THE OECD GLOBAL TAX DEAL AND DEVELOPING COUNTRIES: WHERE DO WE STAND?

By Leopoldo Parada, Associate Professor in Tax Law at University of Leeds

1. INTRODUCTION

On 11 July 2023, the OECD announced that 138 countries of the Inclusive Framework (IF), representing around 90% of the global GDP, agreed on an outcome statement recognising the progress made towards a major reform of the international tax system, the so-called "OECD two-pillar solution".[1] The outcome statement comes out right on time when many sceptical voices have been raised, especially regarding the likelihood of achieving a multilateral agreement on Pillar One (MLC) by the end of this year, and when the critical mass endorsement of Pillar Two cannot be absolutely guaranteed either.[2]

This article argues that unlike the OECD's recent attempt to demonstrate that the two-pillar solution is still alive as a package, the fate of the project will ultimately depend on the individual trade-offs that countries face when opting for endorsing it either fully or partially, or not at all. This is particularly relevant for developing countries, which are generally torn between international cooperation and non-cooperation, on the one hand, and the eternal promise of additional tax revenues versus simplicity and ease of administration, on the other. The timing could not be better to dig into these matters again.

2. PILLAR ONE AND TWO AND THE TAX REVENUE NARRATIVE

If we recall, the two-pillar solution consists of a response elaborated within the OECD/IF, and which addresses two different issues. Pillar One, on the one hand, aims to reallocate business profits generated by the most profitable MNEs around the world to countries where sales take place (the so-called "market countries"), responding at least indirectly to the challenge derived by the taxation of business profits in a modern business world that is substantially more digitalised. Pillar Two, on the other hand, appears as a response to corporate income tax (CIT) competition and aims to ensure that all corporate profits of a large multinational group (MNE group) are subject to a minimum level of effective CIT somewhere.[3]

From a technical perspective, Pillar One introduces a semi-formulaic approach to reallocate 25% of the business (excess) profits generated by these highly profitable MNEs among all market countries, and subsequently, using specific sourcing rules, to determine the individual allocation for each one of them. This reallocation of excess profits is known as Amount A. The second part of Pillar One, known as Amount B, is unrelated to the reallocation of MNEs excess profits, and simply aims at fixing a price for marketing and distribution activities among related parties.[4] Pillar Two, on the other hand, establishes a minimum level of effective CIT rate of 15% through a "top-up" approach that operates with two domestic rules that act in a coordinated manner, that is, taxing with priority in the country of the ultimate parent entity (UPE) of a MNE group when taxation of its foreign subsidiaries was below that minimum (known as Income Inclusion Rule or IIR), or, in case the IIR does not apply, allowing a country of a subsidiary of the MNE group to tax the profits of the other foreign subsidiaries of the MNE group, or those of the UPE, when they are taxed below the minimum. This rule is known as Undertaxed Profit Rule or UTPR. The proposal also contemplates the possibility to exclude from the scope of the rules certain activities represented by a percentage of tangible assets and payroll,

as well as it allows countries to introduce a "domestic minimum tax", resembling both the IIR and UTPR rules, to be considered as a qualified domestic minimum top-up tax or QDMTT.[5] This latter option turns the priority to tax from the IIR to the domestic minimum tax, theoretically allowing countries to keep the revenues at home.[6]

It is evident from the above that both pillars attend to complete different aims. However, they share an important element in common, and this is the revenue narrative installed mainly to increase the global adherence to the OECD two-pillar solution. Indeed, for example, under Amount A market countries are offered an allocation of additional revenues that, despite the current uncertainty as to the final per-country numbers, is presented as a superior alternative in comparison to any other unilateral measures, including digital services tax (DST). A similar tendency can be noticed regarding Pillar Two. In fact, the design of the global minimum tax — i.e., granting taxing rights to some countries as a penalty for the under-taxation in others— is the best demonstration of it, because countries are sold the idea of acting as "default revenue collectors" whilst, at the same time, they ensure a minimum level of effective CIT globally.[7] This feature is even more evident after the introduction of the QDMTT in the Pillar Two project, which is presented as an effective revenue tool for low-tax countries (i.e., those taxing below the minimum) to keep at home the revenues that should primarily go to countries where the UPE of the MNE group is located.[8]

The narrative of additional revenues is attractive, and why not do say it, too, strategically convincing. First, it ensures that an effective international tax cooperation can ultimately take place. It should not a surprise to anyone that both pillars need an important number of participant countries to ensure their ultimate success. Indeed, Pillar One needs a Multilateral Convention (MLC) to be implemented soon, and Pillar Two needs a so-called "critical mass" of countries to introduce the proposed domestic rules to guarantee its aim of limiting CIT competition.[9] Second, it is also realistic since it recognises that pure altruism will not be convincing enough for countries to endorse such an international tax reform, especially when countries must still attend to individual interests, including domestic budgets, public needs, and

local elections. However, the cost of the revenue narrative seems to be very high, too, particularly when one recognises that a good or bad tax policy for a country is not only dependent on how much revenues are collected, but also on how simple or less administratively burdensome the whole tax system may become. This is the current position of many developing countries, which are usually torn between international cooperation and non-cooperation, on one hand, and the eternal promise of additional tax revenues versus simplicity and ease of administration, on the other. This is precisely what the rest of this work will grasp upon.

3. THE CURRENT TRADE-OFFS FOR DEVELOPING COUNTRIES

As noted already, the current international tax reforms under the OECD two-pillar solutions are not a zero-cost option for any countries, and especially for developing countries. Indeed, there are evident policy trade-offs, which are represented in this case by the classic dichotomy between international cooperation versus non-cooperation, on one hand, and additional revenue collection versus simplicity and administrability, on the other.

Let me take the example of Pillar One and the MLC to illustrate the above. If developing countries decided to endorse the MLC, this could be seen as a very positive sign that can end up in further steps towards more inclusivity, positively affecting those cooperative countries in the future. However, the main trade-off is associated again to the idea of revenue collection. Indeed, most of the developing countries that have already in place a unilateral measure to tax digital services will have to give it up, even if the allocation under Amount A provides substantially lower revenues than the unilateral measure in place. That seems to be the idea not only behind the series of political statements and public compromises on this matter, but also from the draft of Article 37 and 38 of the MLC.[10]The trade-off is therefore important and developing countries will be torn when deciding to grant a full adherence to Pillar One.

Nevertheless, a careful reading of the draft of Article 38 gives us some hope to reduce this trade-off. Indeed, as per the literal wording of the draft article, countries would keep an option to maintain their unilateral measures in place, having consequently —as a penalty— a zero allocation under Amount A during that "period".[11] Although the draft of the MLC is not entirely clear, the word "period" seems to refer to any period in which a country has in place a DST or similar unilateral measure, i.e., either in the past, present or future.[12] If this interpretation is correct, developing countries could find a window to lower the costs of cooperating by signing the MLC, but making use of Article 38 as a sort of "escape clause" to protect their domestic revenue interest at any point.

The other classic dichotomy faced by developing countries is related to the trade-off between revenues versus simplicity and administrability. Let me illustrate this using now the example of Pillar Two. As argued already in this work, Pillar Two offers countries a new source of revenues since they can now act as default revenue collectors. In other words, the inaction of one country to tax sufficiently triggers the taxing rights in another country who can now collects what remains to complete that minimum. Moreover, the introduction of a QDMTT does not only promise revenues loosely, but it ensures that these revenues stay at home. This is a very powerful argument to convince developing countries to implement Pillar Two. However, the argument of additional revenues is not only illusory in many cases, but also it carries with important trade-offs in the form of limitations and administrative costs, especially for those countries willing to attract effective foreign direct investment (FDI).[13]

It is not easy to ascertain without any chances of mistakes the magic formula that developing countries must follow right now regarding the OECD two-pillar solution. However, it is evident that no option comes at zero cost, and any decision must consider the individual policy interest and economic reality of the countries individually, also including a degree of flexibility, which can be translated in the form of additional carve-outs and FUTURE review processes.[14] This will allow all countries, but particularly developing countries, to reduce their trade-offs when opting for a more effective international tax cooperation.

4. FINAL REMARKS

Although the OECD remains optimistic that the two-pillar solution can be implemented as a package by countries around the world, the reality is rather different, and depends ultimately on the individual trade-off that countries face when opting for a full, partial, or simply no endorsement at all. These trade-offs are particularly evident in the case of developing countries, which are normally torn between cooperation and non-cooperation at the international level, and revenues versus simplicity and ease of administration, on the other. This simple logic should not be underestimated, because regardless the recent outcome statement representing 138 countries of the IF, and 90% of the global GDP, the ultimate success of the OECD initiative, at least among developing countries, will depend on a simple cost-benefit analysis. Therefore, reducing alternative costs for developing countries can be indeed a good alternative to achieve a success outcome.

Leopoldo Parada

[1]OECD/G20, Outcome Statement on the Two-Pillar Solution to Address the Tax Challenges Arising from the Digitalisation of the Economy (OECD Publishing, 11 July 2023).
[2]The adoption of the EU Directive on Pillar Two, however, represents an important step towards that "critical mass" adoption. See Council Directive (EU) 2022/2523 on ensuring a global minimum level of taxation for multinational enterprise groups and large-scale domestic groups in the Union, 14 December 2022. For the concept of "critical mass" and Pillar Two, see M. Devereux, J. Paraknewitz and M. Simmler, Empirical Evidence on the Global Minimum Tax: What is a critical mass and how large is the Substance-Based Income Exclusion? Oxford University Centre for Business Taxation, Working Paper 2022-23.
[3]Ruth Mason refers to the idea that all a company's income is taxed somewhere as "full taxation". See R. Mason, The Transformation of international Tax, Am. J. Int'l Law 114:3, 353 (2020). For a normative criticism of full taxation, see L. Parada, Full Taxation: The Single Tax Emperor's New Clothes, 24(2) Florida Tax Rev. (2021).
[4]OECD, Statement on a Two-Pillar Solution to Address the Tax Challenges Arising from the Digitalisation of the Economy (OECD Publishing, 8 October 2021). See also, OECD, Statement on a Two-Pillar Solution to Address the Tax Challenges Arising from the Digitalisation of the Economy (OECD Publishing, 1 July 2021).
[5]Id.
[6]For the debate on whether a QDMTT can always guarantee revenues at home, see N. Noked, Designing Minimum Taxes in Response to the Global Minimum Tax, Intertax 50(10) (2022). In contrast, L. Parada, Tailoring Developing Country Advice: A response to Noam Noked, Tax Notes Int'l 105 (2022) (arguing that elasticities of investment and competitive advantages must be considered to determine who is better off).
[7]L. Parada, Global Minimum Taxation: A Strategic Approach for Developing Countries (forthcoming/under review), 2023, available at SSRN.
[8]See Noked, supra n. 5. See also, Parada, supra n. 5.
[9]Devereux, Paraknewitz and Simmler, supra n. 2.
[10]OECD, Public Consultation Document/ Pillar One–Amount A: Draft Multilateral Convention Provisions on Digital Services Taxes and Other Relevant Similar Measures (OECD publishing, 20 December-20 January 2023).
[11]Article 38 states: "Any Party for which a digital services tax or relevant similar measure, or a measure listed in Annex A (List of Existing Measures Subject to Removal), is in force and in effect during a Period: [...]". Id., at 4.
[12]The OECD public consultation document also states that "Article 38 applies to all measures that are in force in a Party and that meet the definition of a DST or relevant similar measure, an existing measure that is not listed in Annex A could also subject to review on the same terms as future measures". Id., at 2.
[13]See more on this argument in: Parada, supra n. 6 (arguing that the promise of revenues is not such when the analysis considers the elasticities of investment as well as the competitive advantages of the countries implementing a QDMTT).
[14]Also arguing for more flexibility in the context of international tax cooperation, see L. Parada, Response to the UN Resolution A/RES/77/244 on Promotion of Inclusive and Effective Tax Cooperation at the United Nations, 3 June 2023, available at https://papers.ssrn.com/sol3/papers.cfm?abstract_id=4452268