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Moving On: The Case for Developing Nations to Leave the OECD Pillar One Behind

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The past 30 June 2024 was anticipated to be a historic moment. Inclusive Framework's (IF) countries, both developed and developing, were expected to publicly commit to a crucial element of the "global tax deal" by signing the Multilateral Convention (MLC) for the OECD Pillar One. Expectations ran high within the OECD camp, though they were more tempered—and at times pessimistic—among academic and political circles. In a year marked by U.S. presidential elections, significant developments were unlikely. As anticipated, nothing materialised.

Some commentators could argue that we should wait until November, when the new President of the United States is elected. Others would assert that it is only a matter of time (and lobby) before Inclusive Framework (IF) countries fully engage with the MLC. However, the issue is, in my view, more substantive and profound: countries no longer find the OECD Pillar One attractive, and this sentiment is particularly strong among developing nations. This feeling should indeed prompt them to reconsider their involvement in the OECD initiative and simply move on.

There are at least three compelling reasons for the above. Firstly, the OECD Pillar One initiative muted from the original idea of taxing business profits in absence of a physical presence to one that attend exclusively to the taxation of the most profitable tech companies worldwide. However, the issue of physical nexus remains unsolved in most of the cases, and it is still the central matter for developing nations. Secondly, the initiative has achieved an unprecedent level of complexity, increasing the overall administrative burden vis-à-vis other available options. Third, and finally, developing countries have already implemented (or are in the way to implement) more efficient ways to collect revenues in the absence of physical nexus, including Digital Services Taxes (DSTs) and Value Added Tax (VAT), increasing the relative costs of international cooperation.

Let me address these three reasons separately.

The forgotten promise: taxing business profits in absence of physical nexus

If we come back to the origin of the OECD Pillar One, and the several discussions about it, it is easy to identify the roots of the problem. Indeed, the discussion regarding the OECD Pillar One started and it was subsequently based on one very important issue: how do we tax business profits in the absence of a physical presence? Indeed, it is no surprise to anybody in the field of

international tax that the current international tax rules that determine the allocation of taxing rights ––i.e., tax treaties–– are incapable to work in a world that is highly digitalised. Hence, the traditional concept of *permanent establishment*, which serves to allocate taxing rights in the source jurisdiction when business profits are generated, appears to be insufficient to face the reality of modern enterprises.

In this reality, the original idea was simple: let's create a nonphysical nexus that allows countries in which (highly digitalised) business operate to tax the business profits generated in there regardless of the traditional physical requirement under tax treaties. As such, the OECD Pillar One was presented as a proposal that would complement the allocation of business profits under treaties, filling an existing gap. To put it differently, countries — especially developing nations— suddenly realised that having immobile consumers in their territories could generate significant revenues, making the whole regulatory proposal under Pillar One an attractive deal.

However, as expected, things got rapidly complicated. The different floating proposals to address the main issue of nexus were unified under one by the end of 2019. [1] An original focus on "consumer-facing business" — whatever that meant— was later disposed, and three clear amounts were settled, each one with a completely different aim. A series of carveout also jumped onto the scene, and the fear of countries following their natural revenue interests with alternative unliteral proposals was used to press countries for an expedite international coordination. Yet, this was not the end of the story, and as has happened with many other similar proposals in the international context, the ABC of international tax ended up with only two letters, that is, (amount) A and (amount) B. In addition, thresholds were increased, the scope reduced, and the OECD Pillar One quickly focused exclusively on MNEs with group turnovers above 20 billion and profitability of more than 10%.[2] That is, a targeted group of no more than 100 companies worldwide, raising uncertainty regarding the actual revenue allocation that market countries will be entitled to after all the calculations were over. In other words, the OECD initiative mutated from the idea of taxing business profits in absence of a physical presence to one that attends exclusively to the taxation of the most profitable tech companies worldwide.

The mutation of aims and scope in the OECD initiative ended up reducing attractiveness of it for developing nations and the reason is simple: the issue of physical nexus remains unsolved in most of the cases, except for those of highly profitable (tech) companies. Therefore, the promise of tax revenues becomes uncertain. Why should then developing nations compromise to cooperate when the (direct) gains from cooperation may end up being lower than acting unilaterally? If nations act as consumers do, that is, taking rational decisions, cooperating appears to be a very irrational choice at this moment of time.

The current reality: increased complexity and administrative costs

The OECD Pillar One structure has achieved such a level of complexity that is only comparable to its doppelganger, i.e., the OECD Pillar Two or Global Minimum Tax. Indeed, one just need to look at the recently released OECD papers on Amount A and B to understand that tax inspectors in countries willing to endorse Pillar One (Amount A) will have a titanic, if not impossible, task ahead. As if it was not enough mixing up financial accounting and taxation to ensure a minimum floor for corporate income tax competition, Pillar One comes with a series of rules on how to allocate the residual profits of an MNE among different jurisdictions based on nexus thresholds and revenue sourcing rules that only increase complexity, and consequently, administrative costs.

Indeed, even if the cases in which the revenue estimation of (direct) gains under Amount A may offer something to market jurisdiction X, one could rightfully argue that in many cases those direct gains can be easily offset with the direct costs of implementing Pillar One in that country. These costs are not only the obvious ones, such as training and capacity building, but they can also be measured in terms of lack of simplicity for the whole domestic tax systems willing to endorse the OECD initiative. Ultimately, a valid question is: why should developing nations commit to an initiative that increases their overall administrative burden vis-à-vis other available options? In fairness, putting aside for a moment all the legal arguments against, even the application of a low tax rate to turnovers generated in a country —which is the basic structure of Digital Services Taxes (DSTs)—, or the application of a withholding tax at source, seem to be simpler than the set of estimations under the OECD of Pillar One, Amount A.

In the rational decision of committing to OECD Pillar One, developing nations should not lose focus on the full picture, which include high complexity and administrative costs versus a promise of revenues that may not compensate the effort relative to other available options.

The promising future: looking at more efficient ways to collect revenues

When the debate on the OECD Pillar One started, countries around the world reacted as expected, that is, looking for alternatives. The most prominent was the creation of a new tax, which would target only certain online digital services, and which would apply a very low rate on the amount of turnovers generated in a market jurisdiction. The idea was brilliant, despite the legal constrains that this and other authors have posed in the past, and countries started to pave the path for DSTs.[3] However, the response did not wait. The United States was not happy, after all such taxes were mainly targeting big tech American companies.

The above not only created international tensions with the United States threatening other countries —especially European countries—- willing to embrace anything that would look like a DST, but also portrayed the whole debate as either or. In other words, countries, including developing nations, were faced with the dilemma of choosing between the OECD Pillar One, on one hand, or chaotic DSTs, on the other.

The good news is that such a black and white portrait of the reality is now rather obsolete. Indeed, many developing nations have started exploring new possibilities to generate revenues related to digital services provided in their countries.[4] Most notably, the extension of their Value Added Tax (VAT) and other similar consumption taxes to capture online digital services have proved to be a very effective tool for at least three reasons. First, VAT and consumption taxes, more generally, can achieve a more neutral broadening of the tax base, taxing consumption of these services where they occur, ultimately aligning the differential treatment between physical and digital businesses. Second, it reduces the costs associated to the implementation of new taxes (such as DSTs), and legal constrains associated to them. Indeed, collecting VAT for countries with an already settled infrastructure and know-how appears relatively simple. Third, and finally, it promotes stability of the whole tax system, avoiding temporary measures (like DSTs living with the promise that one day Pillar One will work) that may only contribute to legal uncertainty.

Consumption taxes, and VAT in particular, play a fundamental role in the total revenue collection in developing nations. As such, it is promising that developing nations have started departing from the black and white picture that portraits the OECD Pillar One versus DSTs as the only available options. This new scenario has also increased the relative costs of international cooperation for

developing nations, making the endorsement of the OECD initiative an almost zero-sum game.[5]

Final remarks

The outcome of 30 June 2024 is not random. Countries around the world share a common sentiment, which is particularly strong among developing nations: the OECD Pillar One is no longer attractive. The loss of focus on the core issue in the debate of digitalisation of businesses (i.e., the lack of physical nexus), and the complexity of an initiative that was supposed to solve a problem for many developing nations, has created a new scenario. This scenario is marked by the end of the portrait that put countries in between the OECD initiative and DSTs. Developing nations are now making use of their current tax systems of consumption taxes to target the disparity between physical and digital businesses, and the formula has become popular. It is time to move on.

[1] For an analysis of that early proposal, see, e.g., Leopoldo Parada, *The Unified Approach under Pillar One: An Early Analysis*, 96 Tax Notes Int'l 11 (2019), at 983.

[2] OECD, *Statement on a Two-Pillar Solution to Address the Tax Challenges Arising from the Digitalisation of the Economy,* OECD Publishing, 8 October 2021.

[3] For a criticism on DSTs from a European Tax Law perspective, see, e.g., Ruth Mason and Leopoldo Parada, *The Legality of Digital Taxes in Europe*, Virginia Tax Review 40:1 (2020).

[4] See more of this trend in: Cristina Enache, *Digital Taxation around the World*, Tax Foundation, April 2024 available at https://taxfoundation.org/research/all/global/digital-taxation/

[5] It is "almost" a zero-sum game since there is still something valuable in it: Amount B and the idea of fixing a price for marketing and distribution activities. However, this could be achieved without the need of compromising the whole international tax system of developing nations, for example, as an amendment of the OECD Transfer Pricing Guidelines. However, this comes with the downside that the OECD TP are not binding rules upon countries.

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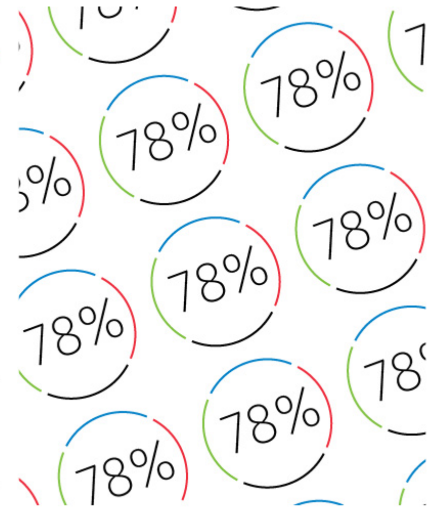

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