The **BEPS**

Monitoring

Group

COMMENTS OF THE G-24 ON THE STATEMENT ON A TWO-PILLAR SOLUTION TO ADDRESS THE TAX CHALLENGES ARISING FROM THE DIGITALISATION OF THE ECONOMY

On 19 September the G24 Group of lower-income countries issued comments on the statement issued on 1st July 2021 by the OECD outlining the agreement reached through the Inclusive Framework of the OECD/G20 base erosion and profit shifting (BEPS) project. These comments by the BEPS Monitoring Group (BMG) explain why we support the views expressed by the G24, and urge that they must be taken very seriously for a durable solution to be achieved. The BMG is a network of experts on various aspects of international tax, set up by a number of civil society organizations which research and campaign for tax justice including the Global Alliance for Tax Justice, Red de Justicia Fiscal de America Latina y el Caribe, Tax Justice Network, Christian Aid, Action Aid, Oxfam, and Tax Research UK. This report has not been approved in advance by these organizations, which do not necessarily accept every detail or specific point made here, but they support the work of the BMG and endorse its general perspectives. It is based on our previous reports, and has been drafted by Sol Picciotto with comments and contributions by Alex Cobham, Alexander Ezenagu, Tommaso Faccio, Jeffery Kadet, Annet Oguttu, Sudarshan Rangan, Jim Stewart, and Attiya Waris.

5 October 2021

SUMMARY

At this critical moment in negotiations to reform international tax rules, the G24 lower-income countries have published their views on the proposals, which we consider state what is needed for an acceptable and durable agreement to be reached. Analysis of the key components of a possible final package shows the importance of the points made by the G24, and why lower-income countries should not be pressurised into accepting rules that would damage them, and prevent any further progress towards more comprehensive and effective reforms.

THE JULY STATEMENT AND THE G24 COMMENTS

At the end of July we published our comments on the Statement of 1st July from the Inclusive Framework outlining a Two-Pillar solution to address the tax challenges arising from digitalisation of the economy. In brief, our analysis showed that:

> * the agreement to apply a formulaic method to allocate a share of MNEs' global profit is a historic step, pointing a way forward to a comprehensive and long-lasting solution;

* however, Pillar One at present is only a stop-gap solution, which for political reasons would apply for a minimum of seven years to only around 100 MNEs, and to only a small share of their profits; and

* the global minimum tax proposed in Pillar Two could be transformational, but as currently designed would be unfair and ineffective for MNE host countries.

The G24 comments confirm our concerns, and show that key elements remain to be negotiated. They point out in particular:

(i) their disappointment at the rejection of the proposal from both ATAF and the G24 for a deemed routine return of at least 30% of total global profits; if this remains so, at least 30% of the residual profits must be allocated under Pillar 1;

(ii) that withdrawal of unilateral measures 'should be gradual and progressively alongside the implementation of Amount A on such companies', and 'if the developing countries are expected to withdraw unilateral measures due to agreement on Pillars One and Two, then there should sufficient revenue under Pillar One and a broader STTR' (subject to tax rule);

(iii) that the STTR should be a simple transaction-based rule covering all situations where, due to a tax treaty, one country gives the other the right to tax the income and the other jurisdiction fails to tax the income up to the minimum level; this rule should apply in particular to payments for services and capital gains and not just interest and royalties, and without a materiality threshold or a low return exclusion;

(iv) that there must be 'a high minimum effective tax rate under the GloBE rules as well as a high minimum rate on gross revenue under the STTR'; and

(v) that there is a need for certainty, but they prefer a focus on dispute prevention rather than resolution.

The statement concludes as follows:

> 'without a meaningful share in amount A and a broader subject to tax rule as suggested above, the solution, if any, shall be suboptimal and shall not be sustainable even in the medium run'.

THE WAY FORWARD

The Nature of the Agreement and Methods of Implementation

Implementation is intended to be by way of a multilateral convention, to be completed in 2022 and in force by 2023. As we pointed out in our previous comments, it would be unprecedented for such a multilateral convention amending existing bilaterally negotiated treaties to be widely ratified and implemented in national law, let alone within a year. Approval by legislatures involves significant difficulties in many countries, and in some federations may require approval and legal changes at sub-state level, notably for example in Switzerland. After five years, the multilateral instrument to implement BEPS measures (MLI) still lacks ratifications, especially by lower-income countries, due to capacity constraints. For the US, ratification of a full treaty needs the consent of two-thirds of the Senate, which seems a pipe-dream in current circumstances. Countries which have treaties that are the most restrictive for host country taxation would undoubtedly be the most reluctant to change them to allow the STTR.

Recent statements and reports suggest that US negotiators consider that Pillar One would not need a full treaty requiring Senate approval. This could be by a multilateral competent authority agreement (MCAA) among the relevant countries, which would take effect under the provisions of existing tax treaties. This method has been used, for example, to implement the system of exchange of tax information. Such an agreement would apply only to the approximately 100 MNEs within the scope of Amount A of Pillar One. It would also require countries such as the US to enact domestic legislation to ensure legal certainty, particularly taking into account that they may not not have tax treaties with all relevant countries.

In contrast, the STTR would require a full treaty, to change existing tax treaties. This might be done by a separate multilateral convention (MLC). However, it would be virtually impossible to ensure that this would change all existing treaties simultaneously. Ratification would be decided by each country separately, hence attaining 100% coverage would be at the pace of the slowest. The best that could be done would be to allow such a convention to come into effect simply between ratifying countries, perhaps once a minimum threshold has been reached.

This MLC could not form part of or legally be linked to the MCAA to implement Pillar One, since officials could not enter into such a binding international agreement without prior approval from legislatures. However, the MCAA for Pillar One and the MLC for Pillar Two could be part of a package of political commitments, which may be described as an agreement.

Each country must decide which commitments it is willing to accept as part of such a package, and be free to decide whether to accept whatever final package is negotiated.

Prohibition of Alternative Measures

The intention is that a halt to alternative measures should be part of such a package of commitments. The G24 position on this is clear: withdrawal of existing measures should be in line with the application of Amount A to the companies in scope. This is particularly important for lower-income countries, because the limited scope of Pillar One would result in little additional revenue for them. Furthermore, a review of the scope could not even begin for seven years, and would still only reduce the size threshold. It is unconscionable to expect states to give up tax sovereignty for little or no gain.

In our view, there is no good reason why MNEs left out of the scope of Amount A should not be subject to alternative measures, if applied within each state's existing international obligations.

The G24 statement also points out that wider withdrawal of alternative measures is appropriate only if there is 'sufficient revenue under Pillar One and a broader STTR'.

Our comments on the July statement pointed out the inadequacy of the STTR as currently proposed, applying only to interest and royalty payments and a few specified payments for services. A majority of existing treaties already allow withholding taxes of 10% or higher on such payments, so an STTR capped at 9% would be ineffective. Negotiations are continuing on the scope, but any extension may be limited to base-eroding payments between related parties for specified services, while the G24 propose inclusion of all services as well as capital gains.

The STTR is unlikely to cover payments for digitalised services. Yet, ensuring taxation of income from the provision of digitalised services has been a primary aim of these long negotiations. Excluding such income from the STTR would mean that only MNE home countries would be able to ensure the minimum effective tax rate on such income (under the GloBE), while those same countries would also be the main beneficiaries under Pillar One because Amount A is so limited in amount and scope.

A fair share of income from services, expressly including digitalised services, should be taxable in countries where such income derives, particularly while Amount A remains so restricted in amount and scope. There should also be a right to tax capital gains from the sale of assets in countries where they are located.

Many countries have adopted, or are contemplating, measures to tax income from or payments for, digitalised services. Many of these are Digital Services Taxes, which are closer to indirect taxes, and may be considered to be trade barriers. An alternative is to introduce a wider test of taxable nexus, such as 'significant economic presence'. This has been done by countries such as India and Nigeria. Application of such provisions may be limited by existing tax treaties. However, these treaties can be renegotiated, for example to include the new article 12B in the UN model allowing taxation of payments for automated digital services.

A potential good alternative, as the G24 statement suggests, could be an STTR which is 'a simple transaction-based rule covering all situations where, due to a tax treaty, one country gives the other the right to tax the income and the other jurisdiction fails to tax the income up to the minimum level'.

In our view, there is no good reason why countries should give up their right to apply alternative measures unless and until such a broad and simple STTR is agreed and implemented.

The Minimum Effective Tax Rate

The G24 statement also stresses that 'there must be a high minimum effective tax rate under the GloBE rules'.

In proposing a minimum effective tax rate of 15%, it seems that the OECD countries have paid more attention to some of their own members, such as Ireland, than to the G24. It is unacceptable that countries that have long facilitated profit-shifting should have such strong influence over the design of measures aimed at ending such practices. Pillar 2 already provides for a substantial carve-out to allow incentives for real activities (7.5% of the carrying value of tangible assets and payroll for 5 years, 5% thereafter). A rate of 15% is substantially lower than the standard rate in most countries, as the average corporate income tax rate globally is 25%, so it would provide no disincentive for MNEs to end profit-shifting out of countries where they have real activities.

To take a key example, Ireland not only provides a low rate of 12.5%, it is still actively facilitating artificial structures that create amortisable intangible assets that cause effective tax rates that are mere fractions of that rate. MNEs have designed internal group transactions to create billions of dollars in amortisable basis in years before Pillar Two could come into effect. This does not incur tax since the gains recognised by the selling group member in its books are not taxable either in the country of the seller or in the home country of the group under CFC or similar rules. Since these gains are in years before Pillar Two comes into effect, there will be no Pillar Two top-up tax. Thus, many billions in profits that have been shifted by the intra-group sales of intangibles will not be subject to any minimum tax under the rules for calculating the effective tax rate in Pillar Two, while continuing to reduce taxable profit for years after its implementation.

In our view, the minimum ETR must be no less than the 25% rate proposed by the Independent Commission for the Reform of International Corporate Taxation (ICRICT) and would be best set at the 30% top of the range proposed by the UN FACTI Panel.

Tax Certainty

The proposals envisage that 'tax certainty' would be ensured for Amount A in Pillar One, through mandatory and binding procedures for dispute prevention and resolution. These would apply both to Amount A itself and to disputes over whether an issue is related to Amount A. The G24 statement supports the need for tax certainty for Amount A, while stressing that it is best secured by preventing disputes.

Amount A itself is designed as a clear and relatively simple formulaic method. The Pillar One blueprint of October 2020 outlined the procedures proposed for its administration. MNEs would submit a self-assessment for verification by their home tax administrations, which would then send the reports to all countries identified as having a constituent entity that meets the relevant threshold. There would then be review panels of representatives of affected tax administrations, while any disagreements would be referred to determination panels for a binding decision. The blueprint was designed to deal with a much larger number of MNEs (perhaps 2,300 rather than 100), so it included proposals for screening out low-risk cases, and left some key issues open.

The selection of panel members remains particularly contentious. The blueprint suggested that the determination panels could include 'independent experts' as well as serving or former tax officials. However, so-called 'independent' experts are generally tax advisers, whose main clients are the MNEs themselves, so their perspective is inevitably biased. Also, the use of such experts would add to the costs, which would disadvantage lower-income countries.

In our view, these decisions should be taken only by serving tax officials, whose costs can be covered by their own government. If independent persons are needed, they should not have been paid for any services to in-scope MNEs for the previous five years, and should be chosen in a transparent process from a published roster of nominees from a wide range of countries.

As we have previously argued, the use of such formulaic methods is the best way to achieve tax certainty. The methodology for Amount A itself should ensure this, so all efforts should be focused on making it as clear as possible, to prevent disputes.

Although disputes will be minimised regarding Amount A itself, there remains an area of uncertainty regarding its interaction with the allocation of the profits outside Amount A. In particular, there may be disputes over whether an MNE with sales in a country also has a taxable presence for activities out of the scope of Pillar One, and/or the amount of profit that should be allocated in that regard. For example, a corporate group may have a segment that is within the scope of Amount A (e.g. cloud computing, unregulated financial services, processing raw materials), while the remainder is out of scope, so remaining subject to existing rules on taxable presence and income allocation.

As we have continually pointed out, these existing rules are deeply flawed and rely on ad hoc subjective judgements, creating tax uncertainty. The allocation of MNEs' total profits by formulaic methods is the only way to achieve certainty. Amount A's formulaic method should minimise disputes, and a well-designed Panel procedure can resolve its detailed application. However, the continued reliance on existing rules for the remaining profits will generate disputes, which it is not appropriate to attempt to resolve by a secretive binding dispute settlement process.

In our view, mandatory biding dispute resolution is not appropriate for issues involving the application of existing taxable presence and profit allocation rules. These procedures should be applied only to determine the quantity of Amount A, which are the relevant jurisdictions, and how much each receives based on sales.

CONCLUSIONS

It has been asserted by the OECD that the Inclusive Framework allows participation of all states on an equal footing. In practice, of course lower income countries face many obstacles to effective participation, due to imbalances of resources and economic power. Despite this, in the past two years in particular, they have put forward cogent and well-argued proposals, particularly through ATAF and the G24.

In our view, the latest comments from the G24 are again cogent and constructive, and should be taken very seriously. They are right to say that any proposed solution that does not take into account their key demands would be unsatisfactory and unsustainable. Some countries have already made clear that they would not accept such an agreement, and others would undoubtedly follow. In this context, as elsewhere, no deal is better than a bad deal. In the absence of a fair deal, developing countries should not be penalised for adopting alternative measures, since corporate tax revenue is of great importance to developing countries, all the more in the current post-Covid period.