

Would Pillar One Fix the Broken System?

I INTRODUCTORY REMARKS

In October 2023, the Inclusive Framework's Task Force on the Digital Economy released the text of the Multilateral Convention to Implement Amount A of Pillar One (the MLC) which reallocates taxing rights on corporate income to market states.¹ The MLC is presented as a key component of the Two Pillar solution to address the tax challenges arising from the digitalization of the economy.²

Pillars One and Two are complementary. The latter introduces a minimum effective rate for in-scope multinationals,³ but Pillar Two alone will not repair the international tax system as it still allows profit shifting to market states.⁴ The problem is that Pillar One will probably not enter into force and, even if it did, it would also not fix the system because it does not sufficiently tax stateless income or allocate enough revenue to market states.⁵

Moreover, Pillar One goes beyond Pillar Two in disregarding legitimacy aspects of the multilateral solutions that are proposed because it meticulously handles the in-scope MNEs, the amounts to be taxed under Amount A, the amount of tax allocated to market states, elimination of double taxation, and prevention and dispute resolution binding mechanisms of which all are related to tax sovereignty.

In this editorial, this author would like to comment on the following aspects raised by the MLC: The amount of revenue reallocated to market states; stateless income and fair allocation of taxing rights; the elimination of unilateral digital taxes; the MLC's rules for the entry into force; and legal certainty and legitimacy.

2 REALLOCATION OF REVENUE TO MARKET STATES

Pillar One applies in addition to existing allocation of taxing rights rules and, differently from bilateral tax treaties, the calculation of the tax is determined by the MLC rules and not by domestic regulations. The MLC is the output of engaged work by the G-20 and the OECD in recent years and is consistent with the OECD purpose of fostering multilateralism. The purpose and the continuous work in the direction of multilateralism are to be praised. The MLC is also the outcome of negotiations in the inclusive framework that comprises both OECD and non-OECD jurisdictions. One hundred and thirty eight members of the OECD/G20 Inclusive Framework on Base Erosion on Profit Shifting (BEPS) (representing over 90% of global GDP) have approved the July 2023 *Outcome Statement on the Two-Pillar Solution to Address the Tax Challenges Arising from the Digitalisation of the Economy*, including Argentina, Brazil, Chile, China, India, Kenya,

Notes

¹ *The Multilateral Convention to Implement Amount A of Pillar One – Two-Pillar Solution to Address the Tax Challenges Arising from the Digitalization of the Economy*(2023), <https://www.oecd.org/tax/beps/multilateral-convention-to-implement-amount-a-of-pillar-one.pdf>; *Explanatory Statement to the Multilateral Convention to Implement Amount A of Pillar One Two-Pillar Solution to Address the Tax Challenges Arising from the Digitalisation of the Economy*(2023), <https://www.oecd.org/tax/beps/explanatory-statement-multilateral-convention-to-implement-amount-a-of-pillar-one.pdf>.

² *International Tax Reform: Multilateral Convention to Implement Amount A of Pillar One*, <https://www.oecd.org/tax/beps/multilateral-convention-to-implement-amount-a-of-pillar-one.htm#:~:text=The%20Multilateral%20Convention%20to%20Implement%20Amount%20A%20of,improves%20tax%20certainty%2C%20and%20removes%20digital%20service%20taxes.>

³ Pillar two was released on 20 Dec. 2021: OECD (2021), *Tax Challenges Arising from the Digitalisation of the Economy – Global Anti-Base Erosion Model Rules (Pillar Two): Inclusive Framework on BEPS* OECD Publishing, Paris, <https://doi.org/10.1787/782bac33-en>, and is being implemented in several jurisdictions, including in the European Union, via a directive: COUNCIL DIRECTIVE (EU) 2022/2523 of 14 Dec. 2022 on ensuring a global minimum level of taxation for multinational enterprise groups and large-scale domestic groups in the Union.

⁴ The reference to an International Tax Broken System was mentioned by Jayati Ghosh (Chairwoman, Independent Commission for the Reform of International Corporate Taxation, ICRITC), in her intervention in Panel 2 of the EU Tax Symposium titled, *Decision-Making on Taxation: Combining the National, EU and International Level* Day 2 12:13:33, <https://acs.europarl.connectedviews.eu/embed/meeting/?refid=20231025-0900-COMMITTEE-FISC&audio=qa&language=en>.

⁵ With a more detailed approach: Lorraine Eden, *The Simple Analytics of Pillar One Amount A*, 50(3) Tax Mgmt. Int'l J. 137–142 (5 Mar. 2021). Reproduced with permission from Bloomberg Tax. Copyright 2021 The Bureau of National Affairs, Inc. (800–372-1033), <http://www.bloombergtax.com>, SSRN, <https://ssrn.com/abstract=3800017> 'the overall impact of Amount A on global CIT revenues is likely to be much larger than predicted due to jurisdictional tax games that boost the direct (tax base) effect. ... [T]he creation of new taxing rights under Amount A essentially applies sales-based global formulary apportionment (GFA) to MNE profit. Sales-based GFA rewards Market jurisdictions with large markets and poorly performing MNEs and punishes those where MNEs earn above the global average return on sales'.

Nigeria, South Africa, the United States, Zambia, and most of the European Union Member States.

However, that does not necessarily mean that the signatory members are satisfied. On the contrary, the primary dilemma of a multilateral convention allocating taxing rights (coordinating a reallocation system in detail) in a world of unequal distribution of wealth and unequal economic interest is the risk that no one will be satisfied.

3 STATELESS INCOME AND FAIR ALLOCATION OF TAXING RIGHTS

First, the purpose of Pillar One is to allocate taxing rights to the market states, and this is because it allegedly recognizes that sales are an important factor originating profit in the current digitalized economy. After so many years of international and European Union discussions on taxation of the digitalized economy, including whether to ring-fence taxation of consumer-facing businesses,⁶ it is clear that there are two interrelated objectives pursued by the allocation of revenue to the market states. One of those is to target stateless income via the market state. It is broadly recognized that residence and source are no longer sufficient for taxing cross-border business income in the absence of sales as a relevant factor for allocation of revenue. The other objective refers to a fair international allocation of taxing rights due to the inadequacy of the current source concept that relies on physical presence, and the digitalized economy does not.

However, the answer to the first objective is not ambitious as only very large and highly profitable MNEs are in scope (i.e., MNEs with annual revenue above EUR twenty billion and profitability greater than 10%⁷). Moreover, if an MNE does not meet those thresholds but one of its reported segments in the consolidated financial statements does, that reported segment would be in scope.

There are some industries excluded from the scope of Pillar One mainly due to the fact that they are either submitted to specific tax regimes or do not raise issues of fair allocation of taxing rights: Extractives, regulated

financial services, defence, and purely domestic-oriented businesses.

It is also to be noted that the threshold for the in-scope companies of Pillar One is higher than the one that is applicable by Pillar Two to MNE groups (for which the threshold corresponds to an annual revenue of 750 million EUR or more in the consolidated financial statements of the ultimate parent entity (UPE) in at least two of the four fiscal years immediately preceding the tested fiscal year).⁸

The second purpose concerning the fair international allocation of taxing rights is also not achieved. Besides the fact that only very large MNEs are in-scope of Amount A, the amount of revenue allocated to the market states is not satisfactory. It results from using a formula and quantitative metrics. The former applies on top of the existing allocation rules, identifies 25% of the MNE's profit in excess of 10% of the MNE's revenue, and allocates this defined portion of excess profit to market jurisdictions using a revenue-based allocation key.⁹ The latter then implies the identification of the eligible market jurisdictions – where the end customer consumes or uses the good or service (referred to as Step 2) – through specific sourcing rules identifying the jurisdiction. A market jurisdiction is entitled to tax Amount A profit through a quantitative threshold (i.e., sourced revenue above EUR one million that is reduced to EUR 250 thousand for jurisdictions with a GDP below EUR forty billion) regardless of the MNE's physical presence.¹⁰

4 THE ELIMINATION OF UNILATERAL DIGITAL TAXES VS. THE MLC ENTRY INTO FORCE

Furthermore, Pillar One requires a compromise by its signatories on eliminating (removal or application of a stand still clause) unilateral digital services taxes and their equivalent when the MLC and its Amount A enter into force. Annex A of the MLC contains an indicative list of existing measures subject to removal. The breach of that compromise will imply the denial of Amount A, and any future measures incompatible with it will be periodically reviewed.

Notes

⁶ Ana Paula Dourado, *Taxing Consumer-Facing Business as a Regulatory Currency*, 13(4) WTJ 541–557 (2021); Ana Paula Dourado, *Digital Taxation Opens the Pandora Box: The OECD Interim Report and the European Commission Proposals*, 46(6) Intertax 566–569, 570–571 (2018), <https://kluwerlawonline.com/journalarticle/Intertax/46.6/TAXI2018058>, doi: 10.54648/TAXI2018058.

⁷ 'Adjusted Group Revenues must exceed EUR 20 billion and are calculated based on the accounting revenues reported in the consolidated financial statements, excluding VAT/similar consumption taxes, and subject to limited adjustments. Moreover, the Pre-tax profit margin must exceed 10% (with an Averaging Mechanism), and is equal to the relevant group profit ignoring losses, divided by the Adjusted Revenues. When the group is not in scope in both of the two immediately preceding periods, two additional tests must be satisfied: i. Pre-tax profit margin greater than 10% in at least two of the four periods immediately preceding the period; and ii. Weighted average pre-tax profit margin over the five periods ending in the current period exceeds 10%'. *Webinar: Multilateral Convention to Implement Amount A of Pillar One* slide 8, <https://www.oecd.org/tax/beps/presentation-mlc-technical-webinar.pdf>.

⁸ Article 1.1.: OECD, *Tax Challenges Arising from the Digitalisation of the Economy – Global Anti-Base Erosion Model Rules (Pillar Two): Inclusive Framework on BEPS* OECD Publishing, Paris (2021), <https://www.oecd-ilibrary.org/docserver/782bac33-en.pdf?expires=1698835803&id=id&accname=ocid54022976&checksum=603CC84764D64955B8141C9FF5A39387>.

⁹ Article 2 d) of the MLC: *The Multilateral Convention*, supra n. 1. As already foreseen in the *Statement on a Two-Pillar Solution to Address the Tax Challenges Arising from the Digitalisation of the Economy* (8 Oct. 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>.

¹⁰ The allocated profit is adjusted downwards to prevent the 'double counting' that would result from the market jurisdictions taxing the MNE's excess profit twice, i.e., the Marketing and Distribution Safe Harbour Adjustment (MDSH).

In light of the above *sanction* – the denial of Amount A in the event that a jurisdiction does not remove a measure that is incompatible with the MLC – it can be questioned on a case by case basis whether it is preferable for a jurisdiction to keep the unilateral measure instead of eliminating it.

Jurisdictions for which their existing measures are subject to removal include some EU Member States, India, Tunisia, Turkey, and the United Kingdom. Unilateral digital service taxes and equalization levies on online advertisement services fall on consumer-facing businesses and are therefore related to big data.¹¹ Pillar One has a broader scope, as recalled above, yet, many of the in-scope MNEs are engaged in big data and consumer-facing businesses.

The fact that only very large groups of companies are in-scope and allocation of taxing rights to the market states is not significant as well as the fact that there is an obligation for the parties to eliminate digital services taxes and alike would indicate that every effort has been taken to convince the United States to adhere to Pillar One. However, not only is it unlikely that it will do so in the near future, but it also has a veto power in its entry into force (Article 48, 1 a), 1 b) and Annex I). This may be justified by the fact that most of the in-scope and most profitable MNEs are US based groups, therefore, Pillar One would, allegedly, disproportionately impact US-based companies.¹²

5 LEGAL CERTAINTY AND LEGITIMACY

Finally, tax certainty is addressed in Pillar One with dispute prevention and resolution mechanisms that will

avoid double taxation in a mandatory and binding manner.¹³ An MNE can submit a request for certainty to the lead tax administration (which will normally be the parent entity). In other cases, a panel of several tax administrations would participate in the review of a measure. The MNE can present its position, and the outcome is binding if there is agreement among the affected parties; otherwise, it is referred to a determination panel for a binding outcome. All procedures will occur with strict time limits. The role of states and their parliaments and courts is either essentially inexistent in determining and interpreting the regime or reduced to very minor aspects.

In most jurisdictions, there is no active intervention of parliaments to discuss the contents of the MLC, such as the allocation of taxing rights and the need to remove unilateral taxes held to be incompatible with Amount A. Moreover, as mentioned above, the MLC exhausts the main aspects under the states' constitutional principle of legality such as the definition of the tax subject, the tax base, or rates. Finally, national courts would have no influence in controlling its proper application.

If the choice under the MLC is in favour of detailing the main tax elements in order to prioritize multilateral efficiency, predictability, and the prevention of double taxation and litigation, the lack of legitimacy would raise many concerns regarding the way multilateralism may be adopted and implemented.

Ana Paula Dourado
Editor-in-Chief

Notes

¹¹ Although the criteria are broader, the tax is applied by reference to market-based criteria (e.g., location of customers and users); it is (de jure or de facto) ring-fenced to non-resident or foreign-owned businesses; and it is outside the scope of tax treaties. There is an explicit exclusion for consumption taxes, transaction taxes that apply on a per-unit or per-transaction basis, and rules to address artificial avoidance of permanent establishments (Slide 46).

¹² Daniel Bunn, *Treasury's Latest Pillar 1 Proposal: A Strategy to Split the Riches or Give Away the Store?* (14 Apr. 2021), <https://taxfoundation.org/blog/treasury-pillar-1-proposal/>. IMF Policy Paper, *Corporate Taxation in the Global Economy*, Policy Paper No. 2019/007 (Mar. 2019), [https://www.imf.org/en/Publications/Policy-Papers/Issues/2019/03/08/Corporate-Taxation-in-the-Global-Economy-46650;file:///C:/Users/Utilizadot/Downloads/PPEA2019007%20\(1\).pdf](https://www.imf.org/en/Publications/Policy-Papers/Issues/2019/03/08/Corporate-Taxation-in-the-Global-Economy-46650;file:///C:/Users/Utilizadot/Downloads/PPEA2019007%20(1).pdf).

¹³ Already foreseen in the *Statement on a Two-Pillar Solution*, *supra* n. 9.