

Agreement? What Agreement? The 8 October 2021, OECD Statement in Perspective

On 8 October 2021, the Organization for Economic Co-operation and Development (OECD) announced that 136 (out of 140) Inclusive Framework members had agreed on a *Statement on a Two-Pillar Solution to Address the Tax Challenges Arising from the Digitalisation of the Economy*.¹ The agreement has been celebrated as being momentous and as building the foundation for a new international tax regime.² This editorial contends that the celebration is premature, misplaced, and disingenuous. It is premature because the proverbial devils await in the many details that are far from being settled by the so-called agreement. Furthermore, there are good reasons to believe that it will not be as effective against undesirable corporate tax planning as it is presented to be. It is misplaced because it has expended political capital in support of an international tax reform on some limited interests of the few most dominant economic powers in the world at the expense of the interests of the rest of the world. This is not a cause for celebration but rather the opposite. Even the so-called winners are likely to discover that they made a disadvantageous bargain since the developing world is unlikely to truly cooperate with this unfavourable outcome that will subsequently likely carve into the effectiveness of the new rules. A similar lesson can be observed in the recent past: The Base Erosion and Profit Shifting (BEPS) agreements of 2015 were loudly celebrated by the OECD and said countries. Many other countries supposedly joined them through membership in the Multilateral Instrument (MLI) and Inclusive Framework, however, in reality countries that were able to do so quickly adopted unilateral measures in blunt defiance of the lauded international

cooperation effort. Stakeholders were cautioned, at the time, that this would be the outcome,³ and it must be reiterated that the outcome is unlikely to be different since nothing has materially changed. Hence, this editorial argues that the celebration is disingenuous. It portrays the agreement as global⁴ when the only clear winners are the OECD, the rich countries' club, and its secretariat who continue to dominate the international tax regime despite its obvious illegitimacy and past failures. The few other purported winners, specifically the most prominent countries of residence of the largest multinational enterprises led by the United States, may find that their gains may not justify the damage to the existing international tax regime and the consequences of the strong odour of neocolonialism that surrounds the agreement.

So, what has been agreed? Pillar One is the response to the demand of market or source countries for a greater amount of taxation. The current agreement delivered a significantly reduced scope for Pillar One: Approximately only 100 multinational enterprises, i.e., those with a global turnover above EUR 20 billion and profitability above 10% with both the extractive and the financial industries excluded. These corporations will be subject to source taxation if they meet a new nexus threshold: EUR 1 million in revenue derived in a jurisdiction (or EUR 0.25 million in jurisdiction with a GDP under EUR 40 billion). The source taxation will amount to 25% of the profit above 10% of revenue. The calculation of profits will be based on the financial statements of the taxpayers with a 'small number of adjustments'. Revenue will be sourced based on yet-to-be determined source rules.

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¹ OECD, *Statement on a Two-Pillar Solution to Address the Tax Challenges Arising from the Digitalisation of the Economy*, OECD/G20 Base Erosion and Profit Shifting Project (OECD Publishing 2021), <https://www.oecd.org/tax/beps/statement-on-a-two-pillar-solution-to-address-the-tax-challenges-arising-from-the-digitalisation-of-the-economy-october-2021.pdf> (accessed 10 Nov. 2021).

² See e.g., US Dept. of Treasury, *Statement from Secretary Janet L. Yellen on the OECD Inclusive Framework Announcement* (8 Oct. 2021), <https://home.treasury.gov/news/press-releases/jy0394> (accessed 10 Nov. 2021) ('Today's agreement represents a once-in-a-generation accomplishment for economic diplomacy. We've turned tireless negotiations into decades of increased prosperity – for both America and the world'); See also European Commission, *Statement by Commissioner Gentiloni on the G20's Endorsement of the Agreement on International Taxation Reform* (15 Oct. 2021), https://ec.europa.eu/commission/presscorner/detail/en/STATEMENT_21_5247 (accessed 10 Nov. 2021).

³ Y. Brauner & A. Baez Moreno, *Taxing the Digital Economy Post-BEPS ... Seriously*, 58 Colum. Trans. L.J. 121 (2019).

⁴ Puzzlingly, the agreement was presented as if it equally distributes the benefits among all relevant jurisdictions. See e.g., statement by Rishi Sunak, the U.K. Chancellor, at P. Inman & M. Savage, *Rishi Sunak Announces 'Historic Agreement' by G7 on Tax Reform*, The Guardian (5 June 2021).

Finally, any such source taxation will be relieved by the residence country in order to avoid double taxation. Disputes will be resolved by a still undetermined established mandatory and binding mechanism; for some developing countries, this mechanism will be elective. A new multilateral convention will implement the agreement and also include the requirement to eliminate all unilateral measures, such as digital service taxes (DST).

Pillar Two is the true focus of the agreement and the most impactful. It legitimizes the implementation of a 15% minimum global tax in the format of a top-up tax over (lower) source taxation or denies a deduction (at source) for payments not subject to the minimum tax at residence. This Global Anti Base Erosion (GLOBE)⁵ inspired rule will be complemented with a treaty provision permitting limited taxation at source of income that is not sufficiently encompassed within the above domestic taxation categories. Inclusive Framework members are not required to adopt the above rules but must respect similar and corresponding rules adopted by other members. The threshold for the application of the minimum tax will be the same EUR 750 million as that for country-by-country reporting (CbCR) with multiple exclusions and carve-outs and an opportunity to expand the scope at the discretion of the imposing countries. The agreement specifically indicates that the United States' Global Intangible Low-Taxed Income (GILTI) regime will be considered to coexist which the United States interprets as being in compliance with Pillar Two.⁶

The annex to the statement includes interesting implementation rules, primarily the need for a new multilateral convention. However, there is also a statement that the OECD will develop domestic law drafts and commentaries for the members to use when they need to amend their domestic laws to comply with their obligations under the statement.

It seems that the OECD has accomplished revolutionizing the international tax regime in seven well-spaced and very legible pages. This is the outcome of the work on what must be the most formidable challenge ever faced by the OECD, i.e., the taxation of the digital economy (and related activities that do not accord with the physical presence basis for taxation that dominates the current international tax rules).

This editorial cannot, of course, exhaustively analyse this so-called agreement (an exercise undoubtedly already performed by the best experts worldwide), however, a few preliminary observations in accordance with its less-than-favourable evaluation of it are due.

First, the agreement is the most extreme outcome of the BEPS Project to date in terms of the balance of goals that it attempts to achieve. It clearly makes the taxation of

Multinational Enterprise (MNEs) the major goal of the project and almost entirely neglects all other goals.

Strangely, the initiative led by the United States targets the largest multinational enterprises more than any prior BEPS outcomes; the large majority of these MNEs are American.

This singular focus is problematic for several reasons. First, portraying multinationals as the enemy and the sole culprit for the state of the international tax regime appears to be a populist move attempted to camouflage the failure of BEPS to deliver a reform that would make the international tax regime fairer and more legitimate. Second, the largest multinationals have consistently proven that they are resilient and very good at adapting to tax law changes. In fact, they are much better than other firms in doing so and may ultimately just leverage their power. Third, the proposed reform is highly complex and, again, multinationals are more effective at dealing with complexity than other firms, leaving the general public to bear the burden of the waste caused by such complexity. The observations that are made only subsequently add to this list. This author thinks that a more principled reform could even do better as (and perhaps because) it would not point fingers and attract less attention to the bravado of politicians and the less wasteful reaction by taxpayers.

Second, the agreement completely disregards the focus of the post-BEPS work on the digital economy. It applies generally with no specific attention to the problems presented by this economy. This is ironic since the one criterion that the current agreement meets is that it does not ringfence the digital economy. It is a criterion that was established early in the project, yet it is not adhered to by the OECD throughout its various iterations. The problem with the current agreement is that it applies only to a small group of companies and only to a small portion of their profits. This results in no resolution in terms of taxation of the digital economy which is what the project was to address from the beginning.

The agreement takes the giant, though expected, step of declaring the fact that physical presence is not necessary for taxation of business income earned by foreign corporations. However, it appears that this innovation only applies to the so-called Amount A of the approximately 100 corporations that are subject to Pillar One in its current iteration. The entire remainder of the digital economy remains in ambiguity and, more probably, left for unilateral measures that, at present, have been viewed as unacceptable and only tolerated as temporary. The key technical issues with which the work on the digital economy has struggled include transfer pricing for intangibles,

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⁵ The Global Anti-Base Erosion Proposal (GloBE) was originally made by Germany and France. See e.g., J. Englisch & J. Becker, *International Effective Minimum Taxation – The GLOBE Proposal*, 11(4) World Tax J. 483 (2019).

⁶ The exact wording is: 'It is agreed that Pillar Two will apply a minimum rate on a jurisdictional basis. In that context, consideration will be given to the conditions under which the US GILTI regime will co-exist with the GloBE rules, to ensure a level playing field'.

the anachronism of the Permanent Establishment (PE) concept, and the difficulty of applying the old source rules to the new economy. All have been, at best, partially and indirectly addressed and only for some taxpayers and a number of jurisdictions.

Third, the agreement completely depends on the conclusion of a future multilateral convention which would be a monumental task. It is especially unlikely that the United States will join such a convention which would be an omission that, due to the United States' centrality to Pillar One, may cause the entire agreement to collapse. Moreover, the envisioned multilateral convention will be a true tax convention and not merely a measure to swiftly amend bilateral tax treaties and preserve their stability. It would be a dramatic change for many inclusive framework members that currently do not have any or only a few tax treaties. The number of bilateral treaty relations will be increased seven-fold. The relationship between this multilateral convention and bilateral tax treaties has not yet been explored by the OECD, and it is initially expected to be very complicated. It will be even more complex for countries with treaty provisions that directly contradict the OECD proposed solution, such as those including Article 12A and Article 12B of the UN Model. Indeed, it is logical to presume that such provisions are precisely the target that the OECD proposal is attempting to eliminate, yet it is suspected that such a reversal will be difficult to explain, especially for developing countries. Note that even the MLI, more than five years after its conclusion, is yet to be ratified by a third of its signatories. A multilateral convention is likely to take a very long time to come to fruition as expected by the agreement, and perhaps that is the goal of the politicians who have been crafting the agreement.

Fourth, the agreement includes commitments to amend domestic laws as required, and it is expected that the OECD will soon release sample drafts for such a purpose. The assumption must be that these laws would not be changed by a multilateral treaty but rather by the countries themselves with each of them going through its domestic legislative process. It is certain that this may even be a more enormous task than the conclusion of the multilateral convention. However, the fact that is more disturbing is that the OECD has taken a position here that gnaws further into the so-called sovereignty of countries without legitimacy. This was already an issue even when tax treaties were concerned, but it is also clearly an issue in the case of domestic law changes. Constitutional challenges will clearly slow or even terminate this process that, in the least, will be very lengthy. Moreover, a mechanism to oversee the implementation of the obligations to amend domestic laws will have to be constructed that will probably involve a peer-review mechanism, which seems to be the OECD's preferred tool. Such a mechanism raises similar, if not even greater, questions about the legitimacy of the process when domestic tax laws are concerned.

Fifth, the agreement relies on a future mandatory and binding dispute resolution mechanism. Well, the OECD failed to reform the treaty dispute resolution regime during BEPS. It again attempted by inserting an opt-in mechanism for mandatory arbitration in the MLI to which only a few of the signatories responded. So, now the future of the complex compromise presented by the agreement will depend on effective dispute resolution mechanism the nature of which has not yet been explored?

Unfortunately (in this author's opinion), the developing world disapproves mandatory arbitration in tax treaty disputes. It must be wondered how the OECD will resolve issues under the new agreement without increasing opposition based on neocolonialism types of arguments.

Sixth, the agreement shifted the focus of Pillar Two from the fight against BEPS to the taxation of the largest world multinationals by their home countries. Obviously, the shift has unavoidable fairness implications. Even the OECD admits that the impact of the agreement will be mainly in favour of the richest countries in the world. The problem is that the key measures of the agreement would not necessarily stop profit shifting. It may narrow the margins for tax planning under the best of scenarios but not eliminate the incentives to profit shifting. Multinationals will find ways to do so, and some of these methods have already been discussed by experts (most notably the manipulation of the applicable accounting rules). Moreover, the distributional impact of the agreement may put politicians from the developing world in a difficult situation if their gains (assuming any) from the agreement are lower than actual or potential gains from a DST or any similar measure that they repealed or could have enacted otherwise.

Seventh, the agreement decimated the magnitude of permissible source taxation by market economies of the largest corporations in the world in comparison to all former proposals by the OECD itself.

Any comparison of such an impact would clearly embarrass developing country politicians who may not view that as a problem at the moment when they are pressured by the OECD and the richest countries. However, over time, the numbers will be exposed, and the likely response would be unilateral measures and aggressive interpretations of the agreement.

This is exactly what occurred with the BEPS agreements into which some countries were rushed and eventually ignored for most purposes.

Eighth, the new nexus rule for Pillar One makes a bold statement that physical presence is not necessary for taxation at source. The proposed rule demonstrates that its designers chose simplicity over accuracy. The problem with such an elementary proposal is that it affects different countries (and corporations) very differently. Hence, it will undoubtedly effectuate meticulous tax planning around it when relevant. Countries that, for example, find themselves benefiting much less from the agreement

in comparison to competitor countries with only slightly different economic measures may be somewhat dismayed. Additionally, the nexus threshold seems rather low which provokes questioning why not completely eliminate it and replace it with formulary taxation with *de minimis* rules that are likely to be at least as simple to calculate. Such rules have the advantage of providing better information to source jurisdictions and, this author opines, should be perceived as fairer and more legitimate since they would apply more proportionately to all countries.

Ninth, the agreement provides for new source rules. Currently, there is little information about these new rules, yet it should be noted that they would be a 'big deal'. The sensitivity of the source jurisdiction for the ongoing gradual diminishment of their tax base requires utmost care in the design of such source rules. However, as has been proven throughout the long journey to solving the problem of taxing the digital economy, it is very difficult to draft sensible source rules for income generated in such an economy. In fact, the concept of source makes little sense in that context. Still, the agreement's design requires that the OECD produce new rules, a task that will most likely create dissatisfaction for everyone. Moreover, it is not clear whether these source rules will apply only to the Pillars and what the relationship would be between them and the traditional source rules. Not addressing these issues will surely instigate litigation.

Tenth, the agreement calls for uniform reliance on financial accounting numbers with only a small number of adjustments as a basis for at least the Pillars' measures. This is a dramatic departure for countries, such as the United States, where tax accounting strives for more accuracy even at the expense of conservatism, acknowledging the very different goals of financial and tax accounting. The key for success in this context will be in the level of adjustments allowed which this author expects to be more than just minimal. There is no question that multinational enterprises will shift much of their tax planning energy to the manipulation of the new tax accounting. This may place pressure on countries to adjust, as much as possible, their domestic versions of tax accounting or even financial accounting. Such pressures may corrupt financial accounting standards, a manifestly undesirable result, and shift the centre of tax competition. The very fragile balance to which the OECD strives here may further be frustrated by special deals granted to different countries. These deals could be expected to be quite numerous since they have already been granted to inclusive framework countries that are reluctant to join the agreements (Ireland, etc.). The problem with these special deals goes beyond applicable accounting standards, of course, and there is no reason not to expect a significant number of them are permitted (or taken) by other countries.

Eleventh, the agreement provides for rules based on the CbCR. Moreover, the Pillar Two solution anticipates the minimum tax to be measured on a country-by-country

basis in order to prevent averaging. Again, the inspiration for this rule appears to be taken from the US GILTI regime despite the fact that the United States chose to prevent averaging for foreign tax purposes based on types of income (known as 'baskets') rather than based on jurisdictions, a method that was used in the past for this purpose. The Biden administration hinted that it will be willing to shift to the same system. The disadvantageous aspect of jurisdiction based anti-averaging rule is that income within a jurisdiction is permitted to be blended. Therefore, high-taxed business income may be blended with low-taxed investment income sourced in the same jurisdiction. Current rules present opportunities for such blending which is exactly the reason for the original shift in the United States from a jurisdiction to a type of income based anti-averaging rule. Beyond manipulability, the new rule creates incentives to shift investment income (more mobile investments) to jurisdictions with high taxation of business income. The precise impact of this incentive should be examined, although it seems to accord with the purposes of Pillar Two. Losing jurisdictions, however, may be very dissatisfied with such an outcome. Finally, the ties between the CbCR and the jurisdiction based anti-averaging rule should have been more carefully explored by the agreement. It should be clear that these are different accounts with different purposes. However, for losing source jurisdictions, the difference may be a warning sign that they had not fully grasped the implications of the agreement and that their consent had been hastened. This would leave them vulnerable to domestic criticism as they are proven to be eventual losers of the new deal.

Twelfth, the agreement calls for immediate withdrawal of all DSTs. This is the primary goal of residence countries in this agreement. There is much to say about this, but this author's key observation is that even this simplest of obligations (a repeal of DSTs) will prove to be very complicated. There is an expectation that many developing countries will be deprived or be perceived as losing revenue from the agreement. The simplest comparison will be revenue raised by a DST (enacted or envisioned) against additional revenue from Pillar One. Such a comparison is predicted to be very problematic for the majority of market economies. If the future of reading the discussions between the United States and European countries in this context could be foreseen, it would indicate that it is becoming clear that simple repeal of the DSTs is not going to occur. Transition rules will be established, and no prophecy needs to be involved to expect that less friendly jurisdictions to the United States will be even less likely to eliminate unilateral measures to tax the digital giants.

In conclusion, the agreement reached by the Inclusive Framework in October will undoubtedly shake the international tax regime. Its tremendous complexity and the intricacies involved in its implementation will reveal themselves in the upcoming months and years. What is clear is that the developing world was again left behind in

the international tax discourse, which this author opines will result in further dismantling of the regime as countries discover ways to defect from the arrangement to minimize their losses. In the past, this author has written extensively in support of cooperation in international tax matters and the potential benefits of genuine cooperation of all countries, and developing countries in particular. This often incites rebuff from colleagues, most notably by Tsilly Dagan, that such cooperation will likely result in the exertion of cartelistic power by the already powerful countries. Unfortunately, the current round of negotiations resulting in the October agreement prove these critics (and

not this author) to be correct. Yet, the shift that BEPS 2.0 took with the awakening of the United States and the dictate of the current agreement to the entire Inclusive Framework indicate to me the importance of genuine inclusivity and the necessity of cooperation among developing countries to prevent such disappointing results in the future. The best focus of such cooperation in the near future will be on the many details of the implementation plan of the October agreement.

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