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ASSESSMENT OF THE TWO-PILLAR APPROACH TO ADDRESS THE TAX CHALLENGES ARISING FROM THE DIGITALIZATION OF THE ECONOMY

AN OUTLINE OF POSITIONS FAVOURABLE TO DEVELOPING COUNTRIES

Report by the South Centre Tax Initiative's Developing Country Expert Group

Irene Ovonji-Odida, Veronica Grondona, Samuel Victor Makwe

Assessment of the Two-Pillar Approach to Address the Tax Challenges Arising from the Digitalization of the Economy [1]

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[2] The views contained in the report are personal to the authors and do not represent the institutional views of the South Centre or its Member States.

Composition of the Developing Country Expert Group

Irene Ovonji-Odida is a feminist and human rights and development specialist, with thirty years' experience spanning social movements, civil society, public service, legislative office and academia. She is a member of the United Nations (UN) High Level Panel on Financial Accountability, Transparency and Integrity (FACTI), the African Union Commission/United Nations Economic Commission for Africa (AU/ECA) High Level Panel on Illicit Financial Flows (IFFs) from Africa (Mbeki panel), and South Centre Tax Initiative Steering Group. She is also a member of the Independent Commission for Reform of International Corporate Taxation (ICRICT), Pan African Lawyers Union Illicit Financial Flows task force and the Advisory Committee of Tax Justice Network Africa, focusing on international and continental advocacy to end IFFs and achieve fair international taxation. She has worked as Legal Director, Directorate of Ethics and Integrity, Uganda; in the Uganda Law Reform Commission; Uganda Constituent Assembly Commission that formulated the National Constitution and was also Chief Executive Officer (CEO) of the Uganda Women Lawyers Association. As member of the East African Legislative Assembly, she spearheaded initiatives for accountability and effective legislative oversight of international trade negotiations, pushed for regional conflict resolution mechanisms, and advocated for inclusion of marginalized groups in regional integration. Ms. Ovonji-Odida has served on several missions including national and regional consultative processes assessing East African Community (EAC) political integration readiness, Commonwealth Observer missions and chaired a probe into corruption in local government. She has been International Board Chair of ActionAid International, Vice Chairperson of the University Council of Makerere University, the largest and oldest public university in Uganda and served voluntarily as trustee on several Civil Society Organization (CSO) boards since 1989.

Verónica Grondona is currently the Director of International Taxation at the Argentine Federal Administration of Public Revenue (AFIP). Between July 2019 and January 2020, Verónica was a researcher for Tax Justice Network (TJN). Previously, she was also an advisor to the Confederal Group of the European United Left/Nordic Green Left (GUE/NGL) in the European Parliament on the Special Committee on Financial Crimes, Tax Evasion and Tax Avoidance (TAX3), and served on the Inquiry Committee into Money Laundering, Tax Evasion and Tax Avoidance (PANA), between September 2016 and June 2019. Prior to this, Ms. Grondona worked as a researcher for the Cultural Centre for Cooperation Floreal Gorini and for the Centre of Economic and Finance for the development of Argentina (CEFID-AR), and produced papers for the International Centre for Tax and Development (ICTD), Development Alternatives for Women of a New Era (DAWN) and the Norwegian Institute of International Affairs (NUPI), among others. Some of her main topics of research have been on transfer pricing, capital flight, illicit financial flows as well as on their impact on gender inequality. Between 2002 and 2007, Verónica worked as an advisor on transfer pricing for multinational companies first from PricewaterhouseCoopers and finally from Transfer Pricing Associates, based from Buenos Aires (between 2002 and 2003), Madrid (from 2003 to 2006) and Amsterdam (from 2006 to 2007). Veronica is an Economist (University of Buenos Aires, 2000), with Postgraduate Studies in Finance (University Torcuato Di Tella, 2002).

Samuel Victor Makwe is a Counsellor (Desk Officer for 2nd Committee and Economic and Social Council (ECOSOC) issues) at the Permanent Mission of Nigeria to the United Nations, New York. He is saddled with bringing Nigerian and African perspectives to international discussions, particularly on issues related to macro-economic policy questions, the achievement of the 2030 Agenda for Sustainable Development, and the realization of the aspirations contained in the Addis Ababa Action Agenda. Since joining the Mission in 2018, he is committed to the advancement of the work of the General Assembly and has served as either the Coordinator or Co-coordinator/Facilitator for the following resolutions: A/RES/73/222; A/RES/74/206; A/RES/73/231; A/RES/74/199; and A/RES/73/336. Mr. Makwe was one of the immediate past Vice Coordinators of the African Group of the Second Committee Experts, in New York (January 2019–January 2020). Prior to his posting to New York, Mr. Makwe was First Secretary (Political & Education) and Head of Chancery at the Embassy of Nigeria in Cairo, Egypt. He served at Nigeria’s High Commission in Kuala Lumpur, Malaysia where he covered consular and educational matters. At Nigeria’s Ministry of Foreign Affairs in Abuja, he has served as a protocol officer, consular officer and a human rights desk officer. Mr. Samuel Victor Makwe has a Masters Degree in International Relations and Strategic Studies (University of Lagos) and a Bachelor of Science Degree in Political and Administrative Studies (University of Port Harcourt).

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Foreword

In March 2020, the South Centre Tax Initiative established a Developing Country Expert Group to assess the "two-pillar approach to address the tax challenges arising from the digitalization of the economy". The Expert Group Members are from tax administrations, the diplomatic corps and civil society and bring a wide range of perspectives on this vital question of the redistribution of taxing rights. A broad outlook is important, for tax is as much a political issue as it is technical, and accordingly the objective is to provide an assessment report that gives equal emphasis to both aspects. Questions of inclusion, representation, due process, transparency, justice and equity cannot be separated from more technical discussions such as the determination of the tax base or the methods of profit allocation. Indeed, it is useful to note that political issues and vested interests have had as much, if not more, impact historically on the outcomes of negotiations on international taxation norms, and it behoves tax decision-makers from the global South to address this underlying factor both in terms of the mandate and the composition of negotiating teams as well as throughout such processes.

This report is written primarily for developing country negotiators in the Inclusive Framework and accordingly contains a technical assessment of Pillars One and Two. The aim is to discuss the positions and principles which can inform the negotiations in developing countries' best interests. However, it is also written for a larger audience, particularly diplomats involved in financing for development discussions and international trade rule making, so as to sensitise them to the nuances of the ongoing discussion on the taxation of the digitized economy. In the midst of the COVID-19 pandemic and a devastating economic downturn, it is more important than ever to ensure that developing countries obtain their due taxing rights. This report is an initial contribution in that direction.

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Introduction: What is the Two-Pillar Solution?

Existing problems in taxing the digitalized economy

The two-pillar solution seeks to address the tax challenges arising from the 'digitalization of the economy'.[3] This phraseology recognizes that it is no longer possible to ring-fence the real economy from the so-called 'digital economy'. However, for the sake of simplicity, the phrase 'digitalized economy' will be used throughout this text. Hence, the two-pillar solution seeks to provide a multilateral solution to the practical problem of taxing highly digitalized businesses, for example the Silicon Six (Facebook, Apple, Amazon, Netflix, Google and Microsoft).

The essence of the problem faced at present is that existing international tax law requires a foreign company to have 'physical presence' in a jurisdiction in order to have a Permanent Establishment (PE). Only then can its profits be taxed in the country of source (where the profits are made), otherwise the profits are allocated to the country where the company is resident. This loophole has made it difficult for developing countries to tax the ever-growing profits of highly digitalized businesses. Most multinational enterprises (MNEs) have their residence in the developed countries and the existing rules are thus biased towards them. It could be argued however that these MNEs use tax havens extensively to structure their operations such that increasingly even developed countries are deprived of the tax revenue. The existing system is often exploited to generate what is known as 'stateless income' that is not taxed anywhere.

This is compounded by existing transfer pricing rules, which are used for allocating profits. Transfer pricing rules require that intra-company transactions take place on an 'arms-length' basis and should be comparable to market transactions. However, the very nature of highly digitalized businesses means that their value creation is done largely through intangibles, and often with a significant component of user contribution. For example a company such as Uber draws its value not from car ownership but rather the source-code used in connecting cabs with users. Similarly, a social media platform such as Facebook or Twitter relies almost entirely on user-generated content for its value. By definition, such intangibles are innovations and hence lack 'comparables', making it difficult for tax administrations to counter abusive transfer pricing. A practical example would be a tech company locating its intellectual property in a tax haven and then setting unreasonably high royalty rates for its use. It would then tell the tax authority of the source country that most of the profits generated in the country were used to pay the royalty fees. The tax authority would find it difficult to assess whether the royalty payments were reasonably priced. Such a problem occurs on an almost daily basis and even the United States' Internal Revenue Service (IRS), arguably one of the most aggressive and advanced tax authorities in the world, is struggling to tax the profits of Facebook.[4]

The Two-Pillar Solution

The Organisation for Economic Cooperation and Development (OECD) began trying to address the issue through the Base Erosion and Profit Shifting (BEPS) project, which was an overhaul of

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[3] OECD, Statement by the OECD/G20 Inclusive Framework on BEPS on the Two-Pillar Approach to Address the Tax Challenges Arising from the Digitalisation of the Economy – January 2020, OECD/G20 Inclusive Framework on BEPS (OECD, Paris). See: www.oecd.org/tax/beps/statement-by-the-oecd-g20-inclusive-framework-on-beps-january-2020.pdf (accessed 26 August 2020).

[4] Paul Kiel, "Who's Afraid of the IRS? Not Facebook.", *Propublica*, 23 January 2020. Available from https://www.propublica.org/article/whos-afraid-of-the-irs-not-facebook.

international tax rules to counter tax avoidance. Action 1 of BEPS was focused on the digitalized economy. However, there was no consensus on a solution, and Chapter 7 of the report outlined three measures that countries could take as a BEPS safeguard. These were (1) equalization levy (2) significant economic presence and (3) withholding taxes on digital transactions.[5] Hence while the report did not outline a consensus solution, it recognized the right of all participating countries to unilaterally undertake these measures to tax the profits of digital companies. **Developing countries should thus be aware that they are fully within their rights under international law to undertake national measures to tax the digitalized economy.** This is especially so in the absence of new rules, agreed within an inclusive international norm-setting process, underscoring the importance of international cooperation.

The Action 1 report stated that "a report reflecting the outcome of the continued work in relation to the digitalized economy should be produced by 2020."[6] However, such a timeline seemed too long as a growing number of countries began implementing some of the three measures outlined on taxing the digitalized economy. A comprehensive catalog of these measures up until April 2020 has been carried out by the South Centre.[7]

In response, the OECD sped up the process and in January 2019 came out with a four page policy note[8] where it suggested a 'two-pillar approach'. This was a revolutionary document as it began from the premise that addressing the tax challenges of the digitalized economy meant a re-examination of taxing rights. Such an exercise had never been carried out since the rules of international tax were first formulated in the 1920s by the League of Nations, thus providing developing countries a historic opportunity to re-work the system towards fair, balanced rules relevant to diverse economic contexts, especially of developing countries, which had hitherto not been the case:

"One pillar addresses the broader challenges of the digitalised economy and focuses on the allocation of taxing rights, and a second pillar addresses remaining BEPS issues. A two pillar approach would recognise that the digitalisation of the economy is pervasive, raises broader issues, and is most evident in, but not limited to, highly digitalised businesses. It raises questions of where tax should be paid and if so in what amount in a world where enterprises can effectively be heavily involved in the economic life of different jurisdictions without any significant physical presence and where new and often intangible value drivers more and more come to the fore. At the same time, the features of the digitalising economy exacerbate BEPS risks, and enable structures that shift profits to entities that escape taxation or are taxed at only very low rates. A solution would therefore require comprehensive work that covers the overall allocation of taxing rights through revised profit allocation rules and revised nexus rules, as well as anti-BEPS rules."[9]

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5 OECD, Addressing the Tax Challenges of the Digital Economy, Action 1 - 2015 Final Report. Available from https://www.oecd.org/tax/beps/addressing-the-tax-challenges-of-the-digital-economy-action-1-2015-final-report-9789264241046-en.htm.

6 Ibid.

7 Veronica Grondona, Abdul Muheet Chowdhary, Daniel Uribe, *National Measures on Taxing the Digital Economy*, South Centre Research Paper 111 (May 2020). Available from https://www.southcentre.int/research-paper-111-may-2020/.

8 OECD, Addressing the Tax Challenges of the Digitalisation of the Economy – Policy Note, 23 January 2019. Available from https://www.oecd.org/tax/beps/policy-note-beps-inclusive-framework-addressing-tax-challenges-digitalisation.pdf.

9 Ibid.

After a series of deliberations in the OECD Inclusive Framework, three competing proposals were presented as being the possible basis for pillar one: Significant Economic Presence (SEP), marketing intangibles and user contribution. SEP was seen as the view of the Group of Twenty-four (G24) group of developing countries, while the other two were seen as representing the US and United Kingdom point of view, respectively. Somewhat controversially[10], the OECD Secretariat intervened in a political discussion and came out with a 'Unified Approach' which claimed to 'integrate' the three proposals into one.[11] Nevertheless, the move was politically accepted by the members of the OECD/Group of Twenty (G20) Inclusive Framework (IF). In January 2020, they released a Statement reiterating the IF Members' commitment to reach an agreement on a consensus-based solution by the end of 2020.[12] The IF also agreed upon an "outline of the architecture of a Unified Approach on Pillar One as the basis for negotiations", intending to reach by July 2020 agreement on the key policy features of the solution which would form the basis for a political agreement. Following the outbreak of the COVID-19 pandemic, this has now been shifted to October 2020.[13]

In essence, the Unified Approach to Pillar One seeks to create new taxing rights which would allow for taxable presence (nexus) even in the absence of physical presence of a company. On profit allocation, it aims to use a modified profit split method using a formulary approach to distribute certain components of so-called 'residual profits'. Pillar Two, on the other hand, seeks to establish a global minimum corporate tax rate and enforce it through four hierarchical rules, which seek to ensure multinational enterprises (MNEs) pay the minimum rate.

Revenue estimates from the Two-Pillar Solution

In February 2020, the OECD presented the results of an analysis on the expected revenue gains from implementing the two-pillar approach.[14] The estimates showed the combined effects of the two-pillar solution would result in an annual increase in revenue collection of USD 100 billion, or up to 4% of global corporate income tax (CIT).[15] While this figure may seem large, it pales in

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10 Alvin Mosioma, Lidy Nacpil, Luis Moreno, Pooja Rangaprasad and Dereje Alemayehu, "Time for developing countries to go beyond the OECD-led tax reform!", Global Alliance for Tax Justice, 12 February 2020. Available from https://www.globaltaxjustice.org/en/latest/time-developing-countries-go-beyond-oecd-led-tax-reform.

11 South Centre, Comments on the OECD Secretariat Proposal for a "Unified Approach" under Pillar One, November 2019. Available from https://www.southcentre.int/scti-submission-november-2019/.

12 OECD, Statement by the OECD/G20 Inclusive Framework on BEPS on the Two-Pillar Approach to Address the Tax Challenges Arising from the Digitalisation of the Economy - January 2020. Available from www.oecd.org/tax/beps/statement-by-the-oecd-g20-inclusive-framework-on-beps-january-2020.pdf.

13 TaxSutra, COVID-19 Pandemic pushes Inclusive Framework plenary meeting on digital economy taxation to Oct 2020, 4 May 2020. Available from https://www.taxsutra.com/news/25428/COVID-19-Pandemic-pushes-Inclusive-Framework-plenary-meeting-on-digital-economy-taxation-to-Oct-2020.

14 Veronica Grondona, Abdul Muheet Chowdhary, Daniel Uribe, *National Measures on Taxing the Digital Economy*, South Centre Research Paper 111, May 2020. Available from https://www.southcentre.int/research-paper-111-may-2020/.

15 See: OECD, "OECD presents analysis showing significant impact of proposed international tax reforms", 13 February 2020. Available from http://www.oecd.org/tax/beps/oecd-presents-analysis-showing-significant-impact-of-proposed-international-tax-reforms.htm.

comparison with the estimated USD 600 billion[16] in revenue lost each year due to tax avoidance. Further, as seen in Figure 1, the distributive implications are problematic as high-income countries are expected to benefit marginally more than middle- and low-income countries, though middle- and low-income countries proportionally face the highest losses from corporate tax avoidance under the current rules.[17]

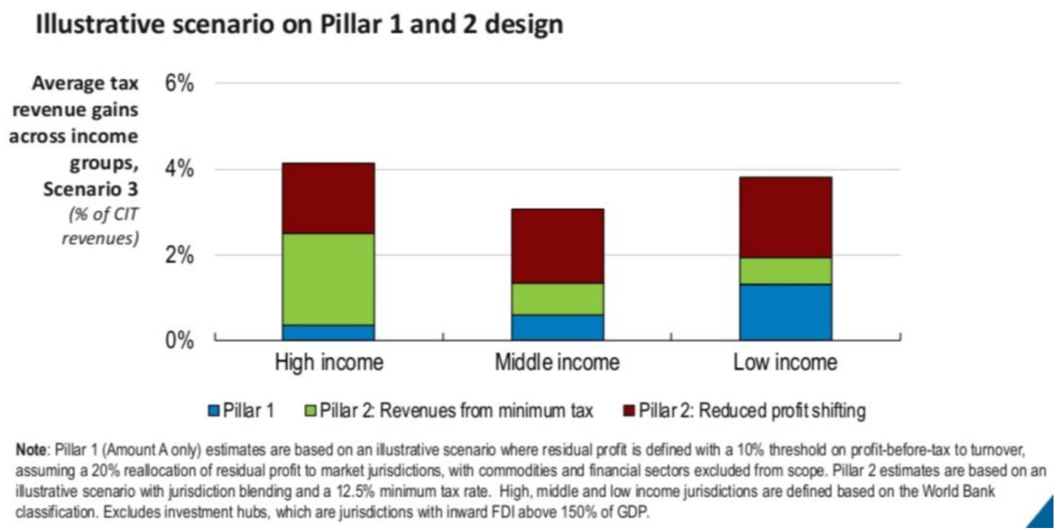

Figure 1: Combined revenue effects of Pillar 1 and 2
Source: OECD, "Tax Challenges Arising from the Digitalisation of the Economy, Update on the Economic Analysis and Impact Assessment", Webcast, 15 February 2020

Participation Challenges for Developing Countries

Faced with this rather grim scenario, developing countries unfortunately have rather limited options to promote their interests. Their efforts are constrained by a negotiating framework within the IF that is skewed towards the interests and conditions of developed countries and underpinned by rules that are are not fit for purpose in view of developments in the modern economy and MNE business models. Those who wish to maximise concessions within the IF have to contend with the following challenges (1) excessive representation for developed countries (2) limited representation for developing countries (3) capacity constraints (4) lack of transparency in decision-making.

Excessive representation for developed countries

Further, the IF itself has some structural features which limit the effective participation of developing countries. To begin with, membership is open to *jurisdictions* and not sovereign

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16 Nicholas Shaxson, "Tackling Tax Havens", *Finance and Development*, vol. 56, No. 3 (September 2019). Available from https://www.imf.org/external/pubs/ft/fandd/2019/09/tackling-global-tax-havens-shaxon.htm.

17 Independent Commission for the Reform of International Corporate Taxation (ICRICT), "The OECD's proposed reform will fail to generate meaningful additional tax revenue, especially for developing countries", 13 February 2020. Available from https://www.icrict.com/press-release/2020/2/13/the-oecds-proposed-reform-will-fail-to-generate-meaningful-additional-tax-revenue-especially-for-developing-countries.

countries. The implication is that of the 137 jurisdictions which are part of the IF, several are colonies of developed countries, many of them being tax havens or financial secrecy jurisdictions to boot, and in effect give them additional voices in the discussions. This breaks the principle of sovereign equality and gives 'one country many votes'. For example the UK has an astounding *eight* jurisdictions in the Framework which are a mix of crown dependencies and overseas territories. These are Bermuda, British Virgin Islands, Cayman Islands, Guernsey, Isle of Man, Jersey, Montserrat and Turks and Caicos Islands.[18] Another example is the Netherlands, which has Aruba and Curacao. Several more exist and a detailed analysis of the IF membership is bound to reveal an interesting pattern of former colonial powers continuing to use their tax haven overseas territories and dependent areas to boost their voice within the IF discussions.

Limited membership of developing countries

While the '137 members' seems like a big number, it must be reiterated that many parts of the developing world have not yet joined the Inclusive Framework. For example, almost half of Africa is not a part of the IF, and this includes countries such as Algeria, Ghana, Uganda and Zimbabwe. This combined with excessive representation for some developed countries overshadows the developing country voice in these discussions.

Limited representation in Working Groups

The remaining work on Pillar One is to be carried out by the Task Force on the Digital Economy (TFDE) and Working Parties 1, 6 and 10.[19] The key players in the working groups are the Chairs, Co-Chairs and Bureau Members as they are involved full-time in the group's functioning. Countries represented here have an edge in setting and steering the agenda. However the final decisions in the IF are taken by the Steering Group. An examination of involvement of non-OECD countries reveals the following:

Group Name	Non-OECD country represented in Chair/Co-Chair or Vice Chair?	Non-OECD country representation in Bureau Members
Task Force On The Digital Economy	Yes, 1/5 (China)	3/9 (Brazil, Cote d'Ivoire, India)
Working Party No. 1 On Tax Conventions And Related Questions	No, 0/2	NA (No bureau members)
Working Party No. 6 On The Taxation Of Multinational Enterprises	Yes, 1/4 (Nigeria)	5/22 (Argentina, Brazil, India, China, Nigeria)
Working Party No. 10 On Exchange Of Information And Tax Compliance	Yes, 1/3 (China)	0/5

Table 1: Involvement of Non-OECD Countries in Inclusive Framework Bodies
Source: On-Line Guide to OECD Intergovernmental Activity, May 2020. Authors' compilation.
https://oecdgroups.oecd.org/Bodies/ListByNameView.aspx?book=true#

[18] OECD, Members of the OECD/G20 Inclusive Framework on BEPS, December 2019. Available from https://www.oecd.org/tax/beps/inclusive-framework-on-beps-composition.pdf.

[19] OECD, Statement by the OECD/G20 Inclusive Framework on BEPS on the Two-Pillar Approach to Address the Tax Challenges Arising from the Digitalisation of the Economy, January 2020, Paris. Available from www.oecd.org/tax/beps/statement-by-the-oecd-g20-inclusive-framework-on-beps-january-2020.pdf.

Hence, Table 1 shows very limited involvement of non-OECD countries in the working groups. If the filter of only non-G20, non-OECD countries is applied, the list becomes even smaller.

Capacity constraints

The discussions within the IF have been taking place at remarkable speed. Highly technical policy proposals are routinely being put out by the OECD for public consultation leaving developing countries with little time to process a response.[20] This is compounded by capacity constraints many developing countries face which limit their ability to put forth substantive responses. One observer found that many African countries are waiting for the outcome at the IF, rather than developing their own plans.[21] This has been aggravated by the COVID-19 pandemic, which has occupied revenue authorities from across the world. Hence, at this juncture it seems even less likely that developing countries can shape the IF discussions towards their interests.

Lack of transparency in decision-making

The functioning of the Inclusive Framework remains shrouded in mystery for outsiders. It is unclear how various decisions are arrived at, especially since the IF lacks formal rules of procedure. An OECD document[22] states that its "decision making process for tax purposes has a two-layer structure", first at the working groups and then at the Committee on Fiscal Affairs (CFA) with agreements reached by 'consensus'. Those decisions on which consensus is elusive are subject to 'further discussions'. There remains a lack of transparency on how varying interests are balanced.

The recent trajectory of events in the IF has resulted in a draft two-pillar solution that is based, to a large extent, on the policy proposals of the developed world.[23] This has led to questions as to just how 'Inclusive' the Framework is. India's representative speaking at the Economic and Social Council stated that "calling a process inclusive does not make it so."[24] Another civil society commentator has observed that the OECD's "standards do not have legally binding force at the national level unless they are incorporated into a country's domestic law. This means that countries may acquiesce to a consensus with which they do not agree, knowing that they can exercise their

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[20] Irma Johanna Mosquera Valderrama, "About the BEPS Inclusive Framework and the role of the OECD", GLOBTAXGOV, 19 November 2019. Available from https://globtaxgov.weblog.leidenuniv.nl/2019/11/19/about-the-beps-inclusive-framework-and-the-role-of-the-oecd/.

[21] Martin Hearson, "Africa responds to the Inclusive Framework's digital tax agenda", International Centre for Tax and Development, 7 August 2019. Available from https://www.ictd.ac/blog/africa-responds-to-the-inclusive-frameworks-digital-tax-agenda/.

[22] OECD, BACKGROUND BRIEF: Inclusive Framework on BEPS, January 2017. Available from http://www.oecd.org/tax/beps/background-brief-inclusive-framework-on-beps.pdf.

[23] Veronica Grondona, Abdul Muheet Chowdhary, Daniel Uribe, *National Measures on Taxing the Digital Economy*, South Centre Research Paper 111, May 2020. Available from https://www.southcentre.int/research-paper-111-may-2020/.

[24] UN, "Corporate Tax Reform Must Focus on Developing Countries' Needs, Combating Inequality, Speakers Tell Special Meeting of Economic and Social Council", Economic and Social Council, 2019 Session, 10th & 11th Meetings, ECOSOC/6978, 29 April 2019. Available from https://www.un.org/press/en/2019/ecosoc6978.doc.htm.

sovereign taxing rights by opting to apply unilateral measures that differ from the consensus solution."[25] A wide range of civil society organizations (CSOs) and academics have critiqued the IF's working style.[26] A Member of the UN Tax Committee from Ghana has called for a shift of the negotiations to a new platform altogether.

Alternatives to the Inclusive Framework

Faced with these challenges within the IF, developing countries have for long tried to strengthen the role of the UN. The Group of 77 (G77) has long demanded that the UN Committee of Experts on International Cooperation in Tax Matters be upgraded into an intergovernmental body[27]. Tax justice civil society has called for the G24 proposal to be tabled as a UN General Assembly resolution. This is an idea with promise and should be developed further.[28] The past experiences of the G77 and the United Nations Conference on Trade and Development (UNCTAD) in the quest for fair global taxation and MNE regulation in the 60s and 70s may have important insights for developing countries. UNCTAD's history as a forum for corporate disclosures means issues of tax transparency such as country-by-country reporting can be discussed there.[29]

Regional intergovernmental bodies such as the East African Community and the South African Development Community (SADC) and regional organizations such as the African Tax

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[25] Joy Ndubai, "If developing countries are not listened to at the OECD, they will vote with their feet", International Centre for Tax and Development, 28 November 2019. Available from https://www.ictd.ac/blog/developing-countries-oecd-inclusive-framework-consensus/.

[26] For a more detailed overview of these critics see:
Tax Notes, "Pillar 3 For The OECD: A Global Excess Profits Tax", *Forbes*, 18 May 2020. Available from https://www.forbes.com/sites/taxnotes/2020/05/18/pillar-3-for-the-oecd-a-global-excess-profits-tax/#7f11a8cd36ac.
Matthew Collin, "Did the EU's attempt to name and shame tax havens into behaving better work?", Brookings, 25 June 2020. Available from https://www.brookings.edu/blog/up-front/2020/06/25/did-the-eus-attempt-to-name-and-shame-tax-havens-into-behaving-better-work/#cancel.
Oxfam, "In support of a comprehensive tax reform to stop corporate tax dodging and limit tax competition", Oxfam Policy Note, August 2019. Available from
https://www.oxfamnovib.nl/Redactie/Downloads/Rapporten/Oxfam%20Policy%20Note%20BEPS%202.0.pdf
Alex Cobham, "A Pyrrhic victory for the OECD?", Tax Justice Network, 31 January 2020. Available from https://www.taxjustice.net/2020/01/31/a-pyrrhic-victory-for-the-oecd/.
Financial Transparency Coalition, "Should a problem for everyone be solved by the few?", 2 December 2015. Available from https://financialtransparency.org/should-a-problem-for-everyone-be-solved-by-the-few/.

[27] Group of 77, Statement on Behalf of Group of 77 and China by Mr. Sameh Elkhishin, First Secretary of the Permanent Mission of Egypt to the United Nations, at the ECOSOC Special Meeting on International Cooperation in Tax Matters, New York, 18 May 2018. Available from https://www.g77.org/statement/getstatement.php?id=180518b.

[28] Alvin Mosioma, Lidy Nacpil, Luis Moreno, Pooja Rangaprasad and Dereje Alemayehu, "Time for developing countries to go beyond the OECD-led tax reform!", *Global Alliance for Tax Justice*, 12 February 2020. Available from https://www.globaltaxjustice.org/en/latest/time-developing-countries-go-beyond-oecd-led-tax-reform.

[29] Alex Cobham, Petr Janský and Markus Meinzer, "A half-century of resistance to corporate disclosure", *Transnational Corporations* Volume 25, Number 3 (2018). Available from https://unctad.org/en/PublicationChapters/diaeia2018d5a2_en.pdf.

Administration Forum (ATAF)[30] have initiated various efforts at standard setting such as developing their own model tax conventions.[31] The South Centre Tax Initiative (SCTI) seeks to promote international tax cooperation among developing countries through strengthened network building.[32] These are welcome efforts that provide developing countries alternative spaces to discuss this and related issues of their interest.

Nevertheless, the IF remains a dominant political reality that cannot be wished away. It is important that developing countries, that are its members, strongly put forth their interests to seek to influence balanced policy discussions and decisions on the two-pillar solution rather than the process and outcomes being totally monopolised by the developed countries. It is highly likely that once the two-pillar solution is finalized, it will become an international standard and efforts will be made to ensure that countries outside of the IF are equally forced to comply with it in some way or the other. Hence, developing countries need to strongly engage within the IF. Accordingly, the rest of the report is focused on the technical aspects of the two-pillar solution, with a view to providing positions beneficial to developing countries.

Overarching Expectations from the Two-Pillar Solution

It is important to begin by laying out that the goal of reform is not just tax certainty, important as that is, but increased Domestic Revenue Mobilization (DRM), which also is not an end in itself, but rather a means of Financing for Development (FfD). Goal 17.1 of the Sustainable Development Goals (SDGs) specifically focuses on "strengthen(ing) DRM, including through international support to developing countries, to improve domestic capacity for tax and other revenue collection." All reform efforts towards the two-pillar solution must be seen in this regard, for the revenue it will generate will enable fulfilment of the SDGs and address existential challenges such as climate change.

For developing countries, USD 2.5 trillion is required annually to finance the Sustainable Development Goals (SDGs).[33] This effort is hobbled by Illicit Financial Flows (IFFs), of which USD 1.3 trillion has left sub-Saharan Africa between 1980-2018.[34] Further, 40% of MNE profits are estimated to be shifted to tax havens each year.[35] Tax avoidance is an intrinsic component of IFFs

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30 ATAF is part of the consortium of African Union bodies and CSOs to stem IFFs from Africa. The consortium was set up by the AU to implement the AU Special Declaration on IFFs from Africa and Mbeki HLP report.

31 ATAF, ATAF Model Tax Agreement for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income, ATAF's International Taxation and Technical Assistance Publication. Available from https://irp-cdn.multiscreensite.com/a521d626/files/uploaded/ATAF%20Model%20Tax%20Agreement_Highres.pdf.

32 South Centre Tax Initiative Website. Available from https://taxinitiative.southcentre.int/.

33 UNCTAD, "Developing countries face $2.5 trillion annual investment gap in key sustainable development sectors, UNCTAD report estimates", UNCTAD/PRESS/PR/2014/021, 24 June 2014. Available from https://unctad.org/en/pages/PressRelease.aspx?OriginalVersionID=194.

34 Landry Signé, Mariama Sow, and Payce Madden, "Illicit financial flows in Africa: Drivers, destinations, and policy options", Brookings, 2 March 2020. Available from https://www.brookings.edu/research/illicit-financial-flows-in-africa-drivers-destinations-and-policy-options/.

35 Ludvig Wier, "International tax avoidance and development", UNU-WIDER blog, April 2020. Available from https://www.wider.unu.edu/publication/international-tax-avoidance-and-development.

and a well designed two-pillar solution may help developing countries by reducing some of these outflows. For this reason, it is essential that:

(1) At minimum, efforts are made to ensure that the OECD proposed solution 'does no harm to' and does not deprive developing countries of revenue;
(2) Taxing rights are redistributed to benefit source countries and the revenue proceeds are fairly distributed between developed and developing countries and that it does not just go to the developed countries, especially because historically, developing countries have been the most affected by tax avoidance and IFFs;
(3) The solution is comprehensive and easy to implement with the least number of exemptions such that as much of the digitalized economy as possible is brought into the tax net;
(4) The revenue gains from the solution are significant and not result in only minor additions, ideally they should be as close as possible to the International Monetary Fund (IMF) estimate of USD 600 billion annually;[36]
(5) Tax mismatches in the digitalized economy are eliminated or at least minimised;
(6) The solution is implemented in a manner that is coordinated.

These can act as guiding principles which can be used by developing country negotiators to assess whether the two-pillar solution is evolving in an acceptable manner.

Contributions to the Programme of Work on Pillar One Issues

Annex A of the January 2020 IF Statement contains the remaining technical and policy issues to be resolved under Pillar One. This section examines these issues and suggests negotiating positions and/or principles that can be advantageous to developing countries.

Scope of Amount A

There are an unacceptably large number of thresholds at present, as shown in Annex B of the IF Statement. These seem almost satirical as it will place most of the companies out of scope and can render Amount A ineffective. Further, even covered companies may contest being categorized as falling in scope which could exacerbate tax related disputes.

Implementing such a complex policy design would be a challenge for even the most developed tax administrations. Developing countries are bound to face far more difficulties in enforcing such a convoluted set of thresholds. Further, the rationale for the different categories of businesses which will come under the scope of Amount A - such as consumer facing business, automated digital services etc - is unclear. Policy design must be reasonable and *also* administrable.

The thresholds may therefore have the net result of increasing tax uncertainty and reducing revenue collection, particularly in developing countries. This would benefit neither taxpayers nor revenue authorities and only add more complexity to the system.

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[36] Nicholas Shaxson, "Tackling Tax Havens", *Finance and Development*, vol. 56, No. 3 (September 2019). Available from https://www.imf.org/external/pubs/ft/fandd/2019/09/tackling-global-tax-havens-shaxon.htm.

This also departs from existing practice where only local thresholds are used and global factors were rightly never a consideration. High global thresholds would violate the principle of tax neutrality. MNEs must pay the same taxes as their domestic counterparts. Failure to do so would mean an uneven playing field and raise competition concerns. It would also trigger a vicious cycle. Domestic companies would suffer and weaken, leading to reduction in income, job growth and overall demand. This would affect the MNEs' profits as well as their sales would reduce in a low-demand economy thus resulting in a loss-loss situation for all. This is the main reason why local thresholds must continue to apply so that each jurisdiction can assess for itself how best to maintain tax neutrality.

Recommendation 1: A single threshold commensurate with the size of the economy is a more sensible approach. This must be de-linked from the Country-by-Country Reporting (CBCR) threshold of EUR 750 million which had a different rationale. It should be enough to have local thresholds and not have any global revenue threshold or global in scope revenue threshold or a de minimis amount for total global profit.

Recommendation 2: Those businesses that are left out of scope should be subject to unilateral measures.

Tax base determinations

There is no rationale given as to why Profit Before Tax (PBT) is outrightly preferable to other profit level indicators. There are other options which increase the tax base.

Recommendation 1: Operating Profit can be taken as a more appropriate indicator. This provides a larger tax base which is more suitable for ensuring the digital giants pay their fair share.

Recommendation 2: Earnings Before Interest Taxes Depreciation and Amortization (EBITDA) can be seen as a second alternative. However, this has a weakness as it allows for base erosion via interest deductions.

Quantum of Amount A

This seeks to address one of the most controversial aspects of the Unified Approach to Pillar One – the appropriate thresholds for the percentage(s) of profit that represents the deemed residual return, and the portion of residual profit allocable to market jurisdictions.

It must be reiterated that the Unified Approach (UA) removes routine profits from allocation to market jurisdictions without giving any rationale. Further, the UA does not provide either methodology or theoretical justification or datasets through which this distinction between routine and non-routine/residual profits can be enforced.[37]

[37] South Centre Tax Initiative, Comments on Session Paper relating to tax consequences of the digitalized economy –issues of relevance for developing countries, June 2020. Available from https://www.un.org/development/desa/financing/sites/www.un.org.development.desa.financing/files/2020-06/CRP%2025%20_SCTI.pdf.

Preliminary estimates show only small benefits for market jurisdictions. It seems to be envisaged that the 'residual' would be a large proportion, either 80% or 90% of the MNE's global profits before tax, but Amount A would be a small part of this, perhaps 20% of the residual.[38]

Recommendation 1: As a matter of principle, once a nexus has been determined in a jurisdiction, all profits should be allocated to it, regardless of whether they are routine or non-routine.

Recommendation 2: Amount A must be at least 33% of Profits Before Tax (PBT), which is then distributed to market jurisdictions on the basis of sales. This would give adequate weight to demand and place it on an equal footing with the other factors that contribute to profit. The G24 proposal on fractional apportionment sought to attribute 1/3rd of profits to sales.

Recommendation 3: If the quantum of Amount A is substantially less than 33%, then developing countries must assess whether it is worth giving up their right to take unilateral measures in exchange for such a small allocation of profit.

Recommendation 4: Implementation may be considered in a phase-wise manner starting with automated digital services and including later consumer facing business. Automated Digital Services (ADS) is where the main problem lies and is of higher priority for developing countries.

Features of Amount B

Similar to the concerns in Amount A, the quantum of Amount B equally needs to be decided. This may be a significant challenge. Amount B would be determined through existing transfer pricing methods i.e. the Arm's Length Principle (ALP), based on the Authorised OECD Approach (AOA) of Functions Assets and Risks (FAR). Normally, a tolerance zone is used beyond which anti-abuse action is taken. The zone may range from 25-75 percentile. With exact quantification given such a wide range, there is the possibility that it may lead to an increased number of disputes.

Further, Amount B is to apply only if the enterprise has a physical presence in a jurisdiction performing marketing and distribution functions to which the fixed return is to apply. There is the danger that taxpayers can simply sidestep the new nexus rule by using remote presence for the supply of goods and services and conduct the marketing and distribution functions from low-tax jurisdictions.[39]

Amount B may also be estimated using definitions of Limited Risk Distributors (LRDs) which has certain ambiguities that could be disadvantageous to developing countries. India for example has expressed reservations to paragraph 5 of Article 5 and the accompanying Commentary in paragraph 96 with a view that LRDs can be Dependent Agent PE (DAPEs).

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38 The BEPS Monitoring Group, Tax Consequences of the Digitalised Economy –Issues of Relevance for Developing Countries, June 2020. Available from https://www.un.org/development/desa/financing/sites/www.un.org.development.desa.financing/files/2020-06/CRP%2025%20-%20BEPS%20.pdf.

39 Intergovernmental Group of Twenty-Four on International Monetary Affairs and Development (G-24), Comments of the G-24 on the OECD Secretariat Proposal for a Unified Approach to the Nexus and Profit Allocation Challenges Arising from the Digitalisation (Pillar 1), 9 November 2019. Available from https://www.g24.org/wp-content/uploads/2019/12/G-24_Comments-on-OECD-Secretariat-Proposal-for-a-Unified-Approach.pdf.

It is also unclear how countries that do not follow FAR based ALP would implement Amount B. The Statement mentions "uncommon interpretations" of the ALP which may become a tool to enforce OECD transfer pricing guidelines.

Recommendation 1: As stated by the G24, to deal with the potential risk of marketing and distribution functions being conducted remotely from low-tax jurisdictions, market jurisdictions should have the right to tax an amount equivalent to Amount B for such remote marketing and distribution activities.

Recommendation 2: An amount based on a formula can be allocated to a remote taxable presence for remote marketing and distribution activities which should be analogous to the Amount B where there is a limited risk distributor (LRD).[40]

Recommendation 3: Interpretations of the ALP that differ from the AOA must be seen as equally valid and legitimate.

Dispute prevention and resolution

Given the complexity of the Unified Approach, a great deal of disputes can be expected. Most of these may arise with regard to Amounts B and C as these would involve the ALP. The extremely complex design of Amount A combined with the large number of thresholds also lends it open to disputes over scope.

The Statement also refers to "safe harbours", which in the way they are presented are problematic and contain risks for developing countries. In ordinary ALP based transfer pricing, safe harbours can be used to tackle disputes domestically. However as a multilateral solution it suffers from design limitations. For safe harbours to work, they must be applied universally, which cannot be guaranteed. If not, then disputes are bound to occur which is why the OECD could push for mandatory and binding arbitration, which is structurally disadvantageous to developing countries. Hence, developing countries would be 'set up to fail'.

There are treaty concerns as well which again involve design flaws. As stated by the Indian Member of the UN Committee of Experts on International Cooperation in Tax Matters,

> "Having a new multilateral convention for UA is a welcome idea. However, as the experience with the multilateral convention to implement BEPS related tax treaty changes shows, there is no assurance on all countries signing and ratifying such multilateral convention within a timeline or even ever. The Statement refers to a critical mass of countries that may be required to join, however; Amount A determination in UA is conceived in a manner that requires hundred percent mandatory joining of the new Convention by all countries. This can never be guaranteed. Without all countries joining such Convention, UA can never be effectively implemented for Amount A."[41]

40 Ibid.

41 Committee of Experts on International Cooperation in Tax Matters, Tax consequences of the digitalized economy – issues of relevance for developing countries, E/C.18/2020/CRP.25, 30 May 2020. Available from https://www.un.org/development/desa/financing/sites/www.un.org.development.desa.financing/files/2020-06/CICTM%2020th_CRP.25%20_%20Digitalized%20Economy.pdf.

The proposal for early determination through a Panel for Amount A too seems unrealistic and problematic as it resembles arbitration. To quote the Indian Member again,

> "There is a proposal for early determination through a Panel for Amount A. However, how many countries can be practically represented on such a Panel say of 10 experts, when MNE operates in 100 countries would be a challenge. Without being represented on such Expert panels, how the solution can be accepted by all countries. This also raises sovereignty concerns. How many countries would be having experts to participate in such Panels and the required resources is another issue."[42]

Recommendation 1: The main focus must be on dispute prevention instead of resolution. This requires clear, objective and administrable rules.

Recommendation 2: Mandatory and binding arbitration must be strongly opposed as it is structurally disadvantageous for developing countries.

Recommendation 3: Multilateral Mutual Agreement Procedure (MAP) without arbitration and Advanced Price Agreements (APAs) can be considered if acceptable within the legal system of other countries and their tax treaties. However, they are resource intensive for developing country tax administrations. Further, there is a large gap in capability between big MNEs and the rest. The former can negotiate more effective APAs in their favor and this can lead to an uneven playing field.

Contributions to the Discussion on Pillar Two

Pillar Two seeks to put in place a global minimum corporate tax rate through four interlocking rules – undertaxed payments, subject to tax, income inclusion and switch-over.

Tax rate

While not officially stated, the OECD has used 12.5% as an illustrative figure for its calculations on the revenue implications of Pillar Two. This has led to speculations that 12.5% is being pushed as the minimum tax rate.

Recommendation: The minimum rate must be one which is commensurate with the revenue requirements of countries, especially in the COVID scenario when healthcare financing needs have increased. An excessively low rate has the dangerous implication of institutionalizing and encouraging the 'race to the bottom' where countries are forced to competitively lower tax rates. As mentioned by ICRICT Commissioners, the minimum rate may end up becoming the maximum rate.[43]

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42 Ibid.

43 ICRICT, "Taxing multinationals: ICRICT calls for an ambitious global minimum tax to stop the harmful race to the bottom", Press Release, 9 December 2019. Available from https://www.icrict.com/press-release/2019/12/9/m9fwnyj7krhupqbasqygn9kkx9msai.

Rule order

The sequencing of the rules is the most important question as this will determine whether source or residence jurisdictions have the 'first claim' on the tax revenue. Present indications are that the income inclusion rule may be placed first in the rule order, followed by the switch-over. The income inclusion rule is based on Controlled Foreign Company (CFC) rules and is designed to protect the tax base of the parent jurisdictions, which are mostly developed countries. It would operate as a minimum tax by requiring a shareholder in a corporation to bring into account a proportionate share of the income of that corporation if that income was not subject to an effective rate of tax above a minimum rate.[44]

The switch-over rule is a mechanism designed to ensure that the income inclusion rule applies to foreign branches exempt under double tax treaties. Hence its role is to facilitate the application of the income inclusion rule.

Placing these two rules first in the rule order will mean that the developed countries will get the 'first claim' on the taxable revenues. There will be nothing left for the developing countries afterwards.

Recommendation: Developing countries are the worst affected by tax avoidance, evasion and illicit financial flows and hence deserve the 'first claim' on the taxable revenues. For this reason, the rule order must give priority to the undertaxed payments rule. This would allow for denying deductions or making an equivalent adjustment in respect of intra-group payments.

This must be followed by the subject to tax rule, which allows subjecting a payment to withholding or other taxes at source and denying treaty benefits on certain items of income where the payment is not subject to tax at a minimum rate.

This would be in the interest of source countries which are also mostly developing countries and would thus address the problem being faced by the market jurisdictions. If these rules do not come first in the rule order, then their being there or not has no impact as the revenues would be taken away by the developed countries.

Tax incentives

A concern has been raised by some developing countries and even developed countries over how Pillar Two would affect tax incentives. It is quite unlikely that developing countries would be giving incentives to digital companies who are presently not being taxed. Incentives presume that the company is paying taxes and is hence availing of these benefits. The digital giants are in fact enjoying de facto tax exemptions.

Recommendation: This problem can also be resolved by placing the undertaxed payments rule first in the order, as it may have a neutralizing effect on tax incentives offered by developing countries.

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44 OECD, Statement by the OECD/G20 Inclusive Framework on BEPS on the Two-Pillar Approach to Address the Tax Challenges Arising from the Digitalisation of the Economy – January 2020, OECD/G20 Inclusive Framework on BEPS (OECD, Paris). Available from www.oecd.org/tax/beps/statement-by-the-oecd-g20-inclusive-framework-on-beps-january-2020.pdf.

Conclusion

Developing countries thus face a challenging period ahead as they have to navigate through impediments in the political structure of the Inclusive Framework to negotiate a highly dense and technical proposal that is stacked against their interests. Although both Pillars One and Two are by default slanted in favor of developed countries, it is imperative that developing countries pool their resources and work together to maximise concessions within the Two-Pillar Approach, while being mindful at all times that they have the right to undertake unilateral or national measures on taxing the digitalized economy and can walk out of the negotiations if the multilateral solution offered is not in their interest. With this objective in mind, this report has laid out a set of positions on both Pillars One and Two, which may be of use to developing country negotiatiors.

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