning incentives so that they conform with the exclusions for qualifying refundable tax credits or substance-based income.

In view of these developments, the Inclusive Framework would do well to reconsider its position on tax credits. Tax incentives will be important mechanisms for accelerating the green transition and other social goods across all sectors. Putting limits on the refundability of tax credits could discourage progress toward these ends. At this stage in the process, it would be unfortunate for the global consensus to get snagged on that point.

The current consensus on Pillar Two remains fragile and must be nurtured. Further delays could put smooth implementation of the rules in jeopardy, and this could lead more countries to introduce DSTs or take other unilateral steps to protect their tax revenue.

Even though these issues remain, the changes that are set to sweep the international tax landscape were unimaginable 10 years ago. The global solution gives a taxing right without a physical presence. It considers the consolidated worldwide position of the taxpayer. It allocates that right to the market jurisdiction based on a formula. The fact that a critical mass of countries have agreed to adopt these game-changing principles is one of the greatest achievements of multilateralism in the past decades.

3 https://www.oecd.org/tax/multinational-enterprises-report-low-taxed-profit-even-in-jurisdictions-with-high-corporate-tax-rates-underlining-need-for-global-tax-reform.htm



Eliminating income inequality

The promise and peril of AI

Some governments may believe income inequality has been rising for decades, but after the pandemic, hyperinflation and supply chain insecurities of recent times, the citizens and nations of the world on the lower end of the income scale are increasingly resentful of the unequal distribution of wealth. They are calling governments, corporations and individuals to account where tax responsibility is seen as lacking.

According to recent statistics on world income and wealth inequality:[4]

- The bottom 50 percent of the world's population earns eight percent of total world income annually (based on purchasing power parity) and owns 20 percent of household wealth.
- The top 10 percent earns more than half of income annually and holds three quarters of household wealth.
- The disparity is even more extreme at the top one percent, who earn 19 percent of the world's total income and own 38 percent of household wealth.

Between countries, research also shows that significant global inequalities exist but have declined over the last two decades. The gap between the average incomes of the richest 10 percent and poorest 50 percent of countries peaked in 1980 at over 50 times more income

[4] https://wid.world/news-article/world-inequality-report-2022/

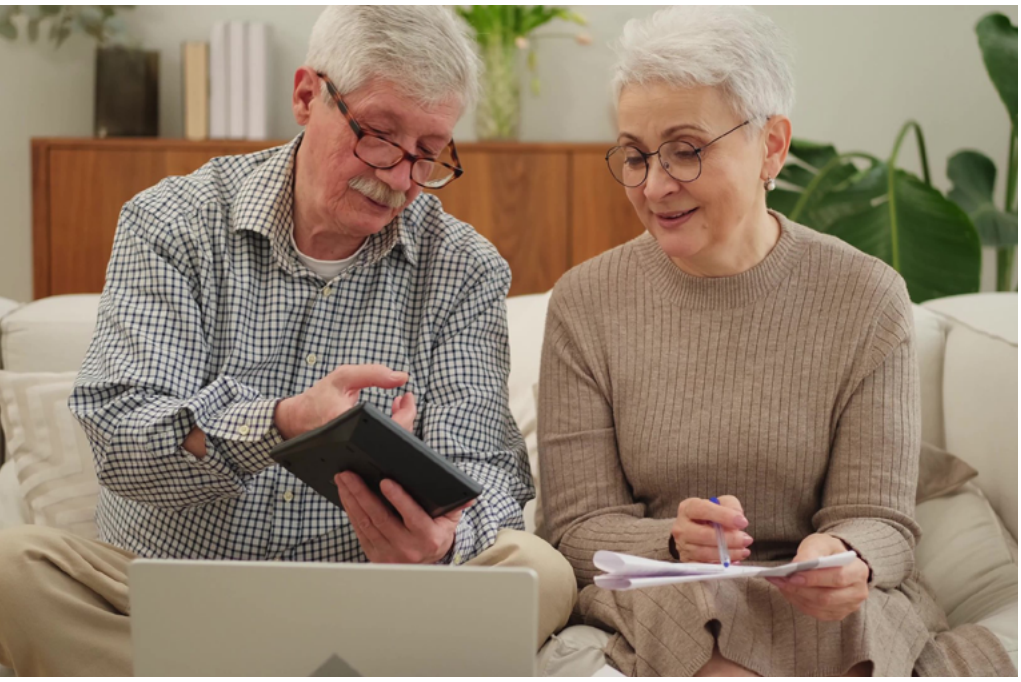
to a little less than 40 times in 2021.[5] Within most countries however, the average income gap between the top 10 percent and bottom 50 percent of individuals within countries almost doubled during that time.[6]

As the income gaps widen, the loss of trust among societies is a powerful undercurrent running through the geopolitical forces discussed earlier in this publication, and the lack of faith extends to tax systems. As rising media scrutiny of the tax practices of global corporations and wealthy individuals has fuelled resentment over the past decade, many middle- and lower-income citizens have come to believe tax systems are rigged against them. Anger has risen over the use of international tax havens and complex global structures by companies and people to avoid tax. Many common types of domestic tax rules for individuals — such as privileged tax rates for capital gains, exemptions for inherited capital property and regressive sales taxes — are coming under fire for aggravating unfairness as well.

Despite growing discontent with politicians and governments among the world's increasingly squeezed middle classes, history has shown that market capitalism produces more prosperity than any other economic system. The problem is that capitalism is seen by many populations as geared primarily toward the short-term interests of making wealthy companies and individuals even wealthier. Healthier capitalist societies set the conditions for ideas to flourish that generate new wealth and sustainable growth that lift the prospects of all citizens.

Consider Africa. With more than 400 million African people now in poverty,[7] much of the continent needs massive investment to raise living standards while greening its economy. But African nations are also rife with opportunity. With ageing demographics in Europe and North America, Africa's higher proportions of youth mean the continent will soon supply one in three workers globally. Sponsoring this shift would require devoting significant funds toward skills training, technology and support for African youth, and especially women.

Private companies have recognized these opportunities and are already looking at strategies to realize them. What's missing are the kinds of innovative financial tools and mechanisms that would stimulate more public-private collaboration across borders on development projects. To eliminate poverty and create the conditions for growth, business and government leaders need to collaborate on policies that steer investment choices toward inclusive, sustainable growth.



[5] HTTPS://WIR2022.WID.WORLD/EXECUTIVE-SUMMARY/
[6] HTTPS://WWW.WEFORUM.ORG/AGENDA/2021/12/GLOBAL-INCOME-INEQUALITY-GAP-REPORT-RICH-POOR/
[7] HTTPS://WWW.STATISTA.COM/STATISTICS/1228553/EXTREME-POVERTY-AS-SHARE-OF-GLOBAL-POPULATION-IN-AFRICA-BY-COUNTRY/

AI can go a long way toward helping improve equality and living standards globally as part of greener, more sustainable economies. But this will depend on ensuring that the businesses that design and deploy AI keep control over the machines and their results, and that they remain accountable to society at large.

Tax and transfer systems can be one of the most potent tools that governments can use to redistribute income and address inequality, but most discussion in the area today remains mired around non-starters such as wealth taxes and taxes on banks. With more creative policy innovations, governments can rebalance the tax treatment of income and capital more equitably and start to close the broadening income gap.

How can AI help improve income equality?

AI and other technologies will be an important element of this process. By applying AI and analytics across vast amounts of data, social benefit programs can be precisely targeted and their intended outcomes verified, tax compliance can be better monitored and enforced, and patterns of tax evasion can be more easily spotted. More broadly, AI could help raise citizens' prospects by breaking down language and accessibility barriers and opening new job opportunities. Its productivity benefits could lessen the impact of projected declines in working age populations in many developed countries.

But like all disruptive technologies, AI holds both promise and peril. Fears are growing over its misuse, given AI's power to sow confusion and interfere in political processes by spreading highly credible misinformation. There are also serious concerns that AI could aggravate existing inequality as gender, racial and other biases in the data that AI uses to learn are rewoven and embedded into generated products.

The rapid development of AI is far outpacing the ability of governments to understand it. Most aspects of AI are controlled by private sector tech companies, who are the only parties with the capacity to understand it. Because governments lack the knowledge and resources to regulate AI, they risk losing sovereignty as companies make up the rules that apply to their digital space.

Governments need to set the right regulatory frameworks to leverage the potential of AI for the common good, while governing risk through principles that promote safety, security and transparency. Early work on a global approach to AI governance is already underway. The European Union is considering legislation that proposes a risk-based approach to govern — or prevent — certain types of AI uses.[8] The current US administration has gained the voluntary commitment of seven of the world's largest AI companies, including Microsoft, to uphold principles of responsibility for the safe, secure and transparent development of responsible AI.

It will be important for businesses to join governments in forums like these to work together to create technical and regulatory safety brakes that keep this technology in check. With appropriate guardrails to address the societal challenges of AI, protect democracies and preserve fundamental rights, economies and populations will realize the full potential of new technologies to advance sustainability and promote sustainable growth.

[8] https://www.europarl.europa.eu/RegData/etudes/BRIE/2021/698792/EPRS_BRI(2021)698792_EN.pdf

Managing through the reboot

Takeaways for tax leaders

Topics like conflict in Europe and the Middle East, income inequality and AI governance may seem remote from the everyday concerns of tax functions. But as geopolitical forces develop and unfold, they drive change in global trade and investment flows, which in turn affect companies' value chains, tax profiles and long-term profitability.

It's important for chief tax officers to keep up with such geopolitical forces and trends. Ultimately these developments will have implications for tax policy. Being up to speed can help to put chief tax officers in the best position to steer their organization's response.

With so many complex events and forces in play, chief tax officers should be seeking to build and work their connections like never before:

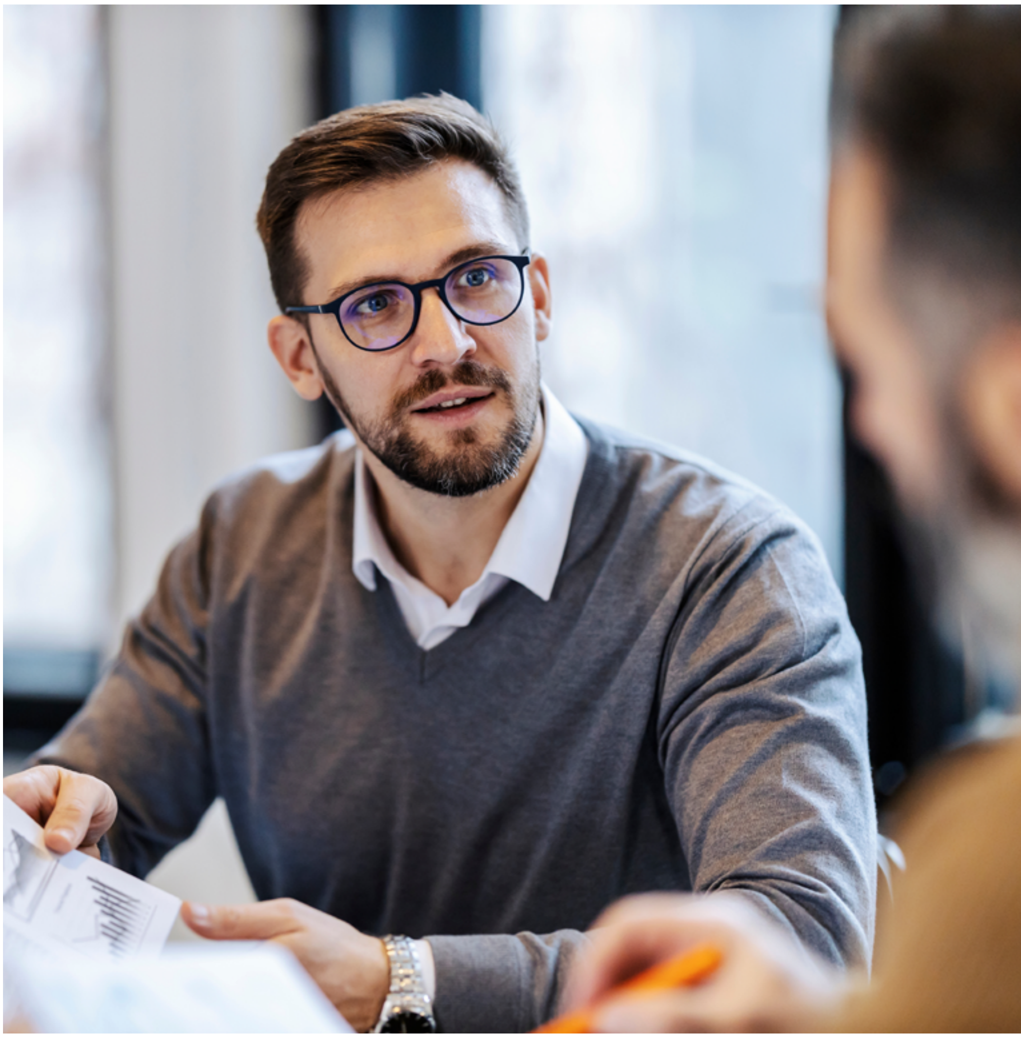
- They should connect with other business functions, customers and suppliers to understand what's happening in the business and what tax impacts might be on the horizon.
- They should connect with their professional peers, advisers, academics and non-governmental organizations to keep up with and engage on emerging issues, social currents and political trends.
- They should connect with tax authorities and policy makers to take part in tax policy debates and make sure business issues are heard.
- They should connect with the C-suite and senior management across the company to explain the sources of tax risk and highlight opportunities.

The key is to shift people's mindsets toward seeing scenario planning and strategic planning not as discrete activities but as one and the same. A geopolitical risk governance framework can help businesses produce an evergreen roadmap for achieving their goals across a range of possible futures.

An emerging leading practice for managing geopolitical risk is to build a robust risk governance framework. These frameworks include tools for management and boards that:

- identify salient geopolitical risks
- map them to actual drivers of revenue and cost
- establish clear responsibilities for developing mitigation plans around each of these risks
- deliver robust internal and external reporting on current risks, future potential scenarios and crisis readiness.

By taking a lead in designing and implementing such frameworks, tax leaders have exceptional opportunities to contribute to mainstream business strategy, build their team's profile, and contribute to the business's sustainability and success.



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