

A step closer to agreement on taxation of the digital world

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On 8 October 2021, the OECD released a further statement in relation to the BEPS 2.0 proposals, aimed at addressing taxation of the modern digital economy. This is the latest development in the attempts to more equally share the tax revenue relating to digital services that have led to some jurisdictions, including the UK, introducing unilateral digital service taxes. The OECD's proposals contain two "pillars". The first ("Pillar 1") seeks to shift tax on large digital service providers into the countries in which their sales take place. The second ("Pillar 2") seeks to establish a minimum global tax rate. An important reason for this development has been the accession to the global minimum tax by the current US administration, as well as the last EU members previously opposed to Pillar 2.

The OECD's statement itself does not offer substantive new information on how the proposals might operate in practice. However, its release follows a significant breakthrough in the four year negotiation process. Ireland, Estonia and Hungary had all previously opposed the introduction of an effective global minimum tax rate, as their corporate tax systems generally allowed for statutory or effective tax rates at or below the proposed global minimum rate. These nations have now agreed to support the proposals, having secured confirmation that the minimum tax rate stated in the proposals is a definite number rather than a tax of "at least" the rate stated. This means that all EU Member States have endorsed the OECD's proposed reforms and that 136 of 140 OECD countries have now agreed to the deal (only Sri Lanka, Pakistan, Nigeria and Kenya have not yet acceded to Pillar 2). The United States Treasury Department generally has been a longstanding proponent of the Pillar 2 proposal. By contrast, previous United States presidential administrations objected to the Pillar 1 proposals as potentially disproportionately affecting US corporations. The changes to the Pillar 1 proposals, targeting only the largest and most profitable corporate groups until several years elapse after enactment of Pillar 1, have led to the Biden administration expressing support for Pillar 1. Importantly, the support of the US President and the US Treasury Department do not mean that the US Congress will necessarily enact enabling legislation.

Pillar 1

At a very high level, Pillar 1 is intended reallocate profits and related taxing rights from certain jurisdictions where multinational enterprises (MNEs) have physical substance to other countries where they have a market presence, regardless of whether or not they have a physical presence in that second jurisdiction. Pillar 1 will only apply to MNEs with turnover in excess of €20 billion and profitability before tax in excess of 10%. It is envisaged that this will operate a de facto digital sales/services tax (“DST”), with global technology giants falling within the rules. The Biden administration had previously stated that it could not accept any result which is discriminatory against US firms. However, the administration has more recently expressed support for the proposal in light of the fact that the rules as now formulated are aimed at a much smaller group of the world’s most profitable MNEs, at least for several years from introduction.

Despite the multilateral negotiations, several OECD countries have already decided to move ahead with or proposed unilateral measures to tax the digital economy. Austria, France, Hungary, Italy, Poland, Spain, Turkey, and the UK have all implemented some form of DST as at the time of writing ranging from 1.5% (in Poland) to 7.5% (in Turkey) subject to varying revenue thresholds. The EU also expressed an intention to impose a digital levy from 2023. These measures have created international tensions with the US, as there is a perception that US companies are disproportionately affected by the DST. This has resulted in the US formally investigating DSTs and threatening to retaliate with significant tariffs.

The recent OECD statement confirms that a multilateral convention will require countries to remove DSTs and similar measures and commit not to unilaterally introduce such measures. On 21 October 2021 the UK, Austria, France, Italy, Spain and the US announced the terms of an agreement providing for the transition from existing DSTs and similar measures to the new multilateral solution. The US and the UK have agreed that the existing UK DST, which was introduced in April 2020 and levies a 2% rate on certain digital service providers, will remain in place until 2023, when the Pillar 1 rules are expected to become effective. However, certain members of the US Congress have raised the possibility that this agreement might constitute a “treaty” within the meaning of the United States Constitution. This would mean that the US could not bring this agreement into force without a 2/3 majority of the United States Senate consenting, which could be difficult to achieve in the current US political environment.

Pillar 2

Broadly, Pillar 2 is the global anti-base-erosion (“GLOBE”) regime which proposes to implement to an agreed minimum effective tax rate of 15% in each country in which an MNE operates. The Pillar 2 minimum tax rate will only apply to MNEs that exceed a consolidated annual revenue threshold of €750 million.

There is some scepticism as to whether the GLOBE regime will have a meaningful impact on competitiveness in the international tax landscape. Having the effective minimum rate set at 15% means that territories which already have tax rates in excess of this, like the US and the UK, are unlikely to be more attractive for large businesses as result of the rules. The 15% floor agreed to is well below average corporate tax rate in industrialised countries of about 23.5%. The agreed rate represents a victory for Ireland, which opposed anything in excess of 15%, and is well below the minimum rate of 21% proposed by the United States. Despite this, the Biden administration has indicated its support for the GLOBE regime. However, as noted above, the administration’s support does not directly translate into enactment of enabling legislation by the US Congress. Further, the same concerns about the Pillar 1 agreement constituting a treaty discussed above apply to the Pillar 2 agreement.

There has been some indication that investment funds, pension funds, governmental entities, international organisations, non-profit entities (which likely includes most tax-exempt organisations in the United States) and entities subject to tax neutrality regimes may be excluded from the scope of both Pillar 1 and Pillar 2 which will be important from the perspective of the funds industry.

Next steps and Implementation

With respect to Pillar 1, the OECD has stated that countries are aiming to sign a multilateral convention during 2022, with effective implementation in 2023. The convention will be the vehicle for implementation of the newly agreed taxing right under Pillar 1, as well as for the standstill and removal provisions in relation to all existing DSTs and other similar relevant unilateral measures.

Model rules to give effect to the GLOBE rules are set to be developed by the end of November 2021. These rules will define the scope and set out the mechanics of the regime. The OECD will develop further rules for bringing Pillar 2 into domestic legislation during 2022, to be effective in 2023.

Some concerns have already been raised about the implementation timetable. The Swiss finance ministry requested that the interests of small economies be taken into account and said that the 2023 implementation date was impossible. The proposals will also have to be enacted by the US Congress before ratification, and such enactment is subject to substantial political uncertainty.

We will wait with interest on the progress in this important area and will report on developments as they become clearer.

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- **David M. Ward**
Associate
- **Martin T. Hamilton**
Partner