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 136 member jurisdictions of the OECD/G20 Inclusive Framework (IF) made on 8 October 2021, on a two-pillar solution to address the tax challenges arising from the digitalisation of the economy. The broad architecture of the agreement is now in place and it is clear to developing countries what they can expect from it.

Overall, the Two Pillar solution breaks new ground in international taxation. It marks a shift away from the arm's length principle in the allocation of income and is based on the recognition that Multinational Enterprises (MNEs) are unitary entities that operate as such. More importantly, demand has been enshrined as a factor in profit allocation, giving market jurisdictions, which are mostly developing countries, their rightful share in the global profits of MNEs.

The agreement on a minimum tax has also solidified the principle that MNEs must pay taxes somewhere and that "stateless income" cannot be permitted to exist.

However, there are several aspects of the agreement which when seen from the perspective of developing countries make it not just deeply disappointing but downright unacceptable. This is particularly the case for Pillar Two.

Pillar One

The entire discussion on Action 1 of the Base Erosion and Profit Shifting (BEPS) project began due to the concern that large, highly digitalized businesses were not paying their fair share of taxes. The solution to this problem should have squarely addressed this and ensured governments could collect the revenue that was being lost. However, Pillar One as it stands will deliver extremely limited revenue benefits in general and especially to developing countries. The OECD has estimated that it will reallocate around USD 125 billion of *profits* to market jurisdictions, but in terms of tax *revenues* this is expected to be around USD 10 billion. This is a minuscule amount, especially when the annual scale of corporate tax avoidance ranges from 100-307 billion.

Developed countries succeeded in turning down the rightful demands of developing countries for a simplified solution that would result in higher revenue collection. What has been agreed to instead is a watered down, highly complex to administer solution that will generate very little revenue.

All the key demands of developing countries were rejected. This included, *inter alia*, at least 30% of residual profit as was called for by the G-24, a minimum rate of at least 20% as was called for by ATAF,[1] no mandatory and binding arbitration and the imposition of unilateral measures on out-of-scope companies.

The agreement contains other aspects that are of concern to developing countries. The eligibility of jurisdictions for an elective binding dispute resolution mechanism has been further narrowed instead of being expanded. Concerns relating to sovereignty and dispute resolution have been brushed aside. Amount B, which is of significant interest to many developing countries, has been pushed to low priority with work on it to be completed only by the end of 2022. This is unacceptable and there must be no implementation of Pillar One without Amount B.

The most concerning aspect of the agreement relates to unilateral measures. Developing countries had strongly argued that restrictions should apply only to in-scope companies. However, the agreement prohibits the introduction of any Digital Service Taxes "and other relevant similar measures" on *all* companies. This is unfair and has no policy rationale. Developing countries who agreed to the IF Statement have also agreed to give up their sovereign right to tax in exchange for a paltry amount of revenue that will be received at an uncertain time. Those countries that introduced unilateral measures have at least some relief till the implementation of Pillar One, however those who did not now have no options whatsoever and will have to wait till the coming into force of the Multilateral Convention (MLC). It can never be guaranteed how many countries will join the MLC and when the so-called "critical mass" will be reached.

Pillar Two

The minimum rate of 15% is far too low, especially when many developing countries have statutory corporate income tax rates (as stated by ATAF, for most African countries it ranges between 25-35%[2]) and even effective tax rates that are higher. To be genuinely effective in deterring profit-shifting to tax havens, the rate should have been between 20-25% as was demanded by various countries.

The low rate is worsened by the certainty that it will be mostly collected by developed countries. The rule order under Pillar Two gives primacy to headquarter jurisdictions through the Income Inclusion Rule (IIR), and the demand of developing countries that primacy be given to developing countries through the Under Taxed Payments Rule (UTPR) has been ignored. Its implementation has been placed in the lowest priority and the rules are expected to come into effect in 2024. To make matters worse, in the rare cases

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[1] African Tax Administration Forum

[2] https://www.ataftax.org/a-new-era-of-international-taxation-rules-what-does-this-mean-for-africa

where it can be applied, the UTPR now has an exemption for MNEs in the initial phase of their activity. This has potential for being misused by MNEs who can structure their operations such that their tangible assets are kept to below EUR 50 million and their operations limited to 5 jurisdictions. Strong anti-abuse rules are required to prevent this.

The primacy of the IIR also has the danger of enshrining the principle that the taxing right on untaxed income is given to the headquarter jurisdiction, which is harmful for source countries.

With regard to the Subject to Tax Rule (STTR), it is welcome that the minimum rate has been agreed upon at 9%. However, this could and should have been higher, but was restricted due to the low overall rate of 15%. Had the minimum rate been between 20-25%, the STTR rate could have been at a more appropriate 10-15%, in line with the withholding rates in many developing country tax treaties.

The scope of the STTR remains under negotiation and should include service fees and capital gains, as has been demanded by developing countries.

The carve-out for international shipping remains without strong rationale and should be removed.

Way Forward

Technical Aspects

On Pillar One, technical work remains to be done. Certain important areas are as follows: revenue sourcing, elimination of double taxation and the composition of the Determination Panel for dispute resolution.

On revenue sourcing, care must be taken that the rules that are developed adequately reflect the principle that revenue is sourced to the end consumer. If this is not done properly, developing countries risk losing out on the tax base.

On elimination of double taxation, it has been agreed that the entities that bear the tax liability will be those that earn residual profit. It must be ensured that the entity that surrenders the profit comes from developed countries and not from developing countries.

On the composition of the Determination Panel, at all accounts it must avoid the structure of international arbitral tribunals. Private lawyers and other private interests must be completely removed from the process. Experience from Investor State Dispute Settlement (ISDS) has shown that such a system is systemically geared against developing countries.

The composition of the Panel can be restricted exclusively to tax officials. In this manner, even if mandatory and binding dispute resolution is accepted, it would be a no-cost process similar to the Mutual Agreement Procedure (MAP) in tax treaties where disputes are resolved by Competent Authorities who are tax officials. As in MAP, since the tax officials are already paid salaries by their governments, States would not have to incur any additional expenses, unlike the system of international arbitral tribunals where the cost is prohibitively expensive, especially for developing countries.

Political Aspects

The IF Statement agreed to by 136 jurisdictions is not a binding legal commitment. Countries are absolutely free to not comply with the terms as laid out and continue using tax policy options that are more suited to their needs. This includes unilateral measures and Article 12B of the UN Model Tax Convention.

However, this will no longer be true after they sign the Multilateral Convention, which is proposed to be open for signature in 2022. Therefore, it is a matter of urgency for developing countries to take a firm and clear decision on whether they want to proceed with an option that will bring in very little revenue, be administratively complex and foreclose important aspects of their tax policy space. Countries which are unsure can follow a 'wait and watch' strategy while continuing to maintain alternative options.

It is particularly important to note whether developed countries sign the Convention. If they do not, then the entire exercise is meaningless as they are the ones who have to re-allocate profit to market jurisdictions.

The pursuance of alternative options will continue to put pressure on the negotiations and the revision of the structure of the Two Pillar solution. At present, only the scope is to be reviewed after 7 years. However, the review period should be shortened and this must include a more comprehensive review, especially of the allocation of taxing rights through the quantum.

On Pillar Two, it is clear that developing countries have nothing to gain by joining it. Since it is optional, it can be ignored and unilateral measures can be maintained which are more appropriate to domestic contexts.

The reform should be seen not as the end but as a step towards a fairer and more equitable re-allocation of taxing rights towards market jurisdictions. The South Centre will continue to support developing countries in this effort.

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