Kluwer International Tax Blog

A Multilateral Convention to implement Amount A of Pillar One

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1. **Introduction**

On 8th October 2021, 136 jurisdictions reached an historic agreement to reform the international tax system and, in the words of the OECD, bring it into the 21st century.[1] The so-called two-pillar solution was presented to the G-20 Finance Ministers and the G-20 Leaders, who endorsed it. Thus, the future work of the OECD and the BEPS Inclusive Framework will focus on the implementation of both pillars.

For the implementation of some of the outcomes of Pillar One (i.e., Amount A and the mechanisms to create tax certainty concerning Amount A), the conclusion of a Multilateral Convention in early 2022 has been envisaged (the "Multilateral Convention").[2] The purpose of this contribution is to analyse why the implementation of Amount A and the mechanisms to create tax certainty concerning Amount A requires the modification of the tax treaty network as well as why, for this purpose, the Multilateral Convention may be a better option than the bilateral renegotiation of tax treaties or the amendment of the Multilateral Convention to Implement Tax Treaty Related Measures to Prevent BEPS ("MLI").[3]

2. **Pillar One**

As most of the international tax community is already aware, Pillar One seeks to produce changes to some of the profit allocation and nexus rules applicable to business profits to expand the taxing rights of market jurisdictions. This is to be achieved through one new and one revised profit allocation rule as well as through the implementation of mechanisms to create tax certainty:

- **Amount A**: 25% of the profit that exceeds a deemed normal return of 10% calculated at the group level to be allocated using a formulaic approach.
- Based on the political agreement reached among the members of the BEPS Inclusive Framework, Amount A will apply only to multinational enterprises – with the exclusion of those active in the extractive industries and the regulated financial services – with global turnover of more than 20 billion Euros and a profit before tax/revenue of more than 10%. Amount A will be allocated to a market jurisdiction when an in-scope multinational enterprise obtains more than 1 million Euros in revenue from that jurisdiction.[4]

- **Amount B**: a fixed remuneration for certain baseline routine marketing and distribution functions taking place in the market jurisdiction. The purpose of Amount B is to standardise the remuneration of related party distributors that perform baseline marketing and distribution activities in market jurisdictions. According to the OECD, this change is meant to benefit both taxpayers and tax administrations by reducing the risk of double taxation and compliance costs, given the large number of tax disputes related to marketing and distribution functions under the current transfer pricing rules.[5]
- **Tax certainty**: effective dispute prevention and resolution mechanisms consisting of: (i) a panel mechanism to allow tax administrations and in-scope multinational enterprises to agree beforehand on the tax base, the results of the implementation of the formulaic approach and any other feature of Amount A; and, (ii) a mandatory binding dispute resolution mechanism.[6]

Thus, although Pillar One intends to largely retain the current transfer pricing rules based on the arm's length principle ("ALP"), it departs in certain circumstances from the ALP by implementing Amount A which is a formula-based solution.

3. **Why implementing Amount A and the mechanisms to create tax certainty concerning Amount A requires modifying tax treaties?**

The implementation of Amount A and the mechanisms to create tax certainty concerning Amount A implies changes to concepts and rules set out in tax treaties. Therefore, tax treaties will need to be amended to implement them. At the moment, it is less clear whether the implementation of Amount B will also require the amendment of tax treaties, as the results of the discussions on the simplified and streamlined application of the ALP to baseline marketing and distribution activities will be available by the end of 2022 only.[7]

In particular, the scope of the following articles found in tax treaties will be impacted by Amount A and the mechanisms to create tax certainty concerning Amount A:

- **Articles equivalent to Article 5 of the OECD Model establishing the definition of a permanent establishment ("PE") and Articles equivalent to Article 7 of the OECD Model dealing with the taxation of business profits**: the PE concept determines whether an enterprise has sufficient connection with a state different from the one it resides in. For creating a PE, a fixed place of business and/or a dependent agent acting on behalf of the enterprise is required. If the PE threshold is not met, the resident state has the exclusive right to tax the active income of the enterprise. Only after the PE threshold is met, the source state may also tax active income of the enterprise sourced therein. Amount A, however, does not require the existence of a PE for granting taxing rights to market jurisdictions, i.e. source states. Under Amount A, the revenues will be sourced to the market jurisdictions where goods or services are used or consumed. Therefore, the PE threshold and the rule granting exclusive taxing rights to the resident state when a PE has not been created are superseded by Amount A. Detailed sourcing rules for different transactions will be developed; particularly for some B2B activities this may prove to be a rather challenging exercise.
- **Articles equivalent to Article 9 of the OECD Model providing for the application of the ALP between associated enterprises:** Amount A is to be allocated to market jurisdictions based on a formulaic approach. Thus, Amount A will not to be subject to the traditional transfer pricing allocation system and the ALP.

As the profits giving rise to Amount A will continue to be subject to the traditional transfer pricing allocation system, the scope of Article 9 might need to be adjusted to ensure the coexistence of Amount A and the traditional transfer pricing rules allocating “residual profits” to entrepreneurial entities without resulting in undesired cases of double taxation. It is foreseeable that jurisdictions that under the traditional transfer pricing allocation system would normally have the right to tax eventually will be obliged to surrender (part of) their taxing rights in favour of the market jurisdictions to avoid double taxation. Nonetheless, so far it is unclear how all this will work.

- **Articles equivalent to Article 25 of the OECD Model setting out the mutual agreement procedure (“MAP”) and the mandatory binding arbitration procedure:** the MAP only requires that the competent authorities of the contracting states endeavour to resolve cases of taxation not in accordance with the provisions of the tax treaty by mutual agreement. Some tax treaties have implemented a mandatory binding arbitration procedure, which is an extension of the MAP. However, the number of tax treaties providing for an arbitration clause continues to be rather limited. To provide tax certainty concerning Amount A, the creation of a panel mechanism to prevent disputes and wide implementation of mandatory binding arbitration has been envisaged, which means that the MAP provisions of tax treaties need to be superseded.

Depending on tax policy and sovereignty concerns, states that have implemented mandatory binding arbitration in their tax treaties may have chosen to implement a baseball arbitration procedure (where the arbitration panel must decide the case by choosing one of the resolutions proposed by the competent tax authorities), or an independent opinion arbitration procedure (where the arbitration panel evaluates the facts and circumstances of the case from the perspective of the applicable tax treaty provisions and the applicable domestic law to render its decision). In the MLI, baseball arbitration is set as primary procedure.[8] It is not clear yet whether the members of the BEPS Inclusive Framework have given preference to one type of arbitration procedure over the other to resolve disputes concerning Amount A. To prevent that more than one type of arbitration procedure is initiated to deal with the same matter leading eventually to contradictory results and misuse of resources and efforts, the mandatory binding arbitration procedure set out in the MLI may need to be superseded in connection to disputes concerning Amount A. This may be particularly relevant if a multilateral mandatory binding arbitration procedure is agreed to be implemented in the Multilateral Convention.

4. **What are the advantages of concluding the Multilateral Convention over modifying tax treaties bilaterally for the implementation of Amount A and the mechanisms to create tax certainty concerning Amount A?[9]**

Some of the considerations made so far to advocate for the conclusion of the MLI can be made also in connection to the conclusion of the Multilateral Convention. Indeed, as the MLI, the Multilateral Convention, in principle, would allow the speedy and synchronized modification of the tax treaty network to implement Amount A and the mechanisms to create tax certainty concerning Amount A. In many cases, the bilateral renegotiation of tax treaties to implement the updates to the OECD Model has proven to be a cumbersome and long process. Broekhuijsen and Vergouwenhas have recently observed that after a modification to the OECD Model takes place, an average time of 18 years is required to incorporate the respective changes into the tax treaty network of the OECD member countries. In the mentioned authors' view, this means that "*updates to the OECD Model either have no effect – the majority of the tax treaties are not amended at all – or are likely to have an effect only after a substantial amount of time has elapsed following a given update*".[10]

Additionally, the Multilateral Convention would result in uniform international tax rules, avoiding the proliferation of unilateral or bilateral uncoordinated tax measures. In this regard, the Statement on a Two-Pillar Solution to Address the Tax Challenges Arising from the Digitalisation of the Economy of 8 October 2021 has already indicated that the Multilateral Convention "*will require all parties to remove all Digital Services Taxes and other relevant similar measures with respect to all companies, and to commit not to introduce such measures in the future*."[11] The main advantage of implementing uniform rules concerning Amount A will be the reduction of undesirable cases of double taxation and double non-taxation since all parties to the Multilateral Convention will be applying the same rules. Another advantage of implementing uniform rules for the allocation of Amount A will be the reduction of tax competition among the parties to the Multilateral Convention. If the rules implementing Amount A are the same for all the parties, taxpayers will not make business decisions based merely on tax advantages.

The implementation of uniform rules through the Multilateral Convention can be equally beneficial for investors, tax administrations and tax courts. They can gain certainty, and also save time and efforts, as they would need to interpret the wording of only one treaty provision that applies to all the jurisdictions involved instead of interpreting several provisions with similar wording but with potentially different meaning and scope. It is true that theoretically the same effect could be achieved if bilateral tax treaties were to follow model conventions without deviations. However, until now, the common practice has been that states deviate in one form or another from the model conventions, making it burdensome for the stakeholders to determine the meaning of the deviations.

The Multilateral Convention can also improve cooperation between competent authorities. The competent authorities of the contracting states can work together to ensure the consistent interpretation and application of the treaty provisions. The uniform interpretation of the provisions of the Multilateral Convention can be beneficial for taxpayers, who will have certainty that a certain interpretation will be acceptable by all the jurisdictions involved. The panel mechanism envisaged as part of the mechanisms to create tax certainty concerning Amount A seems to be targeting this direction. Likewise, under the Multilateral Convention the competent authorities can be authorized to conduct joint audits.[12] Joint audits should expedite fact finding, the resolution of tax assessments and compliance. They can also reduce costs for the competent authorities and for taxpayers.

Furthermore, the Multilateral Convention can be designed to resolve situations involving more than two states, which clearly is not possible under bilateral tax treaties. This is rather important for the implementation of Amount A where all market jurisdictions will have an interest in taxing the residual profit of the in-scope multinational enterprises. This seems to be part of the purpose of the BEPS Inclusive Framework' work, which in the Statement on a Two-Pillar Solution to Address the Tax Challenges Arising from the Digitalisation of the Economy of 8 October 2021 has stated that double taxation will be prevented by the Multilateral Convention.[13]

Finally, the Multilateral Convention can expand the treaty network of states with limited resources or technical expertise to negotiate bilateral tax treaties. This also seems to be the part of the purpose of the BEPS Inclusive Framework with the Multilateral Convention, since it is envisaged that the Multilateral Convention will apply in respect of states that have not concluded a bilateral tax treaty before the Multilateral Convention enters into force.[14]

5. **What are the advantages of concluding the Multilateral Convention over modifying the existing MLI for the implementation of Amount A and the mechanisms to create tax certainty concerning Amount A?**

An alternative option to the conclusion of the Multilateral Convention would be to amend the MLI. Nonetheless, several reasons speak against implementing Amount A and the mechanisms to create tax certainty concerning Amount A via an amendment of the MLI.

The amendment process of multilateral treaties can be cumbersome and long. At times, bringing the amendments into force may be even more troublesome than negotiating the original treaty. Amendment procedures of multilateral treaties have been known to be initiated without the parties being able to conclude an amending treaty due to the difficulties in reaching the required consensus or majority to approve the amendments.[15] Moreover, many countries are still in the ratification process of the MLI and for some of them the finalisation of this process may still take some time. Adding an amendment of the MLI to this package can make the ratification process even more complicated for them.

Besides, the object and purpose of the MLI is limited to ensure swift, coordinated and consistent implementation of the tax treaty-related measures to address certain hybrid mismatch arrangements, prevent treaty abuse, address artificial avoidance of permanent establishment status, and improve dispute resolution developed under the OECD/G20 BEPS project. Without any doubt the object and purpose of Amount A exceeds the described scope, as it intends to reallocate residual profits to market jurisdictions superseding to some extent the PE threshold, the rule granting exclusive taxing rights to residence states in case a PE has not been created and the ALP. Although the object and purpose of the MLI can be expanded by the agreement of its parties, certain parties to this instrument may be against such an amendment, which takes us again to the difficulties of reaching the required votes or consensus to modify multilateral treaties discussed above.

More importantly, the MLI applies only if a bilateral tax treaty has already been concluded. Thus, if a pair of states has not concluded a tax treaty and Amount A and the mechanisms to create tax certainty concerning Amount A are implemented through the MLI, the provisions would not apply to them. The consequences of implementing Amount A only for certain tax treaty relationships would be an uncoordinated tax treaty network with multiple undesirable cases of double taxation. This is the reason why the BEPS Inclusive Framework has indicated that the Multilateral Convention will apply also in respect of states that have not concluded a bilateral tax treaty.

Finally, the MLI is an extremely flexible treaty. First, its scope of application is determined by the parties, who are free to exclude as many tax treaties of their network as they wish. The reason for this is that the MLI serves to update the tax treaty network, but it is not the only existing mean for it. States can always recourse to amending their tax treaties to implement the BEPS measures in a bilateral fashion. Second, the MLI provides for opting-in mechanisms (i.e., optional provisions and alternative provisions) and opt-out mechanisms (i.e., reservations), which allow parties to modify only certain provisions of their covered tax treaties. As anticipated above, the implementation of Amount A and the mechanisms to create tax certainty concerning Amount A requires uniformity to avoid undesirable cases of double taxation. Consequently, a more suitable solution for the implementation of Amount A and the mechanisms to create tax certainty concerning Amount A is the conclusion of the new Multilateral Convention.

6. **Conclusions**

The implementation of Amount A and the mechanisms to create tax certainty concerning Amount A of Pillar One require the amendment of tax treaties. Since uniformity is essential for the proper functioning of the new profit allocation rule, the conclusion of the Multilateral Convention is a more appropriate solution than the amendment of tax treaties bilaterally or the amendment of the MLI.

No doubt the timeline announced in connection to the Multilateral Convention is extremely ambitious (i.e., conclusion of the text of the convention and its explanatory statement by early 2022, signing ceremony in mid-2022 and entry into force and effect in 2023). However, the conclusion of the MLI has already shown us that when political will is present it is possible to achieve broad consensus and finalise in a relative short period of time tasks that otherwise were unimaginable. Of course, only the future can tell whether there is enough political will behind Pillar One and the Multilateral Convention.

[1] OECD, *International community strikes a ground-breaking tax deal for the digital age* (8 Oct. 2021), available on https://www.oecd.org/tax/beps/international-community-strikes-a-ground-breaking-tax-deal-for-the-digital-age.htm?utm_source=Adestra&utm_medium=email&utm_content=Press%20release&utm_campaign=Tax%20News%20Alert%2008-10-2021&utm_term=ctp (accessed on 18 Oct. 2021).

[2] OECD/G20, *Statement on a Two-Pillar Solution to Address the Tax Challenges Arising from the Digitalisation of the Economy* (OECD 2021), at 3 and 6.

[3] *Multilateral Convention to Implement Tax Treaty Related Measures to Prevent Base Erosion and Profit Shifting* (7 June 2017).

[4] OECD/G20, *Statement on a Two-Pillar Solution to Address the Tax Challenges Arising from the Digitalisation of the Economy* (OECD 2021), at 1. Note that the Statement indicates that for jurisdictions with GDP lower than 40 billion euros, the nexus will be set at 250 thousand Euros instead of 1 million Euros.

[5] OECD/G20, *Tax Challenges Arising from Digitalisation – Report on the Pillar One Blueprint* (OECD 2020), at 160.

[6] OECD/G20, *Tax Challenges Arising from Digitalisation – Report on the Pillar One Blueprint* (OECD 2020), at 174 and ss.

[7] OECD/G20, *Statement on a Two-Pillar Solution to Address the Tax Challenges Arising from the Digitalisation of the Economy* (OECD 2021), at 3 and 7. Also, OECD/G20, *Tax Challenges Arising from Digitalisation – Report on the Pillar One Blueprint* (OECD 2020), at 172.

[8] For more details, see N. Bravo, *Mandatory Binding Arbitration in the BEPS Multilateral Instrument*, 47 Intertax 8/9 (2019), at 698-699.

[9] Some of the arguments have been previously made by Nathalie Bravo regarding the MLI and regional multilateral tax conventions (such as, the Convention between the Nordic Countries for the Avoidance of Double Taxation and the CARICOM Agreement), see N. Bravo, *A Multilateral Instrument for Updating the Tax Treaty Network* (IBFD 2020), at sec. 1.4.6. and 1.6.

[10] D.M. Broekhuijsen and T.M. Vergouwen, *How Often Do OECD Member Countries Update Their Tax Treaties?*, : 75 Bull. for Intern. Taxn. 10 (2021), at sec. 5.

[11] OECD/G20, *Statement on a Two-Pillar Solution to Address the Tax Challenges Arising from the Digitalisation of the Economy* (OECD 2021), at 7.

[12] OECD/G20, *Tax Challenges Arising from Digitalisation – Report on the Pillar One Blueprint* (OECD 2020), at 198.

[13] OECD/G20, *Statement on a Two-Pillar Solution to Address the Tax Challenges Arising from the Digitalisation of the Economy* (OECD 2021), at 6.

[14] Idem.

[15] See A. Aust, *Modern Treaty Law and Practice* (2nd ed., Cambridge University Press 2007), at 262 and 263.

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