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The geopolitics of tax: what if BEPS fails?

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In November 2021, over 135 countries signed up to the OECD / G20 'Inclusive Framework' to reform international taxation rules. The two-pillar plan aims to ensure that multinationals pay their fair share of tax wherever they operate, regardless of where they are headquartered. The agreement looked like a triumph for multilateralism. But 18 months on, the two supposedly indivisible pillars show signs of splitting. With no prospect of the US implementing Pillar One – on profit reallocation – in this Congress, debates around Digital Service Taxes are beginning to reignite. How will the political and economic incentives facing different regions diverge as the OECD heads towards a crunch-point this Summer?

WHY DID THE IDEA OF PROFIT REALLOCATION EMERGE AND WHERE IS IT GOING?

The OECD's BEPS (Base Erosion and Profit Shifting) process will reach the ten-year mark this summer. The agreement of over 140 countries to the two pillar 'Inclusive Framework' appeared last year to provide a high watermark for multilateralism when the international system has faltered on so many fronts. But the process is weaker than commonly perceived, and its central profit reallocation proposal (Pillar One) may collapse in acrimony by the end of 2023. Businesses and policymakers are beginning to plan for what may emerge in its place.

The BEPS process was designed to address tax planning used by multinational corporations to shift profits to low-tax or no-tax jurisdictions, resulting in a loss of revenue for the countries where corporations' principal markets exist. It was associated from the outset with the major online platforms whose profits (in relation to their headquarters or major markets of sale) began to receive increasingly critical attention in the wake of the 2008 financial crisis.

In the 2010s, growing budget deficits in many Western economies increased the prominence of corporate tax strategies as both a political issue and a pragmatic target. This was often coupled with a critique of the way in which large digital platforms generated revenues in markets where they had no physical presence and / or shifted profits to lower tax jurisdictions if they did. These criticisms led to the growth of digital services taxes (DSTs) on the turnover of certain suppliers, levied primarily by European countries, including the UK and Turkey and new sales taxes on certain digital services in other jurisdictions. The US, under President Trump, responded with the threat of retaliatory tariffs. Progress in the OECD negotiations - leading ultimately to the November 2021 agreement - persuaded the US to suspend those measures in exchange for a moratorium on new or enhanced DSTs, commitments to set DST payments against future tax liabilities created by the BEPS changes and a promise to revoke existing DSTs once 'Pillar One' of the agreement had been implemented.

Pillar One of the OECD agreement provides mechanisms for a reallocation of profits from markets in which multinationals are headquartered to those in which their revenues are earned. This is a material change in international tax practice and, if implemented, would change decades of practice in bilateral taxation agreements. Pillar Two provides for a global minimum corporation tax of 15%. The OECD has always viewed the two as indivisible, but, in practice, negotiations developed on parallel tracks, with Pillar Two always the easier to deliver. The EU has agreed to implement Pillar Two and all member states will be required to have the regime in place by the end of 2023. From Japan to South Africa, many other jurisdictions

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are progressing towards implementing the measure. But the US - which has spearheaded the process under President Biden and Treasury Secretary Yellen - may yet prove its undoing.

THE US APPEARS TO HAVE GONE AS FAR AS IT CAN, BUT THAT MAY BE NOT FAR ENOUGH.

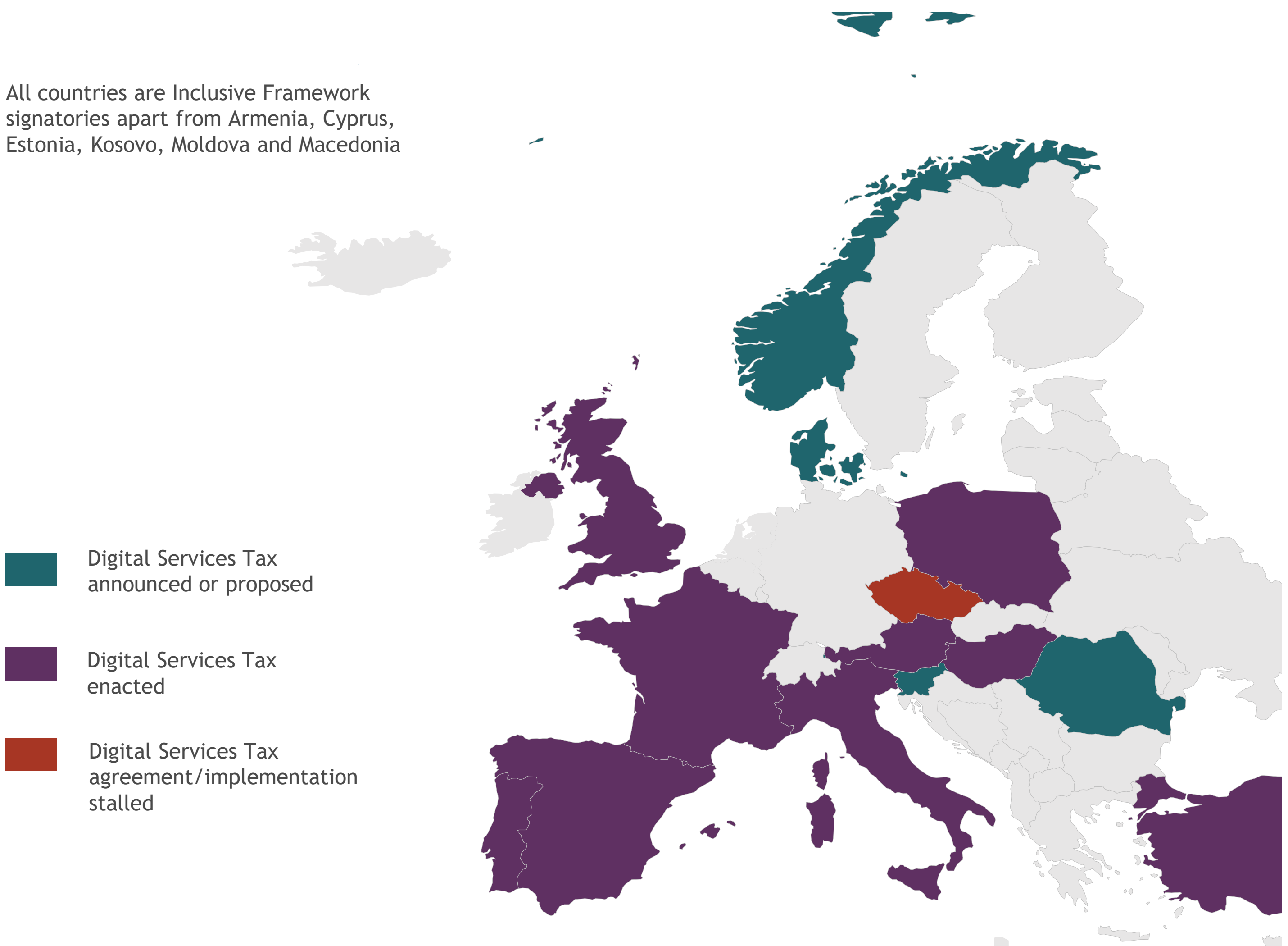
The US view is that - through a combination of tax reforms under GILTI and then the Inflation Reduction Act - it has already implemented Pillar Two via a domestic corporation rate of 15%. Many other countries - particularly Europeans - dispute the detail and suggest that the US has not delivered its obligations in full because the new US tax rules apply a globally blended methodology, rather than insisting on a simple effective tax rate of 15% in each market jurisdiction where a US-parented firm operates. This split will most likely spark further disputes on whether US headquartered MNCs should be paying more tax elsewhere.

But if further US legislation on Pillar Two looks unlikely in this Congress, any movement on Pillar One looks practically impossible. While the scope of Pillar One has now been broadened materially and the focus shifted to income rather than revenue taxation, there exists a widespread view in US business and politics that it was in effect a free pass given to the Europeans which unfairly penalises US Big Tech. There is no majority among Democrats, let alone Republicans, in support of the principle of profit reallocation on this new basis. The irony is that those same tech companies may fare worse if the alternative to Pillar One turns out be a global slew of DSTs.

So far, the OECD process has not acknowledged the reality of a US political block. In theory, a multilateral convention this Summer will expand on the detailed rules through which Pillar One might be implemented, leading to a treaty. The US continues to lend theoretical support to the process, but in practice the sense of US intransigence will become more unavoidable as the year goes on.

This dynamic will impede progress in other regions of the world - particularly in Latin America, Asia and Africa - where legislative implementation of BEPS is mostly at an earlier stage. There is growing pressure from the so-called G77 group at the UN (a coalition of 134 developing countries), backed by China, to create an alternative process to BEPS, potentially culminating in the creation of a UN tax convention or global taxation body which would have broader membership than

FIG 1: DIGITAL SERVICES TAX IMPLEMENTATION ACROSS EUROPE, AS OF MARCH 2023



Source: KPMG, Taxation of the digitised economy

	GENERAL DST APPROACH	BEPS APPROACH
INCOME OR REVENUE?	Defined elements of revenue linked to services in scope	Income, but allocated in part on the basis of revenue
PERMANENT ESTABLISHMENT NECESSARY?	No. Most DSTs focus on revenue because current tax treaty commitments require a permanent establishment to create a nexus for income taxes.	No. BEPS would replace the general taxation agreement approach of allocating income taxes across jurisdictions in which a company has a permanent establishment with a reallocation key based on revenue.
SCOPE?	Generally selected digital services. Some DSTs target only advertising services, most target a range of digital services linked to digital platforms and user participation.	All activities of MNCs in scope. Excludes financial services companies.
THRESHOLD?	Generally, yes. For example, the proposed EU approach sets €750mn in global revenues and €50mn in an individual member state as the dual key.	Yes - $20bn in global revenues.

the OECD or G20. This is not likely to emerge in the near-term, but the fact of an alternative process, or processes, will emphasise questions about the OECD's legitimacy and bind with wider questions (such as climate finance) of North / South equity.

A RESURGENCE OF DIGITAL SERVICE TAXES, BUT UNDER WHAT MODEL?

In Europe, an absence of progress on Pillar One will soon spark calls for the Commission to renew its proposal for an EU-wide framework for DSTs, as a better alternative to fragmented national efforts, as early as next year. The institutions, like the Member States, have both political and economic incentives to progress the issue quickly. The sense that the major platforms have historically failed to pay a "fair share" of tax remains deeply embedded in parts of Brussels, and sits behind many of the other "techlash" currents. The Commission also regards an EU-wide DST as a possible source of revenue for the EU's own budget which could plug fiscal gaps left by Next Generation funding. New DSTs will also look increasingly inviting in emerging economies as fiscal pressures grow this year. But despite their political expediency, DSTs provide a blunt and relatively limited tool by which to deliver the fairness agenda which has always driven the BEPs process.

Where Pillar One is sector-neutral and focused on profit (albeit with a new approach to reallocation), DSTs are, by definition, narrowly focused and based on turnover and therefore harder to justify on either normative or pragmatic grounds. BEPS sidesteps all of the intractable debates around turnover taxation and value creation that the OECD membership could not resolve by focusing on profit. BEPS also explicitly foresees the removal of all DSTs as part of its implementation. In a world without BEPS, all the highly contested arguments about taxing revenue and scrapping the traditional nexus of physical presence will rear their heads again.

In the worst-case scenario, businesses will face a sprawl of overlapping tax regimes, which in fact constrain digital - and broader economic - development in lower and middle-income countries. This could include the proliferation of sales taxes on digital services delivered by non-resident suppliers based on the notion that taxing consumers (in contrast to DSTs which are levied on company revenues, even if they are passed on in part to consumers), provides an easier path to lost revenue. These prospect places a huge onus on the OECD - and its members - to consider the least bad options if the Pillar One process does fail.

There is a common interest in developing a fallback DST paradigm which provides maximum transparency and predictability, and could be adopted relatively easily across multiple jurisdictions with varying levels of technical capability. There is also no reason why rival ideas to the OECD's - such as the G77 UN proposals - should not at least adopt a corresponding set of design principles, which broaden out the scope of the debate from a purely digital turnover tax. However, this will be far from easy. It will be in most businesses' interests to back the OECD process as far as it can go. But there is an even stronger case to avoid complacency towards its potential failure.

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