Submitted: October 5th, 2023
Reviews completed: January 5th, 2024
Published: June 1st, 2024

Financial Law Review

No. 33 (1)/2024

UNIVERSITY OF GDAŃSK • MASARYK UNIVERSITY • PAVEL JOZEF ŠAFÁRIK UNIVERSITY
http://www.ejournals.eu/FLR

GABRIEL STOLLSTEINER*

FAIR TAXATION IN THE DIGITAL AGE: CAN THE OECD TWO-PILLAR SOLUTION REPLACE DIGITAL SERVICES TAXES?

Abstract

Since the emergence of the digital economy at the turn of the 21st century, multinational companies have exploited the inadequacy of international tax regulations to avoid taxation. So far, states and international organisations have been unable to remedy the situation. In recent years, the former have taken the lead in introducing digital services taxes, allowing them to recoup some of the lost tax revenue, at the cost of unilateralism that is damaging to the international tax environment. Meanwhile, the OECD has put forward a multilateral solution aimed at preventing tax avoidance and ensuring a fair international tax system. This article aims at showing how profound an impact a digitalising economy has had on international taxation and to assess the respective merits and prospects of national as well as international solutions presented. Such an assessment is to be made in terms of both tax certainty as well as compatibility with constitutional and treaty provisions. It concludes that digital services taxes, despite serious shortcomings, have proven a necessary step until a multilateral agreement becomes enforceable. The latter remains nonetheless essential in ensuring multinational enterprises contribute their fair share of taxes.

Key words: OECD, digital services, international taxation, BEPS, Two-Pillar approach

JEL Classification: K34.

* Senior Researcher, Ferenc Mádl Institute of Comparative Law, Budapest, Hungary, specializing in tax law and constitutional law.
Contact email: gabriel.stollsteiner@mfi.gov.hu, ORCID: 0009-0007-4482-0309.

1. Introduction

Earlier this February, the OECD published its Guide on the Global Anti- Base Erosion Model Rules [Tax Challenges Arising from the Digitalisation of the Economy, 2023]. The purpose of this document is to help States implement the global minimum corporate tax rate on which an agreement was first reached in October 2021 [OECD Statement 2021]. The OECD also released a revised assessment of the estimated tax revenue expected from the first pillar of this Anti-Base Erosion Model [Revenue impact of international tax reform better than expected, 2023]. It thus represents an important step in the process of making the provisions of said agreement a reality. Nearly two years after the idea of a 15% global minimum corporate tax rate was first endorsed officially at the G7 summit in June 2021 [Rappeport 2021], why does the process of its implementation seem so slow-paced? What motivated political stakeholders to decide in favour of such a solution in the first place? Is the current framework liable to provide a satisfactory answer to the tax challenges arising from the digitalization of the economy?

Before those questions can be answered, it is necessary to take a step back, and lay out the situation that gave rise to the ongoing efforts, spearheaded by the OECD, to arrive at a minimum tax rate that would be accepted worldwide. Then, after presenting how attempts at creating digital services taxes have fared so far, those will be measured against the expected merits of the proposed OECD model.

2. Identifying the widening technological gap within the international tax system

When defining what fair taxation would entail, one can turn to the OECD, according to which “taxation should produce the right amount of tax at the right time, while avoiding both double taxation and unintentional non-taxation” [Addressing The Tax Challenges Of The Digital Economy, 2014: 31]. Another important stated goal is to minimise the potential for tax avoidance. Fair taxation is also essential to ensure broader tax acceptance, as “if there is a class of taxpayers that are technically subject to a tax, but are never required to pay the tax due to inability to enforce it, then the taxpaying public may view the tax as unfair and ineffective.” This explains why policy makers should see the enforceability of tax rules as a high priority. In the context of digital economy, fair taxation would also mean curtailing harmful tax competition between states while ensuring multinational enterprises are not taxed proportionally less than other companies (or, to use OECD’s formula, ensure a ‘level playing field’).

The phenomenon of tax avoidance is not, in and of itself, a new one. However, in the past three decades, several factors have compounded the issue. Large multinational enterprises (MNEs) have grown more confident than ever in turning economic competition between States at their advantage [see Zucman 2015]. Simultaneously, digitalization of the economy has rendered past tax concepts ineffective in appraising and taking hold of the tax basis constituted by company profits. As countries compete with each other in order to attract large companies, a race to the bottom ensues, where States are driven to introduce lower and lower tax rates in the hope of enticing large companies to settle within their borders - in OECD publications, the process described is defined as domestic tax base erosion and profit shifting (BEPS). As a result, the burden of taxation has tended to shift towards other areas of the economy such as consumption (through VAT and other indirect taxes), labour, as well as on smaller companies unable to take full advantage of international tax competition. It also raises an issue in terms of fair competition, as large MNEs using BEPS tools can benefit from a lower effective tax rate, thus gaining a competitive edge on competing companies not able to fully take advantage of those tax schemes.

This state of affairs has proven especially untenable after the 2008 recession, as States found themselves hard-pressed to find sources of tax revenue in an economy in turmoil. While the issue has been perceived more and more acutely since then, States have proven by and large powerless in finding a workable solution. This stems from two main factors. One is the growth of digital companies, which are able to extract revenue from a market country without necessarily being physically present in said country. Most tax treaties rely on the existence of permanent establishment in order to allocate tax rights to a given country. The notion of permanent establishment implies some form of physical presence, such as company offices, local workforce, as well as a degree of decision-making taking place in a given country. Those criteria worked well enough in the pre-digital era, where conducting business in a market country was nigh impossible without a physical presence of some kind. In the 21st century, companies such as Google, Apple, Facebook or Amazon (the GAFA, as they are called) can effectively generate astounding amounts of profit with only minimal presence in market countries. Recently, the Covid pandemic and associated restrictions such as lockdowns have severely hit traditional, brick-and-mortar businesses while digital companies have greatly benefited from these circumstances.

Another factor preventing States from implementing countermeasures to tax avoidance is the existing network of bilateral tax conventions, as well as EU provisions that make it especially difficult to impose tax rules on a single-country basis. As far back as 2010, the idea of taxing Google on its online advertisement activities was floated following a French

public report that originally intended to find ways of financing artistic copyright holders in the digital age [Zelnik et al. 2010]. An amendment was introduced in the Corrective Finance Law for 2010, [Amending Finance Bill 2010] introducing a 1% tax on sums paid by advertisers for online ads, with an expected yield of modest proportions – several tens of millions of euros at most. The entry into force of the tax was delayed due to outcry from the industry, before being pulled out in 2011 before ever coming into effect. During the same period, media groups have sought to assert ancillary copyright over news aggregators. In France as well as several other European countries, such as Germany, Belgium, and Spain, attempts were made at imposing royalty charges for content referenced by Google News, with disappointing results. By then, a form of interdependence had emerged, as news organisations would seldom risk being dereferenced by news aggregators, lest their traffic would plummet. In Belgium, a lengthy lawsuit concluded in an agreement being found between publishers and Google News. In Spain, the news aggregator service was discontinued for eight years, until transposition into this country's national law of article 15 of the 2019 EU Copyright Directive [Directive (EU) 2019/790] made it possible to strike licensing agreements with owners of press publications. In Germany, where such agreements were made, smaller press groups agreed to let news aggregator reference their content for no fee. A larger publisher then brought the case to the German competition authority over the perceived abuse of a dominant position, in the sense of competition law, to no avail [B6-126/14]. In France, the proposed tax was struck down by the Constitutional council, as it left the French tax authority to decide which entities would be subject to the tax – a decision that lies exclusively within the powers of Parliament [2016-744 DC]. All in all, the laws passed during this period did not achieve their projected goals, as they resulted either in news aggregators carrying on their activities free of charge, or the discontinuation of said activities, whilst refusing to pay the intended fees.

Overall, the debate on digital taxation in the 2010s was partly dominated by interest groups linked to the cultural and media industry, which saw their revenues melt away in the face of illegal downloading and digitalization. Over the years, the ever-increasing development of legal offers has changed the situation somewhat, and the industry has had time to make the transition to digital formats. In turn, this has allowed policymakers to refocus on tools to ensure fair taxation of MNEs rather than with the interests of a specific industry in mind. The past years therefore saw a focus on the tax revenue objective, alongside the maturing of the idea of an international solution, discussed below.

3. Digital services taxes, a powerful but incomplete tool to address international tax avoidance

Digital services companies rely on international tax treaties and borderless trade to easily avoid taxation. This makes it immediately apparent that any viable solution must, by necessity, involve the greatest possible number of individual states as well as international organisations (OECD, WTO, IMF). Action by normative, supranational bodies such as the European Union is also imperative in order to go beyond mere non-binding agreements and ensure compliance. Addressing the challenges of a digitalized economy has long been a priority in EU policymaking. Since at least 2014, the EU has sought to create a digital single market. Then candidate for President of the European Commission Juncker put forward the goal of creating a Digital Single Market for the EU [Juncker 2014: 6]. This was followed in 2015 by a Communication from the Commission to the EU Parliament on a Digital Single Market Strategy for Europe, which mentioned the need to take into account tax treatment of e-services. The Commission was "working to minimise burdens attached to cross-border e-commerce arising from different VAT regimes" [A Digital Single Market Strategy for Europe 2015]. One such example is provided by Member States with a lower VAT rate attracting digital services companies' headquarters, granting them full access to the EU market while applying the lowest rate available. The EU's e-commerce system has gradually evolved to its current form, in which the Union-wide threshold of 10 000 € is applied since 2021, above which the VAT due by online sellers is that of the buyer's country. It should be pointed out that, at that stage, EU initiatives were mainly focused on creating a single market and settling issues of tax competition within EU borders. As such, they aimed not at deciding on matters of international tax avoidance, but merely at regulating the European Single Market.

Another promising prospect in combating tax avoidance within the EU was the Common Consolidated Corporate Tax Base (CCCTB), originally proposed by the Commission in 2011 and re-launched in 2016. Defined as a single set of rules to calculate companies' taxable profits in the EU, the CCCTB would mean that multinational companies would only have to apply one, single EU system for calculating their taxable income, rather than many different national rulebooks. In the Commission's plans, the CCCTB would "eliminate mismatches between national systems, preferential regimes and hidden tax rulings", which are tools tax avoiders exploit. It would also remove the need for transfer pricing, which is a primary route for profit shifting. Unfortunately, it has proved difficult for Member States to agree on a common solution, and as of 2023, the CCCTB plans have failed to materialise [CCCTB

Proposal 2016]. Time will tell whether its spiritual heir, the BEFIT initiative, will suffer the same fate [BEFIT initiative].

In a 2017 Communication, the Commission sought to define more broadly the main challenges posed by international taxation in a digitalized economy, where it can become unclear what value should be taxed, how to measure it and where said value is created [A Fair and Efficient Tax System in the European Union for the Digital Single Market 2017]. Those challenges could be summed up as two questions, namely, 'where should taxation happen?' and 'what should be taxed?'. Mirroring the OECD's analysis, the Commission called for "a strong and ambitious EU position on taxing the digital economy". This time around, the focus was less around the single market but rather on tax fairness as well as on EU international competitiveness. The latter was especially highlighted by the remark that "in the absence of adequate global progress, EU solutions should be advanced within the Single Market", which could only sound ominous to US-based digital services companies, who became wary of an EU-wide tariff [Hufbauer & Lu 2018]. On 21 March 2018, the European Commission followed up by putting forward two proposals for new rules aimed at ensuring fair taxation of digital business activities in the EU [Digital Market Proposals 2018]. While the proposals have yet to result in an enacted directive, it is likely to have sped up the aforementioned 'global process' by incentivising active participation of the US in an OECD framework. The proposals also meant that Member States were free to enact digital services tax, pending the implementation of a global agreement for taxation of digital services [For an in-depth analysis of digital services taxes per se, see Simić 2021].

Many European countries have now introduced digital services taxes, especially since 2019, including countries that are outside of the EU as well as Member-States. It is beyond the ambit of this paper to detail each individual system country by country; however, by taking the French digital services tax as an example, the main characteristics of such taxes can be effectively identified [KPMG Taxation of the digitalized economy 2023]. The most relevant characteristics to be examined are the scope, the tax basis and finally the tax rate.

3.1. Scope of digital services taxes (DSTs)

A digital services tax is designed to include in its purview companies that are both large enough to take advantage from the international tax system and engage in activities generating a sizeable revenue from the local market. The former condition is provided by a global revenue threshold: in the French case, companies need to generate a global revenue

of at least €750M to be subjected to the tax. Italy, Austria, Spain, and Turkey set their threshold at the same level, while other countries set a lower threshold or no threshold at all (Portugal, Hungary, Poland). For the latter condition, a domestic revenue threshold ensures that a consistent revenue is actually being derived from the market country. The French digital tax system requires €25M of revenue be made by a company from the French market alone before said company can be subjected to the tax. This guarantees that the company subjected to the tax has a sufficient "Internet presence" in the country, even in the absence of physical installations. Naturally, the domestic revenue threshold varies country by country as smaller market countries would accordingly set a smaller threshold.

Digital services in the scope of the tax mainly include online advertising, sale of user data, as well as video-on-demand services. The exact activities may vary country by country; in practice, the goal is to target Tech Giants – thresholds and scope of activities both serve this purpose. One of the main specificities of digital services tax is their territorial scope: contrary to most corporate taxes, they do not require any physical presence in the market country, either in the form of local manpower, physical assets (offices, factories) or headquarters. In this, they run counter to most bilateral tax conventions, as the latter generally follow the OECD's Model Tax Convention on income and on capital, which traditionally relied on these criteria for the attribution of tax rights [OECD Model Tax Convention 2019].

3.2. Tax basis of DSTs

All digital services taxes implemented in the EU retained gross revenue as its tax basis. The advantage of such an approach is that bilateral conventions do not, as a rule, provide for taxes on gross revenue, but only on net income, as far as companies are concerned. Therefore, a country can introduce this type of digital services tax without needing to embark in a round of painstaking renegotiation of each individual bilateral convention currently in force.

However, choosing gross revenues as a tax basis comes with its own drawbacks. By not allowing the deduction of expenses, taxation based on the sheer volume of sales can only be remotely connected to the company's actual profitability and accordingly, to its ability to contribute financially. Opponents of this form of taxation will often take issue with the fact

that by ignoring expenses, it discourages investments, which could prove detrimental to competition as well as innovation in the long run[1].

3.3. Tax rate of DSTs

To limit the negative effects mentioned above, taxes on gross revenue such as the digital services taxes are typically set at a low level. France, Italy and Spain have their digital services tax rate set at 3%, Poland at 1,5%, while Austria taxes the gross revenue on online advertising at 5%.

Considering the characteristics listed above, only a limited pool of companies is included in the scope of most digital services taxes, and tax rates are typically set at a minimal level. Given the rate applied and the small number of businesses subject to this tax, the yield is rather moderate.[2] This contributes to limit severely the expected tax revenues gained with such measures. Because they are based on the gross revenue, turnover taxes are generally passed on to the consumer, which in itself does little to help change the tax avoidance behaviour of the companies concerned. Digital services taxes affect only a handful of multinationals specialising in new technologies, while the phenomenon of tax evasion concerns a much wider range of activities and companies. Although they are designed to apply outside the field of existing international tax agreements, they are liable to generate litigation both at the EU level and the WTO level. In 2019, Hungary decided to apply a temporary rate of 0% to its digital services tax while the Court of Justice of the European Union was examining its compatibility with EU law, at the behest of Google Ireland Limited. Though the CJEU found that the principle of enforcing registration of digital services companies was not in itself contrary to EU law, the fines imposed on companies refusing to register were contrary to article 56 of the TFEU [CJEU C-482/18].

As US-EU talks were stalling on the subject of digital taxation at the EU level, individual EU countries decided to take steps to introduce digital services taxes at the country level. Because most tech giants happen to be American companies, the US strongly opposed the move and suggested they would refer to the World Trade Organisation if digital services taxes were implemented. It remains unclear to what extent pressures were involved, but Germany abstained from introducing its own digital services tax as the US government

[1] For instance, the German association of digital businesses (Bevh), of which the local branches of Amazon and Google are members, commissioned a report issuing a scathing critique of the digital services tax [Bevh 2018].

[2] In France, the revenue from the digital services tax was 277 million in 2019, 375 million in 2020, and 474 million in 2021 [DGFIP Report 2021].

threatened retaliatory tariffs if digital services taxes were introduced in Europe. The plans for US retaliatory tariffs were withdrawn as an agreement was found on a future new global tax regime for large highly profitable companies [Lawder & Thomas 2021].

Digital services taxes unilaterally decided by individual EU countries are of a supposedly temporary nature. The end-solution would consist of an extensive international agreement which would not only solve the issue of taxing digital services but would also more broadly address tax avoidance as well as disruptive tax competition among states.

4. OECD's Two-Pillar solution, an ambitious multilateral instrument to overhaul international tax rules

For years, an international response has been in the works to come up with a concerted solution to international tax avoidance by MNEs [see also Wach 2019]. Since 2012, the OECD has led an initiative aimed at preventing the use of (tax) base erosion and profit shifting (BEPS) tools by multinational companies.

In 2015, a joint OECD/G20 BEPS project led to 60 countries adopting a variety of 'actions' aimed at guaranteeing a more transparent fiscal environment and improving the coherence of internet tax rules. The OECD/G20 Inclusive Framework was established the following year to involve developing countries (e.g. non-OECD countries) in the discussions and in the implementation of BEPS-related multilateral agreements. One of the first tangible result of this work was the creation in 2017 of the Multilateral Instrument, a regulatory tool designed to enforce BEPS rules without needing to renegotiate bilateral tax treaties.

Given that its self-avowed goal was to tackle tax avoidance and put an end to tax havens, it can be said that the OECD initiative has been largely unsuccessful so far. In the race between tax avoidance schemes and tax regulation crackdown, the former always seemed to be one step ahead. After the infamous "Double Irish" scheme was discovered and eventually dismantled under EU pressure, it was immediately replaced by the lesser-known "Single Malt" tax avoidance scheme, itself later replaced by yet another scheme, called Capital Allowances for Intangible Assets (CAIA) [Ní Chasaide 2023, 39-58]. It is not the purpose of this paper to lay out the exact mechanism of these schemes. In essence, by relocating profits in low-tax jurisdictions, they allowed companies such as Google or Apple to reduce their effective tax rate (ETR) to around 0-2,5%. Notwithstanding the OECD-led multilateral agreements to put an end to harmful tax competition, tax avoidance schemes akin to those mentioned above carry on to this day.

There is reason to believe that the latest development in OECD's BEPS project might constitute a breakthrough. In 2021, more than a hundred countries and jurisdictions joined the new two-pillar solution put forward by the OECD, which aims at nothing less than reforming the entire international tax system and finally ensuring effective taxation of multinational companies regardless of their physical headquarters.

Of the two pillars, the second one is perhaps the most well-known, as it aims at setting up a minimum global corporate tax rate of 15% on multinational groups with revenue exceeding 750 million euros. The most notable feature of this measure is that, instead of taking into account the *headline* tax rate (the rate of taxation that is applied to the profits that a jurisdiction deems to be taxable after deductions), Pillar Two relies on the *effective* tax rate (ETR). To simplify, ETR is calculated by comparing profits before deductions and the actual amount of tax eventually paid. This is because the official tax rate can be misleading when a large proportion of profits are excluded from the tax basis in the first place – and are therefore exempt from taxation, however high or low the rate might be. With a minimum global ETR of 15%, as currently planned, MNEs with subsidiaries that are taxed below 15% ETR would be required to pay a top-up tax related to this income in order to reach 15%. To achieve the ETR and allocate tax rights to different states, a combination of three rules is to be applied, collectively called GloBe rules.

As for the first of the two pillars, it consists in the reallocation of profits to market countries, as follows: Companies will be required to have a nexus (or permanent establishment) allowing allocation of revenue to a market jurisdiction, provided the following conditions are met:

- **a)** Company derives at least 1 million euros in revenue from said jurisdiction,
- **b)** Annual global turnover is above 20 billion euros (threshold to be reduced later to 10 billion),
- **c)** Profitability is above 10%.[3]

Part of the company's profits will then be reallocated to market jurisdictions based, among other parameters, on the proportion of revenue derived from each market jurisdiction. This summarises what is called "Amount A" of Pillar One. Another tool (Amount B), aimed at addressing issues of transfer pricing, is currently in the works. An OECD Economic Impact Assessment released in October 2020 estimated tax revenue gains from implementation of

[3] For smaller jurisdictions (at GDP 40 billion euros or lower) the threshold will be set at 250 000 euros.

Pillar One at an average of USD 5-13 bn per year [Tax Challenges Arising from Digitalisation 2020]. However, a new OECD estimate presented in early 2023 put the expected tax revenue gains closer to USD 12-25 bn per year [Revenue impact of international tax reform better than expected, 2023], while the amount of tax rights allocated under Pillar One would reach USD 200 bn (up from USD 125 bn in earlier 2016 estimate). As for the impact of Pillar Two, the same 2023 forecast estimated global tax revenue gains at around USD 220 bn, up from around USD 150 bn in the 2021 estimate. The 2023 study explained the increase by the fact that MNEs already in the scope of the Pillar One framework had seen a substantial increase in their profits [Economic Impact Assessment of The Two-Pillar Solution, 2023]. The amounts may seem astronomical from the point of view of an average country's budget, or modest in relation to global financial fluxes. In any case, such estimates are by nature subject to substantial change depending on variations in global economic growth and, in particular, profitability of in-scope MNEs. Moreover, the Two-Pillar framework is, by design, liable to increase in scope, which would increase projected tax revenue gains accordingly.

Pillar One of OECD’s BEPS initiative is of particular significance for countries that have implemented digital services taxes, since most of these jurisdictions have made the withdrawal of digital services taxes conditional on the implementation of Pillar One. Although the exact transitional arrangements from digital services tax to Pillar One have yet to be defined, it has already been made clear that implementation of Pillar One goes hand in hand with the deletion of all digital services taxes. As specified in the OECD statement issued in October 2021, a Multilateral Convention (MLC) will be set up, with the purpose of introducing ‘a multilateral framework for all jurisdictions that join’, as well as providing ‘the rules necessary to determine and allocate Amount A and eliminate double taxation’ [Statement on a Two-Pillar Solution, 2021]. An important provision of this MLC is that it 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’ [OECD Draft MLC 2022]. The OECD’s Inclusive Framework has allowed continued progress in implementing the Two-Pillar Solution, publishing an update on July 2023 [Outcome Statement on the Two-Pillar Solution to Address the Tax Challenges Arising from the Digitalisation of the Economy, 2023]. The package delivered on this occasion are a set of technical tools that reflect the compromise attained between large and small jurisdictions, as well as between developing and developed countries. These aim at ensuring that the share of taxation resulting from implementing the Two-Pillar Solution proves satisfactory for all state actors involved.

5. Conclusion

Despite the obstacles inherent to an agreement requiring a broad international consensus, the OECD initiative seems to be on the way to success. If so, the problem of the inadequacy of traditional tax concepts to the emergence of the digital economy may finally be resolved. Though a looming EU-wide tax on Big Tech companies (which happen to be mostly American and are also the largest users of BEPS tools) was certainly critical in getting the US on board with the OECD Two Pillars approach, it can be argued that the former should be pushed forward at least until the latter has proved its worth, which could take many years. Therefore, although national digital services taxes are not without flaws and should, in the long run, be replaced by an international agreement, they are nevertheless necessary for such an agreement to be reached in the first place.

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