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Developing Country Demands for an Equitable Digital Tax Solution

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Introduction

International taxation has moved from being a niche, technical issue to being high on the global agenda. The recent Group of Seven (G7)[1] and Group of Twenty (G20)[2] agreements prominently featured international tax as one of the major issues in the global economy. A historic negotiation is nearing conclusion in the Organisation for Economic Co-operation and Development (OECD)/G20 Inclusive Framework (IF) on Base Erosion and Profit Shifting (BEPS). This is on the "tax challenges arising from the digitalisation of the economy".

It is commonly assumed that the negotiation applies only to large tax-avoiding tech companies such as the FAANG (Facebook, Amazon, Apple, Netflix and Google), who stand accused of avoiding around US$ 100 billion in taxes.[3] However, in reality it has gone much further and seeks to fundamentally change international tax rules that govern how the "nexus" or a taxable presence for Multinational Enterprises (MNEs) is decided and how their taxable profits are allocated between jurisdictions. The digitalization of the economy has meant that MNEs can generate revenues from jurisdictions without needing to have a physical presence. Further, allocating profits between source and residence jurisdictions becomes difficult when highly digitalized businesses barely have any physical assets, relying almost entirely on "intangibles" such as algorithms for creating value. For example, Uber does not need to own cars and Airbnb does not need to own real estate for delivering their respective services.

Abstract

The taxation of the digitalized economy is the foremost challenge in international taxation today. Countries around the world, especially developing countries, are struggling with taxing the rising profits of major tech giants which operate on entirely new business models that have made traditional international tax rules obsolete. A "Two Pillar solution" is being negotiated in the OECD/G20 Inclusive Framework on BEPS that seeks to update these rules, re-allocate taxing rights and establish a global minimum tax. However, as it stands, the solution has very limited tax revenue benefits for developing countries and is administratively complex. For the solution to be durable, it must be equitable, and accordingly must incorporate the concerns of developing countries going forward.

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L'imposition de l'économie numérique est aujourd'hui le principal défi de la fiscalité internationale. Les pays dans le monde entier, en particulier les pays en développement, ont du mal à imposer les bénéfices croissants des grands géants de la technologie, qui opèrent selon des modèles économiques totalement nouveaux, et qui ont rendu obsolètes les règles traditionnelles de la fiscalité internationale. Une "solution à deux piliers" est en cours de négociation dans le cadre inclusif OCDE/G20 sur le BEPS, visant à actualiser ces règles, à réattribuer les droits d'imposition et à établir un impôt minimum mondial. Toutefois, en l'état actuel des choses, les avantages de cette solution sont très limités en termes de recettes fiscales pour les pays en développement et est administrativement complexe. Pour que la solution soit durable, elle doit être équitable, et par conséquent, elle doit intégrer les préoccupations des pays en développement à l'avenir.

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Los impuestos fiscales de la economía digital es el principal desafío de la fiscalidad internacional en la actualidad. Los países de todo el mundo, especialmente los países en desarrollo, están luchando para gravar los crecientes beneficios de los principales gigantes tecnológicos que operan con modelos de negocio totalmente nuevos que han dejado obsoletas las normas fiscales internacionales tradicionales. Una "solución de dos pilares" se está negociando en el Marco Inclusivo de la OCDE/G20 sobre BEPS que pretende actualizar estas normas, reasignar los derechos de imposición y establecer un impuesto mínimo global. Sin embargo, tal y como está planteada, la solución tiene unos beneficios de ingresos fiscales muy limitados para los países en desarrollo y es administrativamente compleja. Para que la solución sea sostenible, debe ser equitativa y, en consecuencia, debe incorporar las preocupaciones de los países en desarrollo en el futuro.

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"Two Pillar" Solution - A Half-hearted Approach

To solve these problems, the IF has produced a "Two Pillar Solution". Pillar One seeks to update international tax rules, while Pillar Two seeks to establish a global minimum tax. The G7 and G20 agreements were hailed by the Western media as "historic", but the contribution of developing countries has been under-reported at best and ignored at worst. Developing country proposals, such as those made by the Group of Twenty-four (G24) and the African Tax Administration Forum (ATAF), have barely received any attention or serious analysis.

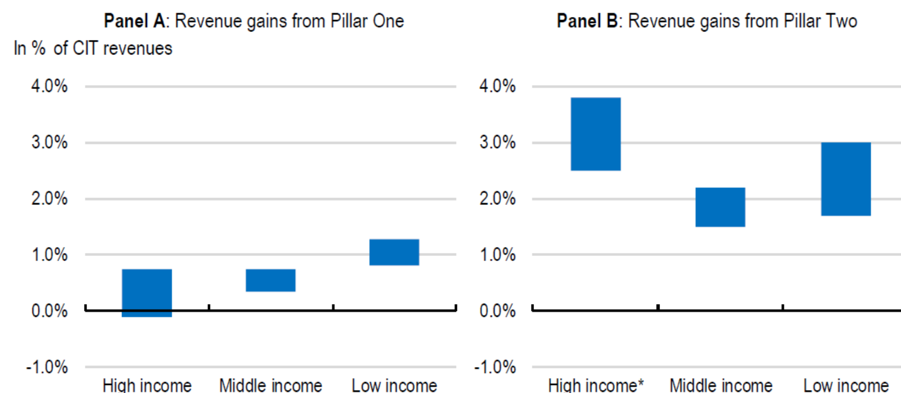
The reality is that were it not for the strenuous efforts of developing countries, the Two Pillar solution would be a carbon copy of American proposals. Even now, much of the architecture of Pillar One is based on a US proposal titled "marketing intangibles".[4] This sought to redistribute only a tiny portion of total MNE profits to market jurisdictions, the so-called non-routine or residual profits. The US later also called for a very high threshold so only a few MNEs would be covered. It demanded a global turnover of over EUR 20 billion and profitability over 10 per cent. This reduced the number of companies in-scope to around 100 from the earlier 2,300 based on a EUR 750 million turnover threshold.

Both these proposals now form the basic foundation of Pillar One. The present estimate is that profits over 10 per cent of revenues will be considered as residual, and between 20-30 per cent, a figure still being negotiated, of these will be reallocated to the entire developing world. Tandon (2021) demonstrates the application of this through an example. Out of 22.5 per cent global rate of profits of Alphabet, Google's parent company, taking out the non-routine profits (assuming a 20% reallocation) would mean only 2.5 per cent [(22.5 – 10) x 0.2] would be available for distribution to source countries. This distribution is expected to take place on the basis of sales. Hence, with 34 per cent contribution by the Asia Pacific countries to global sales of Alphabet, only about 0.8 per cent [2.5 x 0.34] is to be distributed among them which could be less if certain rules of Pillar One approach are adopted.[5]

Pillar Two, similarly, seeks to put in place a global minimum tax through four interlocking rules which essentially determine which country gets to tax the undertaxed income. The present structure of Pillar Two gives the default *first claim* on this income to the developed countries and is again based almost entirely on a US domestic law and meant to serve American interests. For example, if the global minimum tax is agreed upon at 15 per cent, and an MNE pays a developing country government an Effective Tax Rate (ETR) of only 2 per cent, then the remaining 13 per cent will be collected by the country where the MNE is headquartered. This is based on the "income inclusion" rule which is almost entirely modelled on a US domestic measure known as Global Intangible Low-Taxed Income (GILTI), part of the Tax Cuts and Jobs Act (TCJA).[6] If the company is a Big Tech firm like one of the FAANG, then the headquarter jurisdiction would be the US which collects the taxes. Only if the headquarter jurisdiction refuses to collect the taxes – which is quite unlikely – would the "source" country from where the MNE generated the revenue be able to collect the tax.

It is no surprise therefore that even the OECD's revenue estimates for Pillar One and Pillar Two show that developing countries have very little to gain. In fact the total gains are quite limited. Pillar One is expected to lead to an annual tax revenue increase of a paltry US$ 5-12 billion, and Pillar Two between US$ 23-70 billion (Figure 1).[7] This pales in comparison to the United Nations (UN) High Level Panel on International Financial Accountability, Transparency and Integrity for Achieving the 2030 Agenda (FACTI Panel)'s estimate of US$ 500-600 billion lost annually due to corporate profit shifting.[8] The distribution of gains is shown below, with high income countries – developed countries – the clear winners from Pillar Two.

Figure 1: Estimated Effect of the Two Pillar Proposals



Source: OECD Economic Impact Assessment, 2020

It was therefore unsurprising that nine members of the Inclusive Framework (IF) did not sign up to the agreement reached on July 1, 2021. These have now reduced to six: Ireland, Hungary, Estonia, Kenya, Nigeria and Sri Lanka. Negotiations continue to have their concerns taken on board. The October 2021 implementation plan is expected to provide further agreements on outstanding issues. The "consensus" of the other IF Members is also suspect. Negotiators have revealed on condition of anonymity that countries were given an "accept all or reject all" ultimatum and so were forced to accept, even if they deeply disagreed with many aspects of the Two Pillar solution. It points to a larger systemic problem with the OECD's "consensus" approach to decision-making.

Going forward, for the Two Pillar solution to be fair, stable and durable, it is vital that the implementation plan fully reflect the needs of developing countries. It is therefore highly valuable that the future international tax framework be fair with developing countries allowed to collect their fair share of the MNEs' profits in the digital economy. Otherwise, it may run the risk of even more countries abandoning it and opting for unilateral measures or alternative approaches such as Article 12B of the UN Model Tax Convention.[9] Whatever equitable components are there in the Two Pillar solution have been brought about solely due to the painstaking efforts of developing countries. These include the recognition of demand as a basis of profit allocation[10], nexus that does not require physical presence, profit allocation using an apportionment approach, revenue sourcing rules that trace it to the end market jurisdictions where goods and services are consumed, exclusion of the extractives industries and the conditional primacy of the Subject to Tax rule. It is important to give developing countries credit for these hard-won achievements, while highlighting demands that have not yet been accepted and must be incorporated going forward.

Contentious Domains

More work is needed in the following areas of the Two Pillar solution which need to adequately reflect developing country concerns.

Re-allocation of Total MNE Profit

Both the G24 and ATAF demanded the re-allocation of a portion of total MNE profit rather than categorizing it into routine and non-routine, which is administratively complex and irrational in terms of policy.[11] The G24 had called for fractional apportionment which would allocate a portion of the global profits of the enterprise to different jurisdictions based on a formula that gave balanced recognition to both supply and demand factors and would be administratively simple for developing countries.[12] ATAF proposed that the quantum to be reallocated could be a Return on Market Sales based on the Global Operating Margin of the MNE group, whereby the higher the Global Operating Margin of the MNE, the higher the reallocation.[13]

Taxing Income from "Routine" Functions

The G24 and ATAF both argued that routine functions such as marketing and distribution could be carried out remotely, but as they would generate only "routine" profits these would not be re-allocated to the market jurisdictions, which is unfair.

As stated by the G24, it is

> … illogical and inappropriate that an enterprise will have a taxable nexus in a market jurisdiction but would pay tax only when it earns non-routine profit. An enterprise engaged in providing goods/ services remotely, does marketing of its product, distributes its products say TV shows or movies, collects payments from customer and addresses customer grievances. All these activities, which are in the nature of baseline distribution and marketing activities can be performed remotely. It is therefore quite unfair (and ironical) to deny taxing rights in respect of such activities to a market jurisdiction on the ground that these are not performed physically when the very purpose of the discussion is to address precisely this problem i.e., the ability of businesses to operate remotely due to digitalisation.[14]

Mandatory and Binding Dispute Resolution

This has been a red line for many developing countries. Mandatory and binding arbitration has long been criticized for its structural inequities[15] and remains objectionable. While a concession has been made to make the process elective for countries fulfilling certain conditions, this should be made elective for all developing countries.

Subject to Tax Rule

The Subject to Tax Rule (STTR) allows developing countries to impose a withholding tax on certain intracompany payments which have the potential for tax avoidance. This will come first in the rule order under Pillar Two only for developing IF members, defined as jurisdictions with a Gross National Income (GNI) per capita below US$ 12,535. They must request another IF member to incorporate the STTR into their bilateral tax treaty (if it exists). However, it is unclear how this will be enforced. Further, analysis by the BEPS Monitoring Group (BMG) has shown that the STTR will have limited benefits and may not result in any additional taxing rights under the vast majority of tax treaties.[16]

Scope of Subject to Tax Rule

The G24 has demanded that the scope of the STTR must be as broad as possible, and must include all service payments and capital gains. Service payments in particular pose a significant tax avoidance risk to developing countries.[17]

Under Taxed Payments Rule

The Under Taxed Payments Rule (UTPR) gives source jurisdictions the right to deny deductions to bring the effective tax rate up to the minimum. Unfortunately, at present this is applicable only after the Income Inclusion Rule

(IIR) which gives the "first claim" on undertaxed income to headquarter jurisdictions, which are mainly developed countries. Only if they refuse to collect the tax, which is very unlikely, would the UTPR come into effect. Thus, the UTPR must receive primacy in the rule order under Pillar Two.

Minimum Rate

The minimum rate of 15 per cent is too low. Countries such as Argentina have called for 25 per cent and ATAF and the African Union have called for at least 20 per cent. Tax justice civil society organizations such as the Independent Commission for Reform of International Corporate Taxation (ICRICT), Tax Justice Network and Oxfam are campaigning for a 25 per cent rate. This can contribute to higher resource mobilization and support pro-growth policies that will help countries achieve the Sustainable Development Goals (SDGs) and the 2030 Agenda for Sustainable Development.

Conclusion

The Two Pillar solution must incorporate these developing country demands to be fair, equitable and durable. An imbalanced agreement which excessively favors the Global North at the cost of the Global South is unfair and faces the danger of being abandoned or undermined. The developed countries are gaining little by shielding large tech firms headquartered in their jurisdictions, as these are not paying taxes to them either. Major companies like Amazon, FedEx and Nike have paid zero in taxes to the US federal government. Ensuring these MNEs pay taxes in the jurisdictions from where they generate profits will benefit both developed and developing countries and place the world on a sustainable path to a post-COVID recovery.

Endnotes:

[1] See G7 (2021).

[2] See G20 (2021).

[3] See Fair Tax (2021).

[4] See Kibirige (2019).

[5] See Tandon (2021).

[6] See Grondona *et al*. (2020).

[7] These estimates were made before the US' proposal to restrict it to the top 100 companies was accepted.

[8] See UN FACTI Panel (2021).

[9] See Bansal (2021).

[10] See South Centre (2021).

[11] See ICRICT (2019).

[12] See Grondona *et al*. (2020); Uy (2019); G24 (2019).

[13] See ATAF (2021).

[14] See G24 (2021).

[15] See Oguttu (2018).

[16] See BMG (2021).

[17] See South Centre (2021).

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Efforts to reform international cooperation in tax matters are exhibiting a distinct acceleration. The direction of change must recognize and incorporate innovations in developing country policies and approaches, otherwise the outcomes will obstruct practical paths to development.

The policy brief series is intended as a tool to assist in further dialogue on needed reforms.

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