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A critical analysis of the pillar one direct tax solutions for businesses in the digital economy

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A RESEARCH REPORT SUBMITTED TO THE FACULTY OF COMMERCE, LAW AND MANAGEMENT IN PARTIAL FULFILMENT OF THE REQUIREMENTS FOR THE DEGREE OF MASTER OF COMMERCE (SPECIALISING IN TAXATION)

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A CRITICAL ANALYSIS OF THE PILLAR ONE DIRECT TAX SOLUTIONS FOR BUSINESSES IN THE DIGITAL ECONOMY

ABSTRACT

Business profit under the existing international tax system is taxed in the state of residence unless the entity has generated the said profit through a permanent establishment in another state. Traditionally, a business had to have a physical presence in the source state to be considered a permanent establishment. (European Parliament, 2019a, p. 17; World Bank, 2021, p. 26). The digitalisation of the economy allows multinational entities to do business with customers worldwide without having a physical presence in those customers' locations. (World Bank, 2021, p. 26), while the current international tax law is depended on the physical presence of the entity in a location, i.e., a permanent establishment (European Parliament, 2019a, p. 16; World Bank, 2021, p. 26).

In the digital economy, the concept of a permanent establishment becomes irrelevant (Medus, 2017, p. 15).

The OECD acknowledged that businesses with high levels of digitalisation could generate significant profits and engage in national economic life without having a sizable physical presence (OECD, 2015a, pp. 100-102). The European Parliament (2019a, p. 16) reported that due to these gaps in the current international tax system, digital businesses pay an average tax rate of 9%, while traditional businesses pay an average tax rate of 21%.

In October 2020, the OECD published the blueprint with the recommendation to address the direct taxation of the digital economy, entitled ‘Tax challenges arising from Digitalisation – Report on Pillar One Blueprint’ (Pillar One). These recommendations will be effective in 2024 once the inclusive framework members have signed the Multilateral Convention (OECD, 2022a, p. 5). In addition to the Pillar One report, the OECD issued a progress report entitled ‘Progress Report on Amount A of Pillar One, Two-Pillar Solution to the Tax Challenges of the Digitalisation of the Economy’ (Progress Report) in July 2021. Lastly, to address the administrative challenges, the OECD, in October 2022, issued the draft administration principles to be followed by the in-scope multinational entities on the report entitled ‘Progress Report on the Administration and Tax Certainty Aspects of Pillar One’ (the Administration Report).

Researchers and tax policymakers have researched the taxation of the digital economy or e-commerce. However, the focus of those studies was to analyse the tax challenges brought about by the digitalisation of the economy and propose solutions that can be adopted to

address the direct tax challenges brought about by the digitalisation of the economy (European Parliament, 2019).

This research report aims to analyse how digital businesses will be taxed using the recommended direct tax solutions from Pillar One. The OECD issued Pillar One to address the current international tax law gaps.

Keywords: digital economy, permanent establishment, physical presence, direct tax, OECD, nexus, value creation, multinational, arm's length principle, current international tax law and Pillar One.

DECLARATION

I declare that this research report is my own unaided work. It is submitted for the degree of Master of Commerce at the University of the Witwatersrand, Johannesburg. It has not been submitted before for any other degree or examination in any other university.

Sibonelo Khulekani Mthembu

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To the Man Above be the glory.

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CHAPTER 1: INTRODUCTION

1.1 Introduction and background to the research report

> 'Digital transformation spurs innovation, generates efficiencies, and improves services while boosting more inclusive and sustainable growth and enhancing well-being. At the same time, the breadth and speed of this change introduce challenges in many policy areas, including taxation'. (OECD, 2020a, p. 10).

> 'The tax challenges were first identified as one of the main areas of focus of the OECD/G20 Base Erosion and Profit Shifting (BEPS) Project, leading to the 2015 BEPS Action 1 Report on "Addressing the Tax Challenges of the Digital Economy" (the Action 1 Report). The Action 1 Report found that the whole economy was digitalising and, as a result, it would be difficult, if not impossible, to ring-fence the digital economy'. (OECD, 2020a, p. 10).

The taxes on profits ought to be collected where the entity has created the value (European Commission, 2018, p. 8). Certain digital businesses create value in a foreign jurisdiction without a sufficient physical presence in the location to attract direct tax based on the current international tax law (European Commission, 2018, p. 4). Entering into a double tax agreement between the states is one of the systems used in the current international tax law (Dumiter et al., 2019, p. 3). Article 7 of the OECD Model Tax Convention (OECD, 2017, p. 10) allocates the taxing rights of the business income between the source state and the residency state of the multi-national entity that derived income from the foreign jurisdiction.

In October 2020, the OECD published the blueprint with the recommendation to address the direct taxation of the digital economy, entitled 'Tax challenges arising from Digitalisation – Report on Pillar One Blueprint' (Pillar One). These recommendations will be effective in 2024 once the inclusive framework members have signed the Multilateral Convention (OECD, 2022a, p. 5). In addition to the Pillar One report, the OECD issued a progress report entitled 'Progress Report on Amount A of Pillar One, Two-Pillar Solution to the Tax Challenges of the Digitalisation of the Economy' (Progress Report) in July 2021. Lastly, to address the administrative challenges, the OECD, in October 2022, issued the draft administration principles to be followed by the in-scope multinational entities in the report entitled 'Progress Report on the Administration and Tax Certainty Aspects of Pillar One' (the Administration Report). All these reports are referred to as Pillar One in this research report.

The value creation by digital businesses will be examined in Chapter 2, as this will be important when ascertaining whether the Pillar One recommendations address the direct tax challenges.

The OECD (2015a, p. 105) added that because of the borderless nature of the digital economy, administration challenges also arise regarding:

> 'The identification of businesses, determination of the extent of activities, information collection and verification, and identification of customers'.

The use of intangible assets and lack of physical presence in the market jurisdiction within the digital economy give rise to the allocation of transfer pricing to inappropriate locations (European Commission, 2018, p. 18).

The purpose of this research report is to analyse how businesses in the digital economy will be taxed using the recommended direct tax solutions from the Pillar One report, which aims to address the gaps in the current international tax laws.

When conducting business with customers, digital businesses harvest data and information from users when providing their services and later use the data collected to increase their value (International Monetary Fund, 2020, p. 6).

The focus of this research report will be on evaluating how the Pillar One recommendations address the direct tax challenges raised in the past about the taxation of the digital economy by various academics and tax policymakers.

The Pillar One report comprises two components. Amount A aims to allocate the taxing rights to the market jurisdiction where the digital multi-national entity has created value, subject to exceeding the set thresholds (Navarro, 2021, p. 2).

The OECD (2020a, p. 155) states that Amount B aims at:

> 'Standardising the remuneration of related party distributors that perform "baseline marketing and distribution activities" in a manner that is aligned with the arm's length principle'.

Amount B applies to the buy-sell arrangements, where one entity with the group buys goods from the related entity and re-sells them to third parties (OECD, 2020a, p. 14). Buying and re-selling tangible goods does not result in a challenge brought about by the digitalisation of the economy. The scope of Amount B would not be necessary to answer how Pillar One addresses the challenges brought about by the digitalisation of the economy. Therefore, this research report will not discuss it further.

Quantitative factors are used to scope in multi-national entities in Amount A (OECD, 2022a, p. 8).

In Amount A, global revenue of 20 billion euros and a profit margin (profit before tax as a percentage of revenue) exceeding 10% are the set thresholds (OECD, 2022a; Van Dam et al., 2022). Amount B applies to intra-group transactions with a buyer-seller arrangement or agency and commissionaire arrangement.

1.2 Research question.

How do the OECD Pillar One recommendations address the challenges of direct taxation of businesses in the digital economy?

This research report will analyse how businesses in the digital economy will be taxed using the solutions recommended by the OECD to determine how Pillar One recommendations address the direct tax challenges previously raised by several bodies, including academics and tax policymakers. The broader direct tax challenges brought on by the digital economy are nexus, the tax treatment of data, characterisation of payments, and the use of intangible assets, which create challenges for the transfer pricing purposes, and administration of taxation (International Monetary Fund, 2020a, p. 5; OECD, 2015a, p. 97). Characterisation of payments is excluded from this research report.

1.2.1 Sub-questions

In order to answer the main research question, the following sub-questions will be answered:

a) What is the digital economy, and where does a digital business create value?
b) What are the direct tax challenges brought about by digitalisation?
c) What are the Pillar One recommendations on direct taxation of the digital economy?
d) How do the Pillar One recommendations address the direct tax challenges of the digital economy?

1.3 Research methodology

The research report will be qualitative. The primary sources to be analysed will include OECD material, journal articles from electronic databases, electronic books, publications, reports, online articles, and the internet.

1.4 Limitations

Given the complexity and breadth of tax difficulties coming from the digital economy, this research report focused on direct tax (e.g. Income Tax) with a particular emphasis on the nexus of the multinational entity, transfer pricing, tax administration and tax treatment of data. Indirect taxes are excluded from this research report (e.g. the Value Added Tax). In addition to indirect taxes, the impact of Pillar Two which determines the global minimum tax rate, was not incorporated into this research report.

CHAPTER 2: THE DIGITAL ECONOMY AND THE VALUE CREATION

2.1 Introduction

In this chapter the digital economy will be introduced. Digital businesses that derive value without a physical presence in the location will be discussed. How and where multinational digital businesses create value will also be examined. This chapter discusses the following multinational business entities that pose challenges to current international law; e-commerce, app stores, online advertising, cloud computing, high-frequency trading, participative networked platforms, and online payment services. The OECD (2015a, p. 11) stated that the current international law is not able to tax these digital businesses from a direct tax perspective.

The term 'value creation' was introduced by OECD in the action plan of the BEPS project in 2013 (Nikolakakis, 2021). This chapter will discuss the notion of value creation. The revenue streams of the aforementioned digital business models will be discussed.

2.2 Digital economy definitions

The digitalisation of the economy has transformed how traditional businesses conduct their businesses and has created new business models (OECD, 2014b, p. 73 at section 4.2).

The International Monetary Fund (2018, p. 7) stated that the digital economy could be narrowly defined as:

> *'Online platforms, and activities that owe their existence to such platforms, yet, in a broad sense, all activities that use digitised data are part of the digital economy: in modern economies, the entire economy'.*

European Commission (2014, p. 11), stated that the digital economy is difficult to define; it can only be characterised through a set of key features: mobility, network effect, and use of data.

The OECD (2020b, p. 5) proposed the following as a definition for the digital economy:

> *'The digital economy incorporates all economic activity reliant on, or significantly enhanced by the use of digital inputs, including digital technologies, digital infrastructure, digital services and data. It refers to all producers and consumers, including government, that are utilising these digital inputs in their economic activities'.*

The European Commission (2018, p. 10 at section 2.1.2) warned that the Information and Communication Technology (ICT) sector is not synonymous with the digital economy.

2.3 The value creation definition

Value creation is a key concept in the international tax policy debate (Olbert and Spengel, 2017, p. 22).

The OECD's (2015a, p. 137) goal is to ensure there is alignment between where the 'taxable profit is taxed and value creation and economic activities' of the entities.

Hey (2018, p. 1) stated that:

> 'The "taxation where the value is created" can be regarded as being the core of the OECD Base Erosion and Profit Shifting initiatives and claims to answer as to where the profit should be taxed'.

However, 'the term value creation was never defined by the OECD, but the OECD implied that it meant the location where the real economic activities of the multinational entity take place' (Hey, 2018, p. 1).

European Parliament (2019b, p. 5) stated that the concept of value creation can be divided into three categories and defined them as follows:

1. **Value Chain:**

   '*Value chain relates more to traditional business models where value is created along a linear production process, on the basis of which inputs are converted into outputs through discrete but related sequential activities'*.

2. **Value networks:**

   '*Value networks reflect the transition from the mass production of goods that characterised much of the 20th century, to the mass production of services typical for the 21st century*.

3. **Value shops:**

   '*Finally, in the case of value shops, value is created by resolving a customer problem or demand with the use of an intensive technology.* Problems are usually characterised by information asymmetry, in that shop has more information than customers. Examples include business consulting, specialised data analysis, software development or cloud computing, as well as laboratory technology used in university research to conduct experiments'.

2.4 How and where digital business create value?

'The digital economy created some new business models' (OECD, 2015a, p. 54). Owing to their advantage of operating at a greater scale, some of the new digital business models will have little or no physical presence in the market jurisdiction (the location of customers who purchase the goods/services of the entity) to attract direct taxation based on the current tax international law (European Parliament, 2019a, p. 16; OECD, 2015a, p. 1).

Section 2.7 will discuss the digital business models and their value creation. For the sake of comparison, the value creation by traditional businesses will be discussed in section 2.5. How the market jurisdictions will impose direct taxes on generated profits based on Pillar One recommendation will be discussed in section 4.3.

2.5 Traditional businesses

OECD (2015a, p. 25) referred to traditional businesses as 'brick and mortar'. Traditional businesses require a physical location in the market jurisdiction for transactions to be completed with customers; determination of nexus is not a challenge since the location of the business and sale is in the same jurisdiction (European Commission, 2018, p. 12).

For the purposes of this research, a 'traditional business' is defined as an establishment which clients must physically visit in order to purchase the required goods or services rather than having their purchases fulfilled by the establishment online.

The European Commission (2018, p. 36) projected that, over time, traditional businesses would become more and more digital, which would create completely new business opportunities. The United Nations Conference on Trade and Development reported that the impact of the Covid-19 pandemic accelerated the process of digital transformation, with the internet traffic for 2022 estimated to exceed all the internet traffic up to 2016 (United Nations, 2021, p. iv).

2.6 Features of digital economy

There are several features that are increasingly prominent in the digital economy and that are potentially relevant from a tax perspective (OECD, 2015a, p. 64).

These key features are summarised from the Action 1 report as follows (OECD, 2015a, pp. 64-73):

2.6.1 Mobility

Mobility refers to the fluidity of the intangibles, customers and business functions:

- Digital businesses can avoid taxation by transferring the intangible assets between the connected enterprises and separating legal ownership from the activities that created those intangible assets.
- Digital businesses can transact with customers from various countries without a physical presence. Identifying customers' locations is a challenge for tax purposes, where customers hide their identities (by hiding IP addresses). In addition to selling goods and services remotely, the increase in digitalisation allows businesses to manage their global operations from a central location. (OECD, 2015a, p. 65).

2.6.2 A reliance on data and user participation

When transacting with customers, digital businesses collect information from the customers in various ways; for example, a customer captures their personal information when registering for an online transaction or rates their satisfaction with the entity about their product or service experience. The digital business derives value from the information collected by improving the product offering or monetising the information by selling data to other interested parties. (OECD, 2015a, p. 68). The International Monetary Fund (2020a, p. 6) states that gathering data from user participation (data collection) is currently not recognised as a taxable value in the international tax law.

2.6.3 Network effects

The network effect is one of the most crucial aspects of the digital economy whereby the users can share everything, including their favourite movies, shopping cart, location, and important news. The sharing ability creates more value for the business as the content reaches many users quickly (OECD, 2015a, p. 70).

2.6.4 Multi-sided business models

> ‘Multi-sided business models involve multiple groups of people interacting through an intermediary or platform, and each group's decisions affect the outcome of another group of people via positive or negative externalities.
>
> An example of a positive externality would be a payment card system, which will add more value to the business when more customers pay by card and would be more valuable to the customers if more businesses accept the card. An example of a negative externality would be a company like television, which provides the content for free or for a fee that is below the cost of production and earns revenue from advertisers whose ads appear on the television’. (OECD, 2015a, p. 71).

2.6.5 Monopoly or oligopoly

> 'Network effects combined with low incremental costs can enable companies to achieve a dominant position in a short time. This can be achieved by providing a platform or market in which users on one side prefer to use only a single provider. Ease of adoption of a new platform means that some players have been able to rise to a dominant market position quickly'. (OECD, 2015a, p. 73).

2.6.6 Volatility

Due to lower entry barriers for new competitors, few businesses can maintain dominance for a lengthy period. Even though certain businesses could seem to control the industry, other newcomers can provide more sophisticated products and draw in more customers. (OECD, 2015a, p. 73).

2.7 Business models of the digital economy

This section discusses the new business models that are causing challenges to the direct taxation of the digital economy.

Many traditional businesses have changed how they conduct their businesses to incorporate the effects of technology. The digitalisation of the economy has also created new business models. (OECD, 2014b, p. 73). Even though the new business models are initially based on traditional businesses, the advance in information and communications technology has made it possible to conduct many types of business at a substantially more significant scale and over a longer distance than was previously possible, from virtually anywhere in the world. Businesses are now able to sell their products or services, both physical and digital, online to consumers all around the world (OECD, 2015a, p. 54).

In 2015, the OECD issued the Action 1 report, which examined the new business models created by the digitalisation of the economy. These types of businesses discussed in the Action 1 report include e-commerce, app stores, online advertising, cloud computing, participative networked platforms, high-speed trading, and online payment services. Furthermore, the Action 1 report also noted that these business models might work together (complementing one another) and, in some cases, overlap (OECD, 2015a, p. 54).

2.7.1 E-commerce

E-commerce has been broadly defined by the OECD (2015a, p. 55) as:

> *'The sale or purchase of goods or services, conducted over computer networks by methods specifically designed for the purpose of receiving or placing of orders.*

In e-commerce, goods or services can be purchased, paid for, and delivered online. In other cases, the goods or services can be purchased and paid for online but delivered traditionally (OECD, 2015a, p. 55).

With one click from a computer or mobile cell phone using the internet, consumers can purchase goods or services worldwide. In some cases, the delivery does not require the physical presence of the relevant entity. (European Commission, 2018, p. 12). Shein Store is a real-life example of a digital business selling goods to different market jurisdictions with little or no physical presence. This Chinese-based company allows customers to buy their required products and deliver them to their country of location (Devlin, 2021).

OECD (2015a, p. 55 to 56) stated that e-commerce transactions could occur between 'business-to-business', 'business-to-customer', and 'customer-to-customer'.

2.7.2 Business-to-business

Business-to-business refers to businesses that sell or provide their goods or services to other businesses. An example of business-to-business would be a wholesaler that acquires goods for resale or a logistics company providing logistic services to other businesses to transport their goods. (OECD, 2015a, p. 55).

2.7.3 Business-to-customer

Business-to-customer is broadly categorised into three categories: the so-called 'pureplay' online businesses with no physical presence; 'click-and-mortar' businesses that supplement existing consumer-facing businesses with online sales; and manufacturers that use an online platform to allow customers to order and customise their products according to their preferences directly (OECD, 2015a, p. 55).

Examples will be Shein Store, Amazon and Alibaba.

2.7.4 Customer-to-customer

Customer-to-customer businesses play the role of intermediaries between the customers; they provide the platform where customers can meet to sell their products. The business is not responsible for fulfilling the order. (OECD, 2015a, p. 56).

Examples will include the Marketplace from Facebook and eBay.

2.7.5 App stores

The OECD (2015a, p. 55) defines app stores as downloadable computer software to a customer's mobile device. Downloading an app can be done for free or for a fee. Advertisements are common in free apps.

2.7.6 Online advertising

Online advertisers use the internet to reach their intended audience and pay the platform owner for their advert to appear on the platform OECD (2015a, p. 58 to 59).

An example would be an advertisement that interrupts a song for a non-premium user on YouTube, who is then forced to watch the advert for at least 5 seconds before they can skip it.

> While traditional advertising requires paying to have an advert displayed for a set amount of time without much of a method to track their visibility or user response, online advertising has given rise to some new payment calculation methods, such as cost-per-mille, in which advertisers are charged per thousand times that a user sees their message; cost-per-click, in which advertisers pay only when users click on their advertisements; and cost-per-action, in which advertisers only pay when a user performs a specific action (such as a purchase) (OECD, 2015a, p. 59).

2.7.7 Cloud computing

Cloud computing is the provision of the computer services like online storage, management and data processing. Common examples include email, photo storage, and social networks. Cloud computing services are provided for free, and the revenue is generated from advertisements on the platforms or a 'freemium' basis, in which the minimum services (usually based on the space used) are provided for free, and the expanded services require a subscription fee (OECD, 2015a, p. 60).

An example will be a Gmail account, which provides a free email account with up to 15 gigabytes; beyond this, the user pays for the additional space.

2.7.8 High frequency trading

High-speed securities dealing is made possible by high-frequency trading, which employs sophisticated technology, including complicated computer algorithms. The trade is conducted entirely electronically; high-frequency trading generally does not require a physical presence in the country where the infrastructure used to make the trade is located. (OECD, 2015a, p. 62).

2.7.9 Participative networked platforms

Participative networked platforms allow users to collaborate and contribute to creating, enhancing, rating, commenting on, and disseminating user-generated content (OECD, 2015a, p. 62).

Content creators are not expected to profit from their social media content and are not paid directly for their content. However, some participative networked platforms like YouTube may

share their advertising profits with their content creators. Participative networked platforms make a profit from online advertising. Content creators attract a larger platform audience, whose presence will impact the platform's advertising profits. (OECD, 2015a, p. 101; Schoen, 2017, p. 21).

2.7.10 Online payment services

Traditionally, paying for online purchases involved giving the vendor financial information, such as banking information. Online payment service companies (like PayPal and Google Pay) offer a safe method for enabling payments without requiring the parties to exchange financial information. For example, in e-commerce business transactions discussed in section 2.7.1, the consumer is usually required to pay for their online order immediately before the order can be delivered; in this case, the customer would use the service of Google Pay on checkout. (OECD, 2015a, p. 57).

2.8 Conclusion

The first direct tax challenge identified from the above discussion on features of digitalisation discussed in section 2.6 and digital business models is the lack of physical presence; the discussed business models connect with their customers worldwide via the internet. However, the current international law is based on the permanent establishment definition for multinational entities. Sections 3.1 to 3.2 of the next Chapter will expand on the nexus challenge.

During provision of services, digital businesses collect valuable information that is later used to increase their value. Section 3.3 will discuss the challenge arising from the tax treatment of data.

What has also been gathered is that digital businesses rely on intangible assets which are highly mobile; the entities could locate them in a different country far from the location of customers, resulting in transferring pricing challenges as the allocation of value under the transfer pricing follows the assets used, which in the case of digital businesses are located in a country that is different from the customers' location. Section 3.2.2 will discuss the transfer pricing challenge.

CHAPTER 3: DIRECT TAX CHALLENGES BROUGHT ABOUT BY DIGITALISATION

This chapter will examine how current international law fails to tax the digital economy in the market jurisdiction where the value is created (herein referred to as a challenge). International taxation law will be defined in section 3.1.

The 'nexus' will be the first challenge this chapter examines in sections 3.1 to 3.2. Digital businesses can operate in any jurisdiction without a physical presence (OECD, 2014a). Articles 5 and 7 of the OECD' Model Tax Convention' are particularly pertinent to the difficulties the digital economy presents for the current international taxation framework for nexus purposes. Article 5 defines the permanent establishment, while Article 7 provides for the taxation principle of the relevant business profit (OECD, 2017). The definition of a permanent establishment will be discussed in section 3.2.2. Changes to the permanent establishment definition by Action 7 in 2017 did not affect the physical presence requirement. Section 3.2.2 will also explore the insignificance of modifications to the permanent establishment definition for digital businesses.

Section 3.3 discusses the second challenge related to the ‘tax treatment of data’. Digital businesses harvest data and information from the users when providing their services discussed in section 2.7 (e.g., e-commerce and cloud computing) and later use data collected to increase their value (International Monetary Fund, 2020, p. 6). The value derived from data collection raises two challenges: estimating the value of data collected and how to assign the value to the appropriate taxpayer (OECD, 2015, p. 99). Section 3.3 will examine how digital businesses collect data through their normal provision of digital services and the direct tax challenges arising from there.

Section 3.4 outlines the third challenge, related to the ‘tax administration challenges’. Certain digital businesses could operate in a jurisdiction without the knowledge of the country’s tax administrators, and even if identified, determining the extent of activities has proven to be troublesome for tax administrators as some of the digital businesses operate remotely from the location (OECD, 2015, p. 105).

Section 3.5 highlights the principles of taxation as agreed upon in Ottawa Ministerial Conference on Electronic Commerce. These principles form the basis for determining whether the current international tax law aligns with the agreed principles and, later in Chapter 5, assist with assessing whether the OECD’s recommendations conform to these principles.

The last section, 3.6, concludes by discussing how the digital business models pose a challenge to the current international tax law and how the current international tax law is inconsistent with the principles of taxation.

3.1 What is international tax law?

The phrase 'international tax law' refers to regulations addressing cross-border taxation with local and foreign origins (Hongler, 2021); it consists of the following two requirements:

a. International Tax Agreements:

Double taxation agreements (DTAs) are the most common type of international tax agreement. Tax agreements between two or more countries are also referred to as tax treaties, income tax treaties, or tax conventions. (Hongler, 2021). This research report will refer to these agreements as double tax agreements for the sake of consistency.

b. Domestic laws

Under domestic law, taxes are levied on profits following the jurisdiction's tax law; where an entity is considered a tax resident, the jurisdiction takes into account the profits made by the entity worldwide, and for non-resident taxpayers, only profit from the source within the jurisdiction is taxed (source bases) (Hongler, 2021).

The current international tax law followed by countries to determine where profits should be taxed is almost a century old and was created at a time when the majority of commerce was in physical goods, and global value chains were not overly complex (De Mooij et al., 2021, p. 23).

When a multinational entity generates income from a foreign jurisdiction, the question arises regarding which state should tax the profits from the activity. There are at least three possibilities for answering this question. (De Mooij et al., 2021, p. 23):

- Source state*:* the countries where production activities of the entity takes place.
- Residence*:* the entity's country of residence, based on the application of domestic law as discussed in this section.
- Destination or market jurisdiction*:* the countries where sales take place being the real location where the goods/services are consumed.

Income tax is fundamentally territorial. Every state has the authority to create a tax base to implement and collect taxes under its sovereign control. Therefore, nations continually work to increase revenue collection by extending the jurisdiction on which they collect taxes, even expanding their tax base outside their borders. However, practical challenges may be associated with collecting taxes from outside their borders. (de Koker, Benetello, et al., 2018 at section 1.2).

Regarding its legal and fiscal structure, a state's jurisdictional authority to levy taxes is not formally limited by international tax law. However, according to customary international law, a state's ability to charge its citizens is typically constrained by the need for a fiscal attachment between the state and the taxpayer. Traditionally, source or residence taxation has been used to describe the nexus that creates fiscal authority. (de Koker, Benetello, et al., 2018 at section 1.2).

Per De Mooij et al. (2021, p. 48), the current double tax agreements assign the taxing rights as follows:

> 'The primary right to tax active business income is assigned to the country where the business activity takes place as the "source" country, subject to the test of the physical present ("nexus") and the right to tax passive income, such as dividends, royalties, and interest, is given up to the "residence" country, which is where the entity or person that receives and ultimately owns the profit resides'.

The taxation of passive income is excluded from this report; therefore, it will not be discussed further.

For a natural person, the taxpayer's residence status determines which state taxes the income based on his/her physical presence or ordinary residence within the particular state. On the other hand, the nexus of the juristic person is determined by the doctrine of economic or fiscal allegiance, such as the factual basis of a company's place of incorporation, the location of the registered office, the place where management and control are located, or the place where effective management of the juristic person is located. (de Koker, Benetello, et al., 2018 at section 1.2).

When there is a conflicting interest based on the domestic tax laws applied by more than one country to the business profit of the multinational entity, that entity suffers a juridical double taxation. However, because international trade is encouraged, countries enter into double tax

agreements to eliminate such double taxation. (OECD, 2017, p. 9). The OECD Model Tax Convention on income and capital (Model Tax Convention) is commonly used as a basis to negotiate those double tax agreements between member states, even though it is not legally binding (OECD, 2018, p. 7; Vega and Rudyk, 2011, p. 3). Section 3.2 below discusses the principles contained in the Model Tax Convention.

3.2 OECD Model Tax Convention

The Model Tax Convention aims to uniformly resolve the most frequent issue concerning international juridical double taxation, the latest version was published in 2017 (OECD, 2017).

The Model Tax Convention aims to standardise, confirm, and clarify the fiscal situation of taxpayers who engage in commercial activities in multiple jurisdictions (OECD, 2017, p. 9).

3.2.1 Taxation of a permanent establishment

Article 7(1) of the OECD Model Tax Convention (OECD, 2017, p. 10) states that:

> 'Profits of an enterprise of a Contracting State shall be taxable only in that State unless the enterprise carries on business in the other Contracting State through a permanent establishment situated therein. If the enterprise carries on business as aforesaid, the profits that are attributable to the permanent establishment in accordance with the provisions of paragraph 2 may be taxed in that other State'.

Take, for instance, a multi-national entity that is a resident in Country A, conducts business and derives taxable income in Country B. In applying the domestic tax law of these countries, this multi-national entity will suffer double taxation since Country A will claim the taxing rights based on the worldwide income of the resident entity and Country B claiming the taxing right based on the source of this income. (OECD, 2017, p. 10).

Article 7 of the Model Tax Convention resolves this potential double taxation by giving the ultimate taxing rights to the resident state (Country A) unless the company derived the business profit from another country through a permanent establishment; in the latter case, the profit will be subject to tax in another country (Country B) (De Mooij et al., 2021, p. 119; OECD, 2017). Article 5 then defines the permanent establishment (OECD, 2017).

Paragraph 2 of Article 7 from the OECD Model Tax Convention (OECD, 2017, p. 11) provides relief from double taxation when the relevant multi-national business profit is subject to tax in more than one country. The residence country must appropriately adjust the tax charged on those profits. The relief can be in the form of an exemption in terms of Article 23A or a credit for foreign taxes paid in terms of Article 23B, such that the net effect gives the taxing rights to the source country where the entity has a permanent establishment. (OECD, 2017).

3.2.2 The permanent establishment definition

a. Article 5

Article 5 of the Model Tax Convention defines the permanent establishment as the fixed place where the business undertakes its operations either entirely or partly. Included in the examples from paragraphs 2 and 3 of Article 5 is the ‘place of management, branch, an office, a factory, a workshop, mines and construction projects conducted over 12 months.’

Once the business activities of the multi-national entity fulfil the requirements of the permanent establishment in the foreign country, profits from that portion of the entity must be allocated to the permanent establishment. This permanent establishment is not a separate legal entity from its headquarters (De Mooij et al., 2021, p. 150).

The concept of a permanent establishment in paragraphs 1, 2, and 3 of Article 5 essentially entails the business having a physical presence at the location for the source country to exercise taxing rights under the double tax agreements.

Once the business has satisfied the requirements for the permanent establishment, the basis for the business profit allocation rule is outlined in Article 7, that is, the profits attributable to the permanent establishment are those that it would be expected to make if it were a separate and independent enterprise engaged in the same or similar activities under the same or similar conditions, taking into account the functions performed, assets used, and risks assumed by the enterprise through the permanent establishment and through the other parts of the enterprise (De Mooij et al., 2021, p. 150).

Paragraph 4 of Article 5 provides for certain activities specifically excluded from the definition of the permanent establishment, even if the business conducts them in a foreign country. These activities mainly relate to the 'use of facilities for storage, display, or delivery of goods or merchandise, or maintenance of stock for storage' on the condition that these activities are 'of preparatory or auxiliary nature' (being the activity that supports the main activity) and

provided that they are not conducted by the entity that is related to the foreign entity OECD (2017, pp. 8 and 133).

Article 5, paragraph 5 of the Model Tax Convention adds that the entity would be deemed to have a permanent establishment if the said entity conducts the business with an agency that 'habitually concludes the contracts, or habitually plays the principal role', leading to the conclusion of contracts that are routinely concluded without material modification (De Mooij et al., 2021, p. 233).

The words 'habitually concludes contracts' and 'habitually plays the principal role leading' refer to circumstances in which contracts are negotiated but not necessarily concluded in a contracting state (OECD, 2015b, p. 19).

Paragraph 6 of Article 5 further provides for a relief in case the agency that is not related to the entity concludes the contracts on behalf of the entity during the ordinary course of business of the said agent, that is if an agent is independent of the multi-national entity and conducts its business as usual, the agent will not be considered a permanent establishment of the multi-national entity (OECD, 2017, p. 32, 2015a, p. 158).

Paragraph 5 of Article 5 addressed the issue of 'commissionaire' arrangements and similar strategies (OECD, 2017, p. 32). OECD (2017, p. 144) defined commissionaire arrangements as an arrangement through which a foreign company (the owner of the products) enters into an agreement with a local person where its products are in demand to transfer the products for sale by the local person. Through these arrangements, multinational businesses could sell their products in a state without meeting the requirements for a permanent establishment. Before the inclusion of paragraph 5 in Article 5 in 2017, the profit generated from the sale of the products would not be attributed to any party for tax purposes under the following reasons:

- Since the local person does not own the products, the local tax authority cannot tax the profit made. Local person is only taxed on the remuneration received in a form of commission.
- The foreign company was also not taxed on the sale of products since the selling arrangement between the commissionaire and the customer did not create legal rights and obligations between the principal and the customer.

Under the commissionaire arrangements, the direct tax was only charged for the commission made, which is less than the transaction price (OECD, 2015b, p. 15).

After including commissionaire arrangements in the definition of the permanent establishment, the local person will now be treated as having created the permanent establishment for the foreign entity through the dependent agent (OECD, 2017, p. 144).

OECD (2015b, p. 19 to 20) provided an illustrative example of this arrangement, which is summarised below:
Company A, based in country A, is a multinational corporation that sells its goods and services globally via its websites. Company B is a related party entity to Company A in Country B. Employees of company B are paid a percentage of the income earned by company A. These employees frequently locate customers and bargain with them to purchase products from Company A's website. When persuaded to buy a quantity, an employee from Company B describes the pricing, contract terms, and fixed price structure. The customer then follows the employee's instructions to finalise the contract online.

The conclusion reached from this example is that the employees of Company B have an essential role in determining the conclusion of contracts between customers and Company A, which are commonly concluded without significant modification. Although they cannot amend contract conditions, their efforts on behalf of the group immediately result in the contract's conclusion. Convincing the customer to accept standard terms is critical in reaching this result. Consequently, Company B employees' actions are deemed to have created a permanent establishment for Company A. (OECD, 2015b, p. 19 to 20).

Paragraph 6 of Article 5 rules that a person acting on behalf of one or more closely related businesses shall not be considered an independent agent (OECD, 2015b, p. 16).

For the purpose of Article 5, a company or person is 'related' to another company if they hold the majority (more than 50%) of the beneficial interest of the company or if the same parent company controls both of them (OECD, 2015b, p. 16 to 17).

However, as discussed in sections 2.2 to 2.3, digital businesses create value in a foreign jurisdiction without having a sufficient physical presence, and in the majority of the circumstances digital businesses conduct business in the foreign country without the assistance of the related party entity; therefore, the whole definition of the permanent establishment would fail to tax the economic presence of the digital business (European Parliament, 2019a, p. 16; OECD, 2015a, p. 1).

The country where the digital multi-national entity creates value will not have the taxing right, creating a mismatch between where the business creates value and where that value is taxed (European Commission, 2018, p. 4).

In addition to amendments to include agents and commissionaire arrangement, in 2003 the OECD included in the commentary to Article 5 the requirement to treat the servers as having created the permanent establishment for an entity.

According to the OECD (OECD, 2017, p. 152, 2015a, p. 157) a business website which is a combination of software and electronic data, does not comprise in and on itself a physical asset and does not have a physical location for it to meet the definition of permanent establishment.

> 'However, the server where the website is stored and accessible, is a piece of equipment with a physical location, and such location may thus form a fixed place of business for the company that runs the server (OECD, 2017, p. 152, 2015a, p. 157)'.

Therefore, the company would have a permanent establishment in a country where its server is located (OECD, 2017, p. 152, 2015a, p. 157).

On the other hand, (Cockfield, 2014, p. 7) argued that the server's location is insufficiently tied to the location of vital economic activities. Technology has become advanced such that businesses can move the location of a server between different countries or only move the server programs to another server in a different country (Deloitte, 2016, p. 2).

Once the entity has met either one of the requirements of the permanent establishment, that entity follows the profit allocation as required by Article 7, as discussed below (OECD, 2017, p. 33).

b. Article 7

Article 7 of the Model Tax Convention states that the taxing right is first given to the resident country of the entity unless the entity has derived the profit from another country through a permanent establishment. If the entity has generated the profit through a permanent establishment, then the profit generated is taxed by the foreign country where the permanent establishment is situated. (OECD, 2017, p. 33).

The entity must use the transfer pricing principle to allocate profit to the permanent establishment; that is, the profit is allocated to the permanent establishment under the assumption that the permanent establishment is a 'separate and independent entity, taking into account the functions performed, assets used, and risks assumed.' In a case where there is no permanent establishment, no value will be allocated (OECD, 2017, p. 34 and 177).

Medus (2017, p. 4) reported that applying transfer pricing is challenging for digital businesses because the 'value is no longer created solely through the exchange of products or services'. For example, an online advertising company generates revenue by providing a marketing platform to advertisers without necessarily having a physical presence in the country where the advert is viewed. The new digital business models create a mismatch between the key drivers of value allocation under the transfer pricing principle (such as assets used and risks assumed) and where the profit is generated, as a result of the following (European Commission, 2018, p. 16; OECD, 2015a, pp. 103 and 108):

- Digital businesses use more intangible assets than physical assets.

Due to the mobility of intangible assets, digital businesses can avoid taxation by transferring the intangible assets between the connected enterprises and separating legal ownership from the activities that led to the creation of those intangible assets.

- The use of website.

As indicated above, the website is excluded from the permanent establishment definition. Digital businesses could locate their server in a country with a lower tax rate or no tax and have a website appear in the market jurisdictions for the ordering of goods or services by customers.

- The use of agents by digital businesses.

Using agents distorts the allocation of assets used, functions, and risks assumed between the entity and an agent, leading to inaccurate profit allocation to the permanent establishment under the current international tax law.

3.3 Tax treatment of data

'A number of observers have proclaimed data to be the "oil" of the twenty-first century and the technology giants are the new power brokers' (International Monetary Fund, 2020a, p. 11).

The remote collection of data by digital businesses poses a question of whether the remote collection of data give rise to a physical presence in the location (OECD, 2015a. p. 105).

Digital businesses harvest data and information from the users when providing their services discussed in section 2.7 (such as e-commerce and cloud computing) (International Monetary

Fund, 2020a, p 6). The data collection includes customer personal information like country, name, gender, age and product preferences. (International Monetary Fund, 2020a, p 6). The collection of data by the business can be made directly from the user, customer or third parties (OECD, 2015a, p. 102). The collected data is then used by digital businesses to improve their customer services or later monetised through sales to other interested businesses (International Monetary Fund, 2020a, p. 6). OECD (2015a, p. 102) also notes that collected data can be used to 'tailor service offering, improve the development of products and services, to better understand variability in performance, and improve decision making.'

Direct tax challenges arise because the current international law does not recognise user participation or data collection as a taxable transaction (International Monetary Fund, 2020a, p. 6) due to the following (OECD, 2015a, p. 103):

- The value generated from data harvesting is not recognised in the accounting records due to the accounting framework (IFRS) prohibiting such recognition. This leads to omission of the value of data when determining the taxable income.
- Challenges to appropriately assign the value generated between the permanent establishment and other related parties when applying the transfer pricing principle.

The major challenges raised by data collection relate to the allocation of value created by the collected data and how to assign it to the appropriate taxpayer (OECD, 2015a, p. 101).

3.4 Tax administration challenges

The OECD (2015a, p. 105) reported that the digital economy also poses challenges to tax administrators in the form of the following:

1. Since digital businesses conduct business with local customers remotely without a physical presence, it is difficult for tax administrators to identify the relevant activities, consequently making it difficult to enforce their domestic tax law.
2. Without the physical presence in the location or no accounting records being held by the digital business in their country, it may be difficult for tax administrators to determine the extent of the activities. Even though obtaining information about these activities from third parties like customers, or payment intermediaries is possible, this may depend on privacy or financial regulation laws.
3. The tax administrators of the market jurisdiction may need information from parties with no physical presence in the jurisdiction. Collecting the information directly from the digital business can be helpful too. However, it requires knowledge of where the digital entity resides and the information held or available by the reciprocating tax authority.

4. Businesses can identify customers' country of residence or consumption by tracking internet protocol and card billing addresses. However, this method could be complicated for businesses and would not work if customers could disguise their location, making identifying customers difficult.

3.5 Principles of Taxation

The efforts to redefine the concept of a permanent establishment started in 1998 with the Ottawa Ministerial Conference on e-commerce, where member nations agreed on the principles that should guide the formulation of rules in international tax. (OECD, 1998).

The principles agreed upon (OECD, 1998, p. 4).

- Neutrality: Tax law applied to digital and traditional enterprises should be neutral, and taxpayers in comparable situations completing analogous activities should be taxed identically, according to this principle.
- Efficiency: The costs incurred to comply with the tax law should be as close to minimal as possible for the taxpayers and the tax authorities.
- Certainty and Simplicity: Tax rules should be unambiguous and easy for people to understand for taxpayers to foresee the tax implications of a transaction in advance.
- Effectiveness and Fairness: The possibility of tax evasion and avoidance should be reduced.
- Flexibility: Tax law must evolve to keep up with technological and commercial advancements.

The current international law on taxation of the digital economy is not in line with the principle of neutrality, as the taxes on digital businesses are currently smaller by 12%, as reported by the European Parliament (2019a, p. 16) that companies in the digital economy have an effective tax rate of 9%, on the other hand, traditional businesses have an effective rate of 21%.

The OECD acknowledged the gaps in the current international taw law and introduced Pillar One to address the challenges brought about by the digitalisation of the economy, which reflects the effectiveness and fairness and flexibility in the international tax system (OECD, 2020).

Administration of Pillar One achieves the element of certain and simplicity as discussed in section 4.6 (OECD, 2022b, p. 9).

The efficiency is not achieved as the Pillar One is not replacing the current international tax system for in-scope entities as discussed in section 5.2.3 (PWC, 2022c, p. 4).

3.6 Conclusion

As already discussed in above sections 3.1 to 3.2, the permanent establishment concept is primarily used to determine a contracting state's ability to tax the profits of a business located in another contracting state.

Although the changes relating to the introduction of the server, agents and commissionaire arrangement to the definition of the permanent establishment were made to the Model Tax Convention to address some of the broader tax challenges raised by the digital economy, it is clear that they do not specifically address the nexus challenge (Hongler and Pistone, 2015, pp. 13–14).

The definition of permanent establishment refers to the physical presence or fixed place of the business in another state as a determining factor; however, the new digital business model rarely has a fixed place of business in the market jurisdiction (Hongler and Pistone, 2015, p. 12).

Consequently, the changes to the permanent establishment definition were limited and irrelevant to businesses in the digital economy, particularly those with a significant digital presence but little or no physical presence (Medus, 2017, p. 64).

Certain countries implemented unilateral measures to protect their tax bases, such as digital taxation, in their domestic law. However, this was different from country to country. For example, India introduced an equalisation tax of 6% of the digital advertising revenue derived by a digital entity that does not meet the definition of a permanent establishment in India. (PWC, n.d.). While UK introduced the digital service taxation of 2% of the revenue generated by digital businesses like search engines and social media platforms (KPMG, 2023, p. 2).

Failure to cater for all types of new digital business models by the current definition of the permanent establishment and different unilateral approaches taken by different countries necessitated the need for OECD to develop new uniform international tax rules that would apply to digital economy taxation (OECD, 2020a).

CHAPTER 4: PILLAR ONE RECOMMENDATIONS ON DIRECT TAXATION OF THE DIGITAL ECONOMY

4.1 Introduction

The OECD (2020a, p. 19) stated that Pillar One addresses the need to revisit taxing rules in response to a changed economy in which:

> *'Businesses can, with or without the benefit of local physical operations, participate in an active and sustained manner in the economic life of a market jurisdiction, through engagement extending beyond the mere conclusion of sales, in order to increase the value of their products, their sales and thus their profits'*

This chapter will analyse the Pillar One recommendations to address the direct tax challenges brought about by the digitalisation of the economy. How the OECD is planning to implement the recommendations will also be discussed in this chapter. The direct tax challenges identified in Chapter 3 are:

- The current permanent establishment definition only caters for some models of digital businesses, as discussed in section 3.2.2.
- In cases where the definition of permanent establishment has catered for the digital business model, another challenge arises as some of the entity's permanent establishment is linked to the inappropriate country, for example, where the entity located its server in a tax haven instead of the country where the actual business activities occurred, as discussed in section 3.2.2.
- The current international law does not recognise data collection as a taxable transaction, as discussed in section 3.3.
- The new business models create a mismatch between the key drivers of value allocation under the transfer pricing principle (such as assets used and risks assumed) and where the profit is generated, as discussed in section 3.2.2.
- Tax administrators are struggling to regulate the presence of digital businesses operating in their territory. For example, the inability of the country to identify business transactions between their residents and offshore digital businesses, the lack of records from the tax administrators to determine the full extent of the activities conducted by the digital businesses, and the identification of customer's location by multinational entities, as discussed in section 3.4.

The first two of the above challenges can be broadly referred to as the ‘nexus challenge’, the third as ‘tax treatment of data’, the fourth as the ‘transfer pricing challenges’, and the last as the ‘tax administrative challenges’.

The Pillar One recommendations will be discussed for each broad challenge separately; the nexus rules are discussed in section 4.3, tax treatment of data recommendations are discussed in section 4.4, transfer pricing recommendations are discussed in section 4.5 and tax administrative challenges in section 4.6.

The European Parliament (2019a, p. 16) reported that companies in the digital economy have an effective tax rate of 9%, while traditional businesses have an effective rate of 21%.

In response to these challenges caused by the current international tax regime's shortcomings, which have been compounded greatly by the economy's digitalisation, in 2020, the OECD/G20 published the blueprint with the recommendation to address the direct taxation of the digital economy, entitled ‘Tax challenges arising from Digitalisation – Report on Pillar One Blueprint’ (Pillar One). In July 2021, the OECD further issued a progress report entitled ‘Progress Report on Amount A of Pillar One, Two-Pillar Solution to the Tax Challenges of the Digitalisation of the Economy’ (Progress Report). The Progress Report comprises a consolidated version of the operative provisions on Amount A, reflecting the technical work performed thus far (OECD, 2021a). Both of these reports will be considered in section 4.2 to 4.7 in evaluating whether the proposed solutions address the direct tax challenges emanating from the digitalisation of the economy for the purpose of this research report. The impact of the changes effected will also be discussed in section 4.3.3.

The Pillar One report comprises two components Amount A and Amount B. Amount A aims to allocate the taxing rights to the market jurisdiction where the digital multi-national entity has created value, subject to exceeding the set thresholds (Navarro, 2021, p. 2).

The OECD (2020a, p. 155) states that Amount B aims at:

> ‘Standardising the remuneration of related party distributors that perform “baseline marketing and distribution activities” in a manner that is aligned with the arm’s length principle’.

As stated in the introductory chapter, Amount B is outside the scope of this research report.

4.2 The approach to implementation of Amount A.

This section describes how Amount A would be implemented to address the nexus challenges brought about by the digitalisation of the economy.

The new taxation right established by Amount A exclusively applies to multi-national entities that fall within the scope of Amount A (OECD, 2020a, p. 19). What has been noticed is that Amount A has been designed in such a manner that it catches the large and highly profitable multi-national entities, and it has been drafted to be applied in a quantitative and objective manner to strive for certainty and be administrable (OECD, 2022a, p. 8).

This taxing right, however, would be implemented independently as an overlay to the existing international taxation standards to avoid possible tax spillovers (which is defined as the impact on a country's tax base as a result of another country's change in policy) if the existing international tax rules were to be replaced with Pillar One recommendations (International Monetary Fund, 2014, p. 12; OECD, 2022a, p. 9; PWC, 2022a, p. 1 to 2).

At the time of completing this research report, a political agreement on the adoption of Pillar One, for which the OECD intends to complete all implementation stages by 2023, had been reached by 137 out of 140 nations (OECD, 2022a, p. 4).

The Pillar One report in 2020 initially planned to scope in the multi-national entities that provide automated digital services and consumer-facing businesses. This approach was changed after consultations and replaced with the simplified approach discussed in section 4.3.1. (Devereux and Simmler, 2021, p. 2). The impact of changing to a simplified approach will be outlined briefly in section 4.3.2.

4.3 The nexus challenges

This section will present the proposed elements of determining Pillar One tax liability for in-scope activities of the affected digital multi-national entities from Pillar One, specifically Amount A. The proposed elements comprise the three critical components in Amount A: scope, nexus rules, and revenue sourcing rules. These three components directly address the nexus challenge brought about by the digitalisation of the economy, as discussed in section 3.2 (OECD, 2022a, p. 8). Knowing how the multi-national entity would determine the tax base (the tax liability due) under each market jurisdiction is imperative. The in-scope multinational entity follows the two steps to determine Amount A tax liability; the two steps are tax-base calculation and tax-base allocation. (OECD, 2022a, p. 8).

As discussed in section 3.2, the definition of permanent establishment focuses on the physical presence of the entity, being the location of production side; the demand side, or the location of the market, where the business creates value, is completely ignored (de Wilde, 2015, p. 300).

Amount A aims to address the shortcomings of the current international tax system from the nexus challenge by giving the source state or the demand side to have the taxing rights of the relevant business profit (Navarro, 2021, p. 2).

4.3.1 Which entities are subject to Amount A?

The OECD has designed Amount A to catch the large and highly profitable multi-national entities and has drafted it to be applied in a quantitative manner (OECD, 2022a, p. 8). To be included in the scope of Amount A, a multinational entity that is not listed under the excluded services must pass two quantitative threshold tests: the revenue test and the profitability test (Van Dam et al., 2022).

i. The excluded entities:

Extractives and regulated financial services are excluded from being subject to Amount A requirements (Navarro, 2021, p. 7; OECD, 2022a, p. 8). Minerals, mineraloids, hydrocarbons, and similar compounds recovered from the earth's crust are examples of extractive products (PWC, 2022b).

When the entity is not providing the extraction and regulated financial services, it must then proceed with performing the two tests: (OECD, 2022a, p. 8).

ii. Test 1: The revenue test

The multi-national entity must have derived a global turnover above EUR 20 billion (Navarro, 2021, p. 7; OECD, 2022a, p. 10) and this amount will be reduced to EUR 10 billion in due course (Devereux and Simmler, 2021, p. 2).

iii. Test 2: The profitability test

The multi-national entity must have derived a profitability ratio (profit before tax/revenue) above 10% (Navarro, 2021, p. 7; OECD, 2022a, p. 10).

Once the entity has met the scoping requirement of the revenue test and the profitability test, it will be referred to as a 'scoped-in or in scope multi-national entity' for the purpose of Pillar One (OECD, 2022a, p. 10).

4.3.2 Estimated number of in-scope entities

Devereux and Simmler's (2021, p. 5) study among the 500 largest companies found that only 78 multinational entities would be scoped into Pillar One when applying these OECD scoping criteria, and the study also revealed that 131 multinational entities meeting the revenue and profitability threshold falls under the excluded services, therefore excluded from Amount A.

> 'The study revealed that 131 companies that meet the minimum revenue threshold are in the financial (121) and extractive sectors (10), which are excluded from Pillar One. The remaining 369 companies have a total profit of $1.5 trillion. However, the vast majority of the companies do not have a rate of profitability in excess of 10%, and the aggregate size of Amount A for these companies is only $87 billion'.

Table 1: Number of the 500 largest companies, and their aggregate profit, subject to Pillar One:

Among the 500 largest companies	**Companies subject to Pillar one**	**Excluded**	
		Extractive industry	**Financial Sector**
Number of companies			
Total	369	10	121
Subject to Pillar 1	78	2	56
Profits/Amount A in $ billion			
Total profits	1 501	119	982
Amount A	87	17	86

4.3.3 The Impact of changing the requirements

Based on the initial Pillar One recommendation the OECD in 2020 estimated that 2 300 multinational entities could have potentially been scoped into Amount A based on the minimum revenue threshold of EUR 750 million (the initial revenue amount set) (OECD, 2020a, p. 20).

As discussed in section 4.3.2 above, the study conducted by Devereux and Simmler (2021, p. 5) shows that the changes effected by the OECD in the Progress Report (issued in 2022) reduced the number of the scoped-in multi-national entities to only 78.

4.3.4 Special purpose nexus rule

'The special purpose nexus rule identifies market jurisdictions eligible to receive Amount A'. The nexus rule includes quantitative thresholds determined by the revenues a multi-national entity generates in the market jurisdictions, with a lower threshold applied for smaller market jurisdictions. The nexus rule is further supplemented by comprehensive revenue sourcing rules, which offer a mechanism for determining where the revenue of the multi-national entities is generated (i.e., where value creation took place) based on reliable indicators or allocation keys. (OECD, 2022a, p. 8).

The nexus rule allows Amount A to be allocated to a market jurisdiction if the in-scope multi-national entity obtains at least 1 million euros in revenue from that jurisdiction (Navarro, 2021, p. 7; OECD, 2022a, p. 13). This threshold will be reduced to 250 000 euros for smaller jurisdictions with a gross domestic product of less than 40 billion euros (Navarro, 2021, p. 7; OECD, 2022a, p. 13).

The above special purpose nexus rule shifts from testing whether the entity has a physical presence or has a fixed place of business in another country to a more objective assessment of determining how much revenue the entity has generated from that country (OECD, 2022a, p. 10). The in-scope multi-national entity is, therefore, now deemed to be present in the location when it has generated a revenue of 1 million euros as opposed to a lengthy exercise of evaluating the production activities of the entity when testing the permanent establishment definition (OECD, 2022a, p. 13).

The in-scope multi-national entity must split the revenue generated using the revenue sourcing rules to determine the market jurisdiction eligible to receive Amount A as discussed in section 4.3.5 below (OECD, 2022a, p. 13).

4.3.5 Revenue sourcing rules.

The scoped-in multi-national entity must use the revenue source rules, which identify the jurisdiction in which revenue arises for Amount A purposes, to establish whether it fulfils the nexus test for Amount A in a market jurisdiction, as outlined in section 4.3.4 (PWC, 2022a).

Of significant importance is that the revenue must be sourced on a transaction-by-transaction basis in accordance with the kind of revenue derived from the transaction. This means that the scoped-in multi-national entity will determine the source of each revenue-generating item.

The multi-national entity uses the sourcing rules to identify the real location of the end users of the product or service offered (OECD, 2022a, p. 13). The observation made from the sourcing rules is that the OECD wants the in-scope entities to identify the location of the final customer (PWC, 2022a, p. 2). The essential allocation rules that are relevant to the nexus challenges are outlined below (OECD, 2022a, p. 13; PWC, 2022a, p. 3).

- The revenue generated from the sales of finished goods has a deemed source in the country where those goods were delivered. The entity would refer to the delivery address for this.
- The revenue generated from the sale of components has a deemed source in the country where the relevant finished goods were delivered.
- The revenue generated from providing location-specific services has a deemed source in the physical location where the services were rendered.
- The revenue generated from the provision of services by a business has a deemed source at the customer's location.
- The revenue generated from the advertising services has a deemed source in the viewer's location or where the advertisement is displayed.
- The revenue generated from online intermediation services facilitating the sale of tangible goods is deemed a source based on the location of the purchaser and the seller in equal proportion. In the case of the service, the revenue is shared equally between the purchaser's location and where the service is performed.
- The revenue from the transportation of people has a deemed source at the passenger's destination.

Once the entity has met the relevant special nexus rule of 1 million euros in a country after applying the above revenue sourcing rules, it would be required to determine the tax base that must be reallocated to the market jurisdiction (OECD, 2022a, p. 13).

Buriak (2020, p. 303) notes that once Pillar One recommendations are implemented, there would be a new state being given taxing rights, that is, the market jurisdiction. Traditionally, taxing rights were given to the resident state and source state, which linked with the permanent establishment of the entity.

4.3.6 Tax base rules

The in-scope multi-national entity refers to the tax base rules to determine the amount of tax liability due to the market jurisdiction. The entity must use the consolidated financial results prepared under the recognised accounting framework as a starting point. The Progress Report further provides some ‘permissible adjustments’ the entity could make on the net profit or loss figure. The list of permissible adjustments includes ‘tax expenses, dividends, equity gains or losses and impairments. (OECD, 2022a, p. 15).

International Financial Reporting Standards and Generally Accepted Accounting Principles are recognised accounting frameworks (OECD, 2022a, p. 23).

Using the adjusted profit before tax, the entity moves to the allocation of profit to the market jurisdiction (OECD, 2022a, p. 16).

4.3.7 Profit allocation rules

The in-scope multi-national entity uses the following formula to allocate the tax base to the relevant market jurisdiction. The OECD (2022a, p. 16) states that the entity must allocate profits to the market jurisdiction in the same ratio as the total revenue generated from each market jurisdiction (embedded into the formula):

A = (B-(C x 10%)) x 25% x (D/C)

A: is the amount of profit allocated to the market jurisdiction.

B: is the adjusted profit before tax.

C: is the total revenue of the group.

D: is the revenue generated from the relevant market jurisdiction.

The observation from the above formula is that the allocation is at the profit level, not the revenue generated from the market jurisdiction and this; can be broadly referred to as a residual profit allocation. The International Monetary Fund (2020b, p. 7) states that the residual profit allocation principle comprises two key components of profit allocation: the 'routine profit' (C X 10% from the formula) and the excess profit (B-(C x 10%) from the formula). Shay (2021, p. 2) defines 'routine profit' as the minimum return a project or business will make from the invested capital. The routine profit is also referred to as the rate of return, and this rate assists the investors in deciding whether to take a risk by investing in a given project or business (Shay, 2021, p. 2). The aim is to find the optimal rate of return such that when the excess profit is taxed, the investment returns are not distorted. However, economists have not agreed on the optimal rate in all circumstances.

The OECD set 10% as a routine profit and a rate of 25% for residual profit to be reallocated to the market jurisdiction; however, it did not provide its rationale (Shay, 2021, p. 5).

It is concerning that, even though routine profit is excluded from taxation at the Amount A profit allocation level, it is still taxed under the current international tax law since Pillar One is implemented in overlay with existing international tax law (Shay, 2021, p. 5).

Shay (2021, p. 5) further found that the total aggregate global tax base would not change. However, only the total tax liability of the group might increase or decrease depending on the applicable tax rate of the market jurisdiction where the profit was allocated.

Overall, the residual profit allocation method gives rise to a smaller allocation of the tax base than the traditional tax base allocation since only the portion (residual) of profit generated, not the total amount, is reallocated (Shay, 2021, p. 1).

Mathematically speaking, only a maximum profit of 3.75% would be available for reallocation. Shay (2021, p. 5) explains this by providing an illustrative example with the following inputs:

a) Assuming that a multi-national entity derived an adjusted consolidated profit before tax of 25%.
b) Based on the formula, the routine profit is 10%, and the profit to be allocated is 25%. Then, the residual profit percentage would be 15% (25% – 10%).
c) 25% (a) x 15% (b) = 3.75%.

Shay's (2021, p. 1) study concluded that Pillar One has no sensible reason to use the residual profit allocation approach, as applying the formula leads to a low effective rate of 3.75% of the profit reallocation.

4.4 Tax treatment of data

Pillar One did not include any solution to address the challenges raised by the tax treatment of data, even though digital businesses derive a fundamental value from the collection of data.

4.5 Transfer pricing

Introduction

This section explores the transfer pricing solutions recommended by the OECD under both components of Pillar One, Amount A and Amount B.

The OECD has developed transfer pricing solutions, included under Amount B, for certain arrangements conducted by multinational entities. Amount B aims to simplify sharing of the 'routine profit' between the related parties in the group for countries that lack sufficient capacity. However, the OECD narrowed the scope to only cater for marketing and distribution activities (OECD, 2020, p. 14).

The OECD did not explicitly include the transfer pricing principles that deal with the distribution of Amount A, which deals with the reallocation of 'non-routine/residual profit'. However, applying Amount A principles concomitantly addresses some transfer pricing challenges.

4.5.1. Transfer pricing – Amount A

Under the transfer pricing principles, arm's length pricing is a widely used method to allocate value between the related parties of the group (PWC, 2021a, p. 2). Performing the functional analysis (considering the assets used and risk assumed) of each entity within the group is one of the steps required to determine the transfer pricing (Rudzika, 2017). However, the assets used and risk assumed can only be linked to a permanent establishment or registered entity. In contrast, it was confirmed in section 3.2 that the digital business could operate in a market jurisdiction without having a physical presence. Therefore, transfer pricing principles would not allocate any value to those market jurisdictions. (PWC, 2021a, p. 2).

Digital businesses distort profit allocation under the current international law by locating their assets in a tax haven and conducting business with customers in a market jurisdiction without a physical presence (Hongler and Pistone, 2015, p. 12). Take, for instance, PWC (2021a, p. 5) states that there is a possibility that under the transfer pricing principle, the entity could derive a loss or no allocation in the jurisdiction due to a lack of physical presence. However, from the quantitative approach of Amount A, the profit gets allocated.

4.6 Tax administration challenges

To curb the administrative challenges brought by the digitalisation of the economy, the OECD, on 06 October 2022, issued a request for inputs regarding the administration principles to be followed by the in-scope multi-national entities on the report entitled 'Progress Report on the Administration and Tax Certainty Aspects of Pillar One' (the Administration Report). There was no final confirmation of the administrative report when completing this research report,

and the Administration Report has been used to illustrate the OECD's intentions in resolving administrative challenges.

The Administration Report has three parts: Part one deals with the Administration of Amount A, Part two deals with the tax certainty framework for Amount A and lastly, Part three deals with the tax certainty for issues related to Amount A (OECD, 2022b). The report reiterates the OECD's objective of ensuring that the new compliance principles will be efficient and effective and assigning compliance responsibility to the single-scoped-in multinational entity (OECD, 2022b, p. 8).
Part two and Part three are irrelevant to answer the research question and will not be considered further.

- **Part One**

Part One outlines the relevant procedures that the in-scope multi-national entity would follow to comply with Amount A's requirements, defined under the administrative framework (OECD, 2022b, p. 8).

In terms of the administrative framework, the OECD aims at minimising the administrative costs of complying with Amount A, considering that it would be implemented in overlay with the current international tax law (OECD, 2022b, p. 8).

The current international tax law differs significantly from Pillar One; the latter is based on the group level of the in-scoped multinational entities, while the former applies to entity-by-entity on the group by reference to the permanent establishment test in each jurisdiction (OECD, 2022b, p. 8).

The entity would find itself in a possible situation of juridical double taxation, as the existing international tax law could have already taxed the profit at the entity level that Pillar One's compliance requirement wants to tax. In this case, Amount A provides relief from double taxation by giving the responsible entity (the entity tasked by the group to oversee the compliance to Pillar One) the right to engage with the corresponding tax administrators who have already taxed the income based on the current international tax law. The elimination of double taxation will be in a form of credit or exemption as discussed in section 3.2.1. (OECD, 2022b, p. 9).

What is interesting to note is that the Administrative Report assigns compliance responsibility to the parent entity that has generated profit in different market jurisdictions to determine the additional tax obligations from Pillar One and register with all affected parties (tax administrators of each market jurisdiction) for the new Amount A tax liability. The responsible entity will be obliged to use the pre-formatted templates called – 'Amount A Tax Return and Common Documentation Package' (OECD, 2022b, p. 9).

4.7 How the Pillar One recommendations will be implemented

The member states will be required to sign the multilateral convention, 'which will establish the legal obligations of the parties to implement Amount A in a coordinated and consistent manner' (OECD, 2022a, p. 5). Member states will be required 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, 2021b, p. 12).

CHAPTER 5: HOW DO THE PILLAR ONE RECOMMENDATIONS ADDRESS THE DIRECT TAX CHALLENGES OF THE DIGITAL ECONOMY?

5.1 Introduction

The OECD and other organisations had previously recommended that taxes should match with value creation, i.e., business profits must be taxed where economic activity and value creation occur. Thus, the idea of value and the creation of value appears to have promoted the establishment of the new taxation right under Pillar One. (Buriak, 2020, p. 303). Therefore, assessing how Pillar One recommendations address the direct tax challenges brought about by the digital economy is imperative.

Section 5.2 compares the challenges discussed in Chapter 3 to the recommendations presented in Chapter 4 to ascertain how Pillar One addresses the direct tax challenges brought about by the digital economy.

As discussed in Chapter 3, direct tax challenges brought about by the digitalisation of the economy include the nexus challenge in sections 3.1 to 3.2, transfer pricing challenges in section 3.2.2(b), the tax treatment of data in section 3.3, and lastly, tax administration challenges in section 3.4

Section 5.3 of this chapter will discuss the remaining international tax law gaps not addressed by the Pillar One report.

Section 5.4, the last section of this chapter, outlines the difficulties faced by Pillar One implementation. When the OECD fails to resolve these difficulties, the project will fail, and the current direct tax challenges will persist (Davis and Baumgarten Jr, 2022).

5.2 Challenges with the associated solutions

This section analyses how each of the direct tax challenges brought about by the digitisation of the economy is addressed by Pillar One recommendations:

5.2.1. The nexus challenges

This section discusses how Pillar One addresses the nexus challenges brought by digitalisation of the economy.

Initially, the permanent establishment concept was introduced to ensure the business profit is taxed at the source state, where the production activities of the entity take place as the commerce was based on physical goods and global value chains were not overly complex (De Mooil et al., 2021, p. 23). However, some digital businesses no longer need a permanent establishment in the jurisdiction due to the digitalisation of the economy. How digitalised multinational entities generate profit differs from traditional businesses; the former uses the customers as its market jurisdiction without having a physical presence in the market jurisdiction ('market jurisdiction' is defined as the locations where the income is realised, not the entity's physical location). Based on current international law, no established international tax principle exists to allocate the so-derived profit to market jurisdiction. (Buriak, 2020, p. 307).

Therefore, the lack of physical presence by the multinational entity in the location where they conduct business with their consumers using the internet and computer software, while the current international taxation on the permanent establishment definition requires the physical presence in the jurisdiction of sale for a state to exercise the taxing right on the generated profit, has been identified by OECD (2022a) as the main challenge raised by the digitalisation of the economy and introduce the nexus requirement that is not based on the location of the entity as discussed in section 4.3 above.

In addition to the physical presence or fixed place of business, the permanent establishment definition also refers to the server's location as the factor to consider when ascertaining which state would have a taxing right to the multinational entity's business profit, as discussed in section 3.2.2(a).

In terms of commentary 23 of Article 5, the entity would be deemed to have a permanent establishment where its server is located (Cockfield, 2014, p. 7; OECD, 2017, p. 152). However, there was a concern that the technology had become so advanced that the server could be located in a different country from where the website appears. Allocating the taxing rights based on a server's location creates a mismatch, as the market jurisdiction could differ from the server's location. (Deloitte, 2016, p. 2).

How Pillar One addresses the nexus challenge? The OECD, in 2020, issued Pillar One with recommendations to address this challenge; nexus principles are included in Amount A (OECD, 2022a, p. 8), as discussed in section 4.3.

As opposed to the qualitative factors that are applied in the permanent establishment definitions, Amount A is based on quantitative factors, which the entity cannot easily control.

The entity will now be deemed to have created a nexus based on the revenue it has generated from the particular location; currently, the nexus is set at 1 million euros or 250 000 euros for countries with a gross domestic product below 40 billion euros of revenue generated from each market jurisdiction. Amount A nexus rule does not consider the physical location or fixed place of business for the business and the server's location to determine the nexus of the entity. (Navarro, 2021, p. 7; OECD, 2022a, p. 13).

International Monetary Fund (2023, p. 12) reported that the adoption of Pillar One recommendations would lead to the reallocation of around 2% of multinational entities' overall profit, primarily from low-tax investment hubs, to other nations, increasing worldwide corporate income tax revenue by $12 billion.

By assigning the taxing right based on the location of final consumption (the market jurisdiction), the International Monetary Fund (2023, p. 10 at section 10) confirms that Pillar One addresses the challenge caused by the digitalisation of the economy concerning some multinational entities' lack of physical presence in the location. The possibility of disjointing the entity's economic activities and value creation is eliminated. Pillar One requirements would reallocate the residual profit made by the group back to the states where the final consumption is located. (OECD, 2022a, p. 13; PWC, 2022a, p. 3).

5.2.2. Transfer pricing challenges

This section discusses how Pillar One recommendations address the transfer pricing challenges brought about by the digitalisation of the economy.

In section 4.5.1, it was discussed that in determining the arm's length price, the entity performs the functional analysis, which considers the assets used and the risk assumed by each entity within the group to allocate the price (Rudzika, 2017). However, the assets used and risk assumed can only be linked to a permanent establishment or registered entity (European Commission, 2018, p. 16; OECD, 2015a, p. 103). In contrast, the digital business could operate in a market jurisdiction without having a physical presence, as discussed in section 3.3. Based on the current transfer pricing principles, no value would be allocated to the market jurisdictions where the entity has created value without having assets in the location. (European Commission, 2018, p. 16; OECD, 2015a, p. 103).

Digital businesses rely on intangible assets, and they can avoid taxation by transferring these intangible assets between the connected enterprises and separating legal ownership from the

activities that led to the creation of those intangible assets, and more so, determining the value for intangible assets which doesn't have a comparative could lead to incorrect allocation of transfer pricing (European Commission, 2018, p. 17).

To mention how Pillar One recommendations address the transfer pricing challenges brought by the digitalisation of the economy, the principle of Amount A ensures that the profit is reallocated to the market jurisdiction where the entity has generated the revenue without necessarily considering the location of assets. By doing so, Pillar One indirectly resolved the transfer pricing challenges (PWC, 2021b, p. 3).

5.2.3. Tax administration challenges

This section discusses how Pillar One recommendations address the tax administration challenges brought about by the digitalisation of the economy.

As discussed in section 3.4, tax administrators struggle to regulate the presence of digital businesses in their territory. The key contributing factors include the inability of the country to identify business transactions between their residents and offshore digital businesses, the lack of records from the tax administrators to determine the full extent of the activities conducted by the digital businesses, and the identification of customer's location by multinational entities (OECD, 2015a, p. 105).

To mention how Pillar One recommendations address the tax administration challenges brought by the digitalisation of the economy, Pillar One included the following fundamental administration principles that address the key contributing factors to tax administration:

- Administration of taxation was burdensome since the tax authorities must deal with several entities and determine their permanent establishments; however, as discussed in section 4.6, the Administration Report assigns the Amount A tax responsibility to a single entity to facilitate compliance for the whole group.
- It would be the entity's responsibility to determine whether they fall into the scope of Amount A or not, following the scoping rules as discussed in section 4.3.1.
- Since the responsibility to determine the additional tax obligations from Amount A lies with the entity, it would be required to report the generated profit with all affected parties (tax administrators of each market jurisdiction) for the Amount A tax liability, as discussed in section 4.3.4
- To assist with the identification of the market jurisdiction, Amount A provides for the sourcing rules, as discussed in section 4.3.4

The major concern of the administration of Amount A is that the in scope entity is not relieved from applying the current international tax law since Pillar One is not replacing the current system. Therefore, from the taxpayer's perspective, Amount A adds more administration to the entity than simplification, contrary to OECD's claims. (OECD, 2022a, p. 8; PWC, 2022c, p. 4).

5.2.4. Agents and commissionaire arrangements.

As discussed in section 3.2.2(a), agents and commissionaire arrangements also lead to the satisfaction of the permanent establishment (OECD, 2017, p.152).

Commentary 123 of Article 5 also concluded that agents and commissionaire arrangement would lead to a permanent establishment for the entity. These arrangements are applied to the resale of physical goods, whereby one entity enters into an agreement to sell another entity's tangible goods. As discussed in section 4.5, this challenge is not necessarily linked with the challenges brought by the digitalisation of the economy. It is, therefore, excluded for further consideration.

5.3 Remaining challenges

This section discusses the remaining direct tax challenges that are not address by the Pillar One recommendations.

5.3.1. Narrow Scope

The OECD narrowed down the scoping rules from the Progress Report in 2022. The expected number of multinational entities that would fall under Amount A is now 78, compared to the 2 300 that OECD initially estimated in 2020 based on the Pillar One report scoping rules as discussed in sections 4.3.2 and 4.3.3. Therefore, a substantial number of multinational entities will escape the effect of Pillar One; the enormous profit of the remaining businesses will not be reallocated to the market jurisdiction. (Devereux and Simmler, 2021, p. 5; International Monetary Fund, 2023).

5.3.2. Nexus rule based on revenue

Buriak (2020, p. 316) cautions against relying on revenue to determine the place where value is created since some highly digitalised businesses create value in different ways from different places without deriving the corresponding revenue. Like the collection of data, as

discussed in section 3.3 above that has proven to be of high value to the digital business, however, it remains untaxed (International Monetary Fund, 2020a, p. 6; OECD, 2015a, p. 105).

The International Monetary Fund (2023, p. 11) is concerned that the practical implementation is not improved since Pillar One applies in addition to the existing international tax system. As a result, Pillar One is unavoidably more challenging to accomplish legally than maintaining the status quo since it calls for changes in the law.

5.3.3. Residual profits

Shay (2021, p. 4) stated that the approach by the OECD to reallocate revenue based on 'residual profit' is inefficient as the routine profit is still subject to tax under the current international system; as a result, the multinational entities could still have the opportunity to distort the location of investments, i.e. the assets. Based on the algebraic calculation, only a maximum of 3.75% of the profits of each entity could be reallocated under Amount A requirements, meaning the significant portion of the profit could still be subject to investment distortion (Shay, 2021, p. 4).

5.4 Challenges facing implementation of Pillar One

Even in the best circumstances, Pillar One will inevitably encounter challenges because its success already rests on obtaining the political and legislative support of multiple nations to reallocate the taxing rights. The future becomes less promising when one considers that its approach is a significant departure from the established framework for international taxation and can be seen as a path toward universal formulary apportionment. In spite of this, the chances of success for multilateralism are better now than they have ever been in modern history because of the quick resuscitation of the business digitisation and taxation narratives after the OECD/G20 Base Erosion and Profit-Shifting (BEPS) Project's conclusion. (Davis and Baumgarten Jr, 2022).

Davis and Baumgarten Jr (2022) identified the following as the three challenges that will determine the success or failure of Pillar One:

First, politics and the unfamiliarity of multilateralism in the tax field are two practical reasons why the United States might not implement Pillar One, or at least not soon. According to the US, the distribution of taxing rights through a multilateral agreement is undoubtedly new. Although it should theoretically be possible to execute a multilateral tax instrument, the United States typically only signs bilateral tax treaties and, to date, has never signed a multilateral tax agreement that distributes taxing rights. 'A failure by the biggest economy in the world to implement Pillar One will damage other members of the Inclusive Framework'.

The second obstacle to Pillar One's success is the number of design elements, guidelines, and definitions that must be developed to animate its effective implementation but are currently being circulated for stakeholder input.

Last, multilateralism, a strategy that has been conceptualised as the best one for resolving tax challenges raised by digitalisation, is embodied in Pillar One. But it cannot be denied that, in contrast to less politically sensitive issues like information exchange, multilateralism has played a very limited role in the allocation of taxing rights between the nations up to this point. Allocating taxing rights through bilateral agreements has been a typical practice in the international taxation arena.

CHAPTER 6: CONCLUSION

6.1 Introduction

This research report aimed to determine how Pillar One recommendations address direct tax challenges brought about by the digitalisation of the economy. Section 6.2 will summarise the findings and address the research question after an in-depth exploration in the previous chapters of the direct tax challenges under the current international tax law posed by the digitalisation of the economy, such as the concept of the permanent establishment, value creation, allocation of value under the transfer pricing, tax treatment of data, and the tax administration challenges and explored the corresponding solutions in Pillar One. Last, section 6.3 will conclude by recommending future research.

6.2 Summary of findings

The in-depth exploration of direct tax challenges brought about by the digitalisation of the economy and corresponding Pillar One solutions outlined in Chapters 3, 4, and 5 of this research report has led to the conclusion that Pillar One addresses only some of the challenges brought about by the digitalisation of the economy; work is still needed from the OECD to enhance the requirements of Pillar One so that it will address all direct tax challenges brought about by the digitalisation of the economy. The addressed and remaining challenges are summarised below:

- The introduction of a uniform approach in the form of Pillar One to address the challenges brought about by the digitalisation of the economy and requiring the member countries to remove unilateral measures implemented to address similar challenges improve certainty and simplicity as the taxpayers will have one common international tax to handle, as discussed in sections 4.1 and 4.7.
- The nexus challenge arising from gaps in the current international tax law is addressed because, as opposed to the current definition of the permanent establishment, which is based on physical location, fixed place of business, assets used, or server's location. Amount A nexus rules do not consider the location of the business, assets used or server's location but rather the entity is deemed to have a nexus with the location where its final customers are located, reflecting the alignment between direct taxes and the location of the value creation, as discussed in sections 3.2 and 4.3.
- However, the allocation of generated profit remains challenging since the Amount A allocation rules only allocate residual profit to the market jurisdictions, not the total profit. The principles of residual profit could only allocate a small portion of profit to

the market jurisdiction; this means that multinational entities could still make investment decisions based on direct taxation, as discussed in section 4.3.7

- Administration of taxation arising from Pillar One is improved, as the Administration Report assigns the full tax administration responsibilities to multinational entities, such as determining whether the entity is in scope, identifying market jurisdiction and reporting relevant Amount A's tax liability to all affected countries. The downside of this requirement is that Pillar One is not replacing the current international law, meaning the entity must still comply with the current requirements, such as testing against the permanent establishment definition, which adds a burden to administration to in-scope multinational entities, as discussed in sections 3.4 and 4.6.
- The tax treatment of data remains a challenge, as Pillar One does not have the requirements to tax the value the multinational entity derives from data collection, as discussed in sections 3.3 and 4.4.

6.3 Recommendations for future research

A number of recommendations for future research can be made following this research report's findings, conclusions, implications and limitations.

The recommended future research topics are as follows:

- A similar study can be conducted to determine how Pillar One addresses indirect tax challenges brought about by the digitalisation of the economy.
- In addition to Pillar One, in 2020, the OECD also released Pillar Two, which deals with the global minimum tax; a study could be conducted to determine how a combination of the two Pillars addresses the direct tax challenges arising from the digitalisation of the economy.
- Since the OECD intends to implement Pillar One in an overlay to existing international tax law to avoid possible tax spillovers, a study could be conducted to determine the impact of replacing the existing international tax law with Pillar One.
- Last, the impact of Amount B to addressing the transfer pricing challenges on the remuneration of related party distributors that perform ‘baseline marketing and distribution activities’ could be considered.

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