Statement by the South Centre on the Two Pillar Solution to Address the Tax Challenges Arising From the Digitalisation of the Economy

The South Centre takes note of the statement by 130 members of the OECD/G20 Inclusive Framework (IF) on a two-pillar solution to address the tax challenges arising from the digitalisation of the economy. The agreement by the members is indeed historic and marks progress in the right direction. Unfortunately, the agreed upon solution is limited and disappointing as it falls short of the more ambitious and transformational reforms needed for a balanced agreement that fully responds to the concerns of developing countries, especially in the backdrop of the socioeconomic challenges posed by the COVID pandemic. Nine jurisdictions have not agreed with the statement, with the reasons still not public; however, it is a signal that cannot be ignored.

Nevertheless, it is important to first acknowledge the progress obtained through the agreement.

Foremost in this regard is the recognition of the essential role of demand as a factor in profit allocation. Profit itself is the outcome of the interaction of both demand and supply factors, as without demand there will be no market for goods and services. However, profit allocation under the OECD's transfer pricing guidelines allocate profit to jurisdictions based entirely on supply factors of Functions, Assets and Risks (FAR), through the Authorized OECD Approach (AOA). In practical terms this meant developed, industrialized jurisdictions with high value exports were privileged in profit allocation. This also disadvantaged market jurisdictions, which are largely developing countries, and often net importers, especially of high value goods and services, and capital.

The recognition that profit should be allocated to jurisdictions based on sales responds to a long-standing demand of the developing world.

Similarly, it is a positive development that revenue will be sourced to the end market jurisdictions where goods and services are used or consumed; the sourcing rules that will be prepared must adequately reflect this principle.

The South Centre also welcomes the efforts to put a floor on the harmful and damaging "race to the bottom" through a floor on tax competition. A particularly positive aspect is the accordance of a "minimum standard" status to the Subject to Tax Rule and the requirement that it be incorporated into tax treaties when requested by a developing member of the IF.

On the other hand, there are several aspects of the agreement which are disappointing from the perspective of developing countries' interests.

Pillar One

The agreement was expected to address the issue of the imbalance of the allocation of taxing rights between source and residence countries. It was also expected to result in a meaningful, substantial and sustainable reallocation of revenue to market jurisdictions. However on these fronts, further work is needed.

Developing countries, through groupings such as the G24 and the African Tax Administration Forum,[1] had called for the reallocation of profits as a portion of the MNEs' total profits instead of its residual profit. It is disappointing that the Inclusive Framework has decided not to adopt this approach, which is rational and easier to administer.

Instead, the approach seeks to reallocate a portion of residual profits, proposed to be in the range of 20-30%. A lower end of 20% is wholly inadequate and a meaningful allocation to market jurisdictions should be much higher with at least 35% of residual profits, as also called for by ATAF.

The issue of taxing profits from remotely conducted marketing and distribution activities needs to be resolved. It is possible for an enterprise that is providing goods and services remotely, such as a TV show, to market the product, distribute it, collect payments and address consumer grievances, all entirely on-line or remotely. However, under the present approach the taxing right to market jurisdictions is denied because these activities are not performed physically, which is unfair as the very purpose of the Two Pillar discussion is to address this problem of businesses being able to operate remotely. As demanded by the G24, market jurisdictions need a "return for deemed performance of certain activities like baseline distribution and marketing of digital goods and services for remote sale activities in a jurisdiction."[2]

Concerns remain among some developing countries[3] that the mandatory and binding nature of the dispute settlement process is problematic, and would impose a demanding and complex process. The elective binding dispute resolution mechanism should be made available to all countries with limited capacity and no or low level of MAP disputes, and regardless of whether or not they are eligible for deferral of their BEPS Action 14 peer review.

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[1] https://www.ataftax.org/130-inclusive-framework-countries-and-jurisdictions-join-a-new-two-pillar-plan-to-reform-international-taxation-rules-what-does-this-mean-for-africa
[2] https://www.g24.org/wp-content/uploads/2021/06/Comments-G-24-to-BEPS-IF-SG-May-2021_FINAL.pdf
[3] https://www.ataftax.org/130-inclusive-framework-countries-and-jurisdictions-join-a-new-two-pillar-plan-to-reform-international-taxation-rules-what-does-this-mean-for-africa

The requirement for the removal of unilateral measures, such as all Digital Service Taxes and other relevant similar measures, also impinges upon tax sovereignty. Tax sovereignty is an essential feature of statehood, and it is up to countries to take decisions in this regard in their interests.

This becomes more problematic as for Pillar One to work, it requires ratification of a multilateral agreement by all IF members. However, as experience with treaties in general, and the BEPS Multilateral Instrument show, it cannot be guaranteed that all countries will sign and ratify a treaty. This will have implications on the implementation of Pillar One. As a result, it cannot be said with certainty when jurisdictions will actually be able to begin collecting revenue through this approach. Thus, to ask them to give up their tax sovereignty in exchange for an uncertain future is deeply problematic.

Pillar Two

The minimum tax rate of 15% is inadequate and must be much higher, with countries such as Argentina calling for 25%, ATAF and the African Union calling for at least 20% and civil society organizations such as ICRICT also calling for 25%. This would contribute to higher resource mobilisation and support pro-growth policies that will help countries achieve the Sustainable Development Goals (SDGs) and the 2030 Agenda.

The implication of treating the Subject to Tax Rule as a minimum standard is that it would come first in the rule order, which is most welcome as it would give source countries the first right of refusal. However, to be truly effective, its scope must be as broad as possible. It is welcome that interest and royalty payments are covered. However, it must also include all service payments and capital gains. Service payments in particular pose a significant tax avoidance risk to developing countries.

Conclusion

It is unclear how Pillar One will be implemented as there still remain a large number of jurisdictions outside of the Inclusive Framework, including half of Africa. These jurisdictions contribute to MNE profits and it is unclear how Amount A will be redistributed when they are not part of the agreement.

The South Centre agrees with ATAF's concerns that political pressure should not be brought on countries which are not Inclusive Framework members to apply these rules or join the Inclusive Framework. Taxation continues to remain an essential sovereign right which each jurisdiction exercises as it sees fit.

There remain further details that need to be worked out, and it is essential that the concerns of developing countries are fully incorporated. For this, improved and more effective coordination is needed between them with a view that their interests and concerns are taken into account into the measures that will be developed. The South Centre will continue to provide its support to developing countries in the negotiations in the Inclusive Framework with a view to a balanced, equitable and easy to administer outcome that effectively contributes to the mobilization of resources needed to achieve the SDGs.

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