OECD Pillar One Reform and the European Union: Do good things come to those who wait?

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Considering the ambivalent efficiency of EU Digital Service Taxes adopted by various EU Member States, and as the countdown for the OECD Pillar One Tax Reform unfolds, the European Union appears to be largely investing in the latter's successful implementation. However, Pillar One's success is heavily dependent on US participation in the Multilateral Convention implementing Amount A, which is currently hanging by a thread in view of the upcoming US presidential and congressional elections. This note presents the current Pillar One landscape and discusses the *bras de fer* between the European Union and the United States in this respect.

1. And there was ... the OECD BEPS 2.0

The tale of the two pillars of the OECD BEPS 2.0 project began in 2019, when more than 130 jurisdictions agreed to discuss the tax parameters arising from profit shifting as a result of the digitalization of the global economy. It has been estimated that in 2019, on average, 37% of multinationals' foreign profits were shifted to tax havens, generating significant tax revenue losses worldwide, amounting roughly to between USD 100 billion and USD 240 billion.

2. The technical aspect

Essentially, the BEPS 2.0 tax reform plan included a two-pillar approach aiming to ensure cohesion of the international tax rules and ultimately to create a more transparent tax environment. On the one hand, Pillar One focuses on preventing the largest and most profitable multinational enterprises (MNEs) owning highly movable intangible assets from benefiting from scale without mass by reallocating taxing rights to market jurisdictions (Amount A) and simplifying compliance for MNEs by streamlining taxation of income related to baseline distribution and marketing activities (Amount B). Pillar Two (which has been implemented at the EU level through the adoption of the EU Minimum Taxation Directive (2022/2523)), on the other hand, aims at establishing a minimum effective tax rate for large MNEs to mitigate the race to the bottom in corporate income tax.

Pillar One's two key reform features, Amounts A and B, essentially address specific aspects of the digital economy:

- **Amount A** provides for the reallocation of taxing rights to market jurisdictions (i.e. where end-users are based) beyond the traditional physical presence (permanent establishment) test.

  Under the Amount A taxing right, market jurisdictions shall be able to claim part of the revenue generated by an MNE as taxable in their jurisdiction under a specific formulaic approach. Per the OECD proposal, this could be achieved through the implementation of a multilateral convention (MLC), essentially amending the current division of taxing rights as governed by bilateral tax treaties currently in place. The draft text of the

MLC, released on 11 October 2023 and reflecting the consensus achieved among members of the Inclusive Framework at that date, was contemplated to be signed by the end of June 2024 and enter into force in 2025 in the signatory jurisdictions. However, this deadline was not met, since negotiations continue to date, while no new deadline has been communicated by the Inclusive Framework.

- **Amount B** aims to simplify the existing transfer pricing rules and take transfer pricing disputes over baseline marketing and distribution activities off the table.

  The mechanics of Amount B determine the expected return of local entities with low-complexity functionality on a formulaic basis by introducing a pre-set return with respect to the above-mentioned routine activities, depending on the industry, the intensity of the use of assets or the OpEx/sales ratio. While the OECD Final Report on Amount B was published in February 2024, jurisdictions may opt to apply the Amount B approach for in-scope transactions in their jurisdictions as of 1 January 2025. Unlike Amount A, Amount B does not provide for a specific revenue threshold for its application; thus, it may apply to a wider pool of MNEs. However, although the OECD List of Covered Jurisdictions expressed an initial (yet non-binding) political commitment to adopt Amount B, several EU Member States are opposed thereto, presumably estimating that they may ensure higher returns (and thus taxable revenue) for their local entities by applying the arm's length principle as currently in place.

Even prior to the introduction of Pillar One, several states had introduced unilateral provisions to address taxation of revenue generated in the absence of critical mass. The digital services taxes (DSTs), initiated as an "interim solution" by the European Commission in March 2018 and heavily supported by the European Parliament, failed to reach unanimous agreement by the finance ministers in the Council after opposition from a number of countries. As a result, certain EU Member States, including Austria, France, Italy and the United Kingdom, introduced such DSTs unilaterally, which, due to the inevitable discrepancies in their applicability, essentially led to further administrative burdens for MNEs. It is to be noted that, per the Pillar One MLC, local DSTs and relevant similar measures would need to be removed upon implementation of Pillar One.

3. The political aspect: The EU-US dynamics

Research suggests that approximately half of the MNEs captured by the scope of Amount A constitute US multinationals, while nearly 70% of the total reallocated profit is estimated to derive from US MNEs, leading to a net revenue loss of USD 1.4 billion for the United States had it been enacted in 2021. This essentially renders the success of Pillar One highly dependent on US participation in the MLC. From a tax revenue standpoint, without the United States, the number of Pillar One covered groups would decrease to 37 and the Amount A profits available for redistribution to EUR 38 billion, as opposed to the EUR 91.2 billion expected under full implementation of Amount A.

History-wise, it has been made quite clear that the United States has not been very keen on Europe's DSTs, resulting in the initiation of an investigation by the US Trade Representative to France, one of the first unilateral DST movers, on alleged discrimination against American companies and violation of international tax principles. Shortly after, investigations were also launched into the DSTs of other EU Member States, including Austria, Italy, Spain and the United Kingdom, as well as the European Commission's DST, sparking fears of a full EU-US trade war. This fuelled the intensification of the negotiations of the BEPS 2.0 two-pillar solution in 2019. However, although the current US President, Joe Biden, has embraced the Pillar Two developments, the participation of the United States in the Pillar One MLC remains relatively uncertain, considering the upcoming US presidential and congressional elections in November 2024, as well as the likely two-thirds majority requirement in the US Senate.

In the meantime, the European Union has largely counted on the prospective benefits of the implementation of Pillar One for its economy. It is to be borne in mind that the EU Member States mainly constitute market jurisdictions envisaged to benefit from Pillar One. Under the proposal, the European Union would capture 15% of Amount A profits allocated by the reform to EU Member States. To reflect the strength in numbers, EU net revenue gains are expected to reach EUR 2.6 billion, based on study estimates. All of the above should be seen in conjunction with the European Union's increased need for revenue resources in the coming years, considering the recent significant decline in tax revenue it has experienced since 2022. Indicatively, in the aftermath of the coronavirus crisis recovery package, the Recovery and Resilience Fund (RRF), the European Union was left with a debt of approx. EUR 720 billion to be repaid by 2058. In this context, the EU Parliament stressed that "in the event of clear lack of progress [on Pillar One] by the end of 2023, the Commission should submit a legislative proposal for a digital levy or a similar measure", while the European Commission reiterated that "the implementation of the OECD/G20 Pillar One agreement remains an essential priority in the area of corporate taxation for the EU and its Member States".

4. Looking ahead

Europe has indeed waited long enough on a consensus on Pillar One and, considering its prior unfruitful attempts to substitute for the objectives of Pillar One with other similar measures, it appears that this may be a key (and probably its best) chance to increase its tax revenue in the short run.

IBFD references

- For an overview of legislative initiatives at the EU level on direct tax matters from the moment they are planned by the European Commission until their adoption by the Council of the European Union, *see* the EU Direct Tax Law Initiatives Tax Dossier.
- EU tax law developments are reported in the daily IBFD Tax News Service.
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- IBFD webinar: Get Ready for Amount B: Key Strategies for Businesses