KPMG

The Future of Pillar One

On 11 July 2023 the OECD/G20 BEPS Inclusive Framework (Inclusive Framework) released an *Outcome Statement on the Two-Pillar Solution to Address the Tax Challenges Arising from the Digitalisation of the Economy*, the next step in the Inclusive Framework's efforts to reshape the allocation of taxing rights between countries.

The *Outcome Statement* was approved by 138 of the Inclusive Framework's 143 members, with Canada being the most notable holdout (alongside Pakistan and Sri Lanka, with Belarus and Russia also absent because they no longer attend Inclusive Framework meetings).

The *Outcome Statement* reaffirms the Inclusive Framework's view that the Two-Pillar Solution has an important role in ensuring fairness and equity in the international tax system and "fortifying" that system in the face of new business models. This statement sends a clear message that the Inclusive Framework does not intend to abandon Pillar One, even if the implementation of Pillar Two proceeds smoothly.

The *Outcome Statement* was presented to the G20 Finance Ministers and Central Bank Governors meeting in India on 17–18 July. G20 members responded with a statement expressing appreciation for the significant progress made and calling for the finalization of the pending work.[1]

For those that have followed the negotiations around Pillar One closely, the *Outcome Statement* raises six questions that this article seeks to address:

1. Why is the Inclusive Framework proceeding with Pillar One, despite the steps taken by over 50 jurisdictions to implement Pillar Two?
2. When will the Amount A Multilateral Convention ("MLC") be released and when might Amount A be implemented?
3. Will there be an extension of the current moratorium of Digital Services Taxes ("DSTs") and relevant similar measures, and why did Canada not sign-up to the *Outcome Statement*?
4. How is the European Union ("EU") responding to the delay in the implementation of Pillar One?
5. Could Amount B, the simplification of transfer pricing rules in respect of baseline marketing and distribution activities, proceed in the absence of agreement on Amount A?
6. What comes next?

[1] G20 Press Release, Third meeting of G20 Finance Ministers and Central Bank Governors (FMCBG) under the Indian G20 Presidency 17–18 July 2023, Gandhinagar, Gujrat

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1 Why is the Inclusive Framework proceeding with Pillar One?

A question that is frequently asked is why the Inclusive Framework is proceeding with Pillar One, despite the success of Pillar Two, where 50 jurisdictions are taking steps towards implementation and the OECD is optimistically estimating annual global tax revenue gains of USD 200bn.

Here, it is important to understand that, for some Inclusive Framework members, the Two-Pillar project was only partly about combatting perceived base erosion and profit shifting. For many, the allocation of taxing rights between jurisdictions was as, if not more, important.

The *Outcome Statement's* slightly cryptic reference to *"fortify[ing] the international tax framework in the face of new and changing business models,"* reflects the view of many Inclusive Framework members that the current international tax framework fails to give them sufficient taxing rights over businesses that are increasingly able to generate significant revenues from within their borders without establishing a local taxable presence.

Pillar Two, in contrast, is designed to put a floor on corporate tax competition and does not address the fact that multinational enterprise ("MNE") groups may not pay tax in a particular jurisdiction.

2 When will the Amount A MLC be released and when will Amount A be implemented?

Amount A is arguably the core component of Pillar One. It will reallocate taxing rights over the 'residual profit' of large, highly profitable MNE groups to market jurisdictions (i.e., the location of the end consumer or user). Amount A is seen as the alternative to the unilateral implementation of DSTs, which Inclusive Framework members have agreed is undesirable.

The *Outcome Statement* somewhat confusingly states that the Inclusive Framework has "delivered a text of an MLC on Amount A," without providing the text or indeed offering any definitive timeline for its delivery. This reflects that some jurisdictions have "expressed concerns with some specific items in the MLC," over which discussions are ongoing.

What items might these be? A European Commission Progress Report on Pillar One at the end of June identifies several contenders, noting that the following items were still under discussion: "the elimination of double taxation, the marketing and distribution safe harbour and the treatment of withholding taxes, the standstill and rollback of [DSTs] and other relevant similar unilateral measures, the implementation of an autonomous domestic business exemption and the carve-out for defensive [industry] revenues, as well as the condition of entry into force." Those familiar with the mechanics of Amount A will understand that these are not small issues but have the potential to materially impact the effect Amount A would have on each jurisdiction's revenue.

It has long been recognized that the implementation of Amount A will require changing existing bilateral tax treaties and standardization through an MLC. This means the first step in the implementation of Amount A is publication of the MLC, which the Inclusive Framework commits to do in the second half of 2023 in the *Outcome Statement*. Jurisdictions would then need to sign and ratify the MLC before it could come into effect. Thus, Amount A realistically cannot come into effect before 2025, which the Inclusive Framework has set as its new target date.

While the *Outcome Statement* does not state the conditions for the Amount A MLC to enter into force, the July 2022 Progress Report stated that "[t]he MLC will enter into force only upon ratification by a critical mass of countries, which will include the residence jurisdictions of the ultimate parent entities of a substantial majority of the in-scope companies whose profits will be subject to the Amount A taxing right, as well as the key additional jurisdictions that will be allocated the obligation to eliminate double taxation otherwise arising as a result of the Amount A tax." Presumably, this means that US ratification is a precondition for entry into force.

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3 Will there be an extension of the current moratorium on Digital Services Taxes

In October 2021, the Inclusive Framework released a statement committing to remove DSTs following the introduction of Amount A, and not to introduce new DSTs until the earlier of 31 December 2023 or the coming into force of the MLC. The end of 2023 is fast approaching, and hence the Inclusive Framework has agreed to extend the moratorium on new DSTs until the earlier of 31 December 2024 or the entry into force of the MLC.

This extension comes with an important condition — at least 30 jurisdictions accounting for at least 60 percent of the Ultimate Parent Entities (UPEs) of in-scope MNEs must sign the MLC before the end of 2023. Though it is not entirely clear how this determination will be made, the EU Tax Observatory has released a report indicating it would be difficult to achieve without the United States.

What does this mean? The conditions are in place for an extension of the moratorium on new DSTs until the end of 2024, but the big unanswerable question is whether the Amount A MLC will receive enough signatures by the end of the year for that extension to take effect. Notably, the Biden Administration can sign the MLC without any action from the US Congress. Thus, while there are significant questions about whether the MLC can ever garner the support of two-thirds of US Senators, whose vote would be required for it to enter into force in the United States, the Biden Administration can, in theory, sign the agreement before obtaining that support.

What about Canada? Canada was the only G7 member not to affirm the Outcome Statement. This decision was quickly followed by a statement by the Canadian Deputy Prime Minister and Minister of Finance, stating that Canada does not disagree with the substance of the Amount A MLC, but would not commit to not introduce a DST from 1 January 2024, without a deadline stipulating when Amount A would come in force. The statement indicated that Canada felt disadvantaged relative to those jurisdictions that had introduced and were continuing to collect revenue under their own DSTs. Hence, there was no major surprise when Canada released revised legislative proposal for a new 3 percent DST, though a few eyebrows were raised by the news it would apply retrospectively to digital services revenues for 2022 and 2023.[2]

4 How is the EU responding to the delay in the implementation of Pillar One?

A number of EU Member States have been strong advocates for Pillar One. When finalizing the EU Pillar Two Directive, Poland required the insertion of a provision mandating the European Commission ("EC") to assess the implementation of Pillar One by 30 June 2023 and, if appropriate, to submit an alternative legislative proposal in the absence of the implementation of the Pillar One solution.

The EC report, published just before the publication of the *Outcome Statement*, welcomed the "great efforts and the progress made so far" by the IF and urged all EU Member States to make a final effort to reach an agreement on the MLC. The subsequent publication of the *Outcome Statement* seems likely to provide the comfort EU Member States require, for now at least. But, the EC is set to provide a further report by the end of this year that reassesses the situation.

European Member States and the EC have been exploring changes to the allocation of taxing rights (comparable to Amount A) for over five years. There are several European-specific issues and ideas that will continue to shape how Europeans approach Pillar One:

- **No EU-wide consensus in support of DSTs.** EU Member States discussed the introduction of coordinated DSTs extensively between 2017 and 2019, but were ultimately unable to reach consensus, with a number of states strongly opposed to the proposal. There is still no reason to believe that consensus will emerge in the EU on the introduction of an EU-wide or coordinated DST.
- **Amount A (and digital taxation) as an "own resources issue."** In 2020, the EU agreed to search for new EU 'own resources' to be used in a repayment plan for the EU Covid recovery fund. This was followed by a public consultation, launched by the EC, in 2021 on three options for a new digital tax (or digital levy), including: (a) a supplementary corporate tax on certain in-scope businesses; (b) a digital levy based on in-scope end use of a product or service at the consumer

[2] For more details see *KPMG TaxNewsFlash Canada: Businesses — Canada revises digital tax proposals*

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level; and (c) a transaction-based tax on certain B2B transactions within the EU. The concept of a new EU digital tax or levy, but not a specific proposal, received support from the European Parliament in 2022 but has ultimately not led to any legislative initiatives. In 2022, the EC proposed that each EU Member State would provide a national contribution to the EU budget amounting to 15 percent of the share of the taxable profits of MNE Groups re-allocated to that Member State under Pillar One. This was followed in 2023 by a new EC alternative to introduce a temporary statistical own resource based on the profits of companies to be effective until an effective implementation of Pillar 1 (communication and accompanying legislative proposal).

- **Sector-based levies as an alternative.** The EC also has proposed applying sector-based levies, as an alternative to new taxes. One example is the 2023 exploratory consultation on the future of the electronic communications sector and its infrastructure, which suggests a 'fair contribution' by all digital players (network access fee). Another is the 2023 EC rules for charging providers of very large online platforms and search engines annual supervisory fees in the context of the EU Digital Services Act.

The history of EU action, or inaction, in the digital tax space shows that there is significant interest from some EU Member States and the EC in changing the way digital businesses are taxed, either in the absence of or potentially alongside the implementation of Amount A. However, there is no consensus on the form those changes should take, or indeed on whether there should be changes in the first place.

5 Could Amount B proceed in the absence of agreement on Amount A?

Pillar One is largely perceived to be a "digital business" issue, but the proposal to simplify the application of the arm's length principle to baseline marketing and distribution activities has much broader application (and indeed is unlikely to apply to many "digital businesses").

Alongside the *Outcome Statement*, the Inclusive Framework released a public consultation on Amount B, which KPMG summarised in this report. This consultation document provides much more detail on the design of Amount B than is contained in the *Outcome Statement*.

An interesting question raised by some commentators is whether Amount B — which will be introduced through changes to the *OECD Transfer Pricing Guidelines* rather than an MLC — could proceed in the absence of agreement on Amount A. The anticipation that Amount B could come into effect from January 2024, when we still may not know whether the Amount A MLC will be ratified, certainly means this is a possibility. Though, the *Outcome Statement* also states that consideration will be given to "the interdependence of Amount B and the signing and entry into force of the [Amount A] MLC," indicating that some Inclusive Framework members consider Amount A and B inseparably linked.

6 What comes next?

It seems we are approaching the Pillar One endgame. There are many people (these authors included) who are surprised the Inclusive Framework has managed to take discussions on Pillar One, both Amount A and B, so far, given the divergence in views of Inclusive Framework members.

The Amount A MLC likely will be published later this year, though the precise date remains uncertain. The two big questions are: will the MLC receive sufficient signatures by 31 December to extend the moratorium on DSTs and ultimately whether Amount A will take effect from 2025. Canada's statement, the recent announcement that New Zealand intends to implement a DST from 2025 if Amount A is not implemented, and the continuing noise emanating from the EU demonstrate that questions about the allocation of taxing rights among jurisdictions are not going away and the risk of ongoing instability to the international tax system will remain high.

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