

Lost in Construction: What Is the Direction of the Work on the Taxation of the Digital Economy?

The majority of our 2019 editorials was devoted to the Base Erosion and Profit Shifting (BEPS)/OECD/Inclusive Framework work on the taxation of the digital economy, including a special issue to conclude the year. At the turn of the year, this issue is still very much at the top of the international tax agenda and the road to a solution seems to be as winding as ever. The recent United States declaration of support of the work may prove to be a Trojan Horse for the project since it included a vague statement about the so-called ‘Pillar One’ being acceptable yet only as a ‘safe harbour’ device,¹ a statement that immediately triggered a multiplicity of responses, most of which based on speculations regarding the intent of the United States’ statement above.² Despite the very strong optimism projected by the OECD about the imminence of agreement, the most distinct feeling that one gets from a sober study of the matter is one of disagreement over the appropriate direction of the work on the taxation of the digital economy.

Let’s recall a few of the key events that led to the present. The original BEPS document identified the issue as a key pressure area that must be addressed by the BEPS project.³ The BEPS Action Plan made the taxation of the digital

economy the number 1 action item on its agenda, although, soberly, promised solely a ‘report’, rather than actual action items or reform recommendations.⁴ Indeed, the BEPS project delivered a report, which eventually included exposition of challenges in the taxation of the digital economy and of three possible solutions: a virtual Permanent Establishment (PE) (a ‘nexus’ approach), a withholding mechanism, and an equalization levy.⁵ Follow-up work occupied the next three years that resulted in a 2018 ‘interim report’ that reflected above all the disagreement among countries over the desired solutions and the conflict between countries supporting ‘interim measures’ (i.e. turnover taxes) and those opposing such measures and urging for focus on a sustainable long-term solution.⁶ Another interim document was published in February 2019 as a public consultation document, changing course and presenting two new perspectives: a US/UK⁷ proposal for a solution focusing on the profit allocation rather than on the nexus decision, and a German/French proposal for an anti-base erosion tax based on the new U.S. GILTI rules.⁸ And finally in the Fall of 2019 the OECD releases two public consultation documents: the ‘Pillar One’ Secretariat proposal,⁹ which elaborates on a future virtual PE solution

Notes

- ¹ Letter from Secretary S.T. Mnuchin to OECD Secretary-General J.A. Gurría (3 Dec. 2019), <https://home.kpmg/content/dam/kpmg/us/pdf/2019/12/treasury-letter-oecd-digital-services-tax.pdf> (accessed 18 Dec. 2019).
- ² Secretary-General J.A. Gurría responded with a concerned letter to Secretary S.T. Mnuchin (4 Dec. 2019), <https://www.oecd.org/newsroom/Letter-from-OECD-Secretary-General-Angel-Gurría-for-the-attention-of-The-Honorable-Sтивен-T-Mnuchin-Secretary-of-the-Treasury-United-States.pdf> (accessed 18 Dec. 2019). See also A. P. Dourado, *Editorial: The OECD Unified Approach and the New International Tax System: A Half-Way Solution*, 48 Intertax 1 (2020); and A. P. Dourado, *Editorial: The Global Anti-Base Erosion Proposal (GLOBE) in Pillar II*, 48 Intertax 2 (2020).
- ³ OECD, *Addressing Base Erosion and Profit Shifting* 47 (OECD Publishing Feb. 2013).
- ⁴ OECD, *Action Plan on Base Erosion and Profit Shifting* (OECD Publishing July 2013).
- ⁵ OECD, *Addressing the Tax Challenges of the Digital Economy, Action 1 – 2015 Final Report*, OECD/G20 Base Erosion and Profit Shifting Project (OECD Publishing 2015).
- ⁶ OECD, *Tax Challenges Arising from Digitalisation – Interim Report 2018 Inclusive Framework on BEPS*, OECD/G20 Base Erosion and Profit Shifting Project (OECD Publishing 2018).
- ⁷ The proposal included two practically different solutions, the UK emphasizing user participation and the US emphasizing marketing intangibles as key factors in the attribution of profits under Art. 7, yet both address solely the concerns of residence countries about profit shifting by multinational enterprises, and both essentially ignoring the still unresolved issue of nexus without physical presence.
- ⁸ OECD, *Addressing the Tax Challenges of Digitalization of the Economy*, Public Consultation Document 13 Feb.–6 Mar. 2019 (OECD Publishing Feb. 2019), <https://www.oecd.org/tax/beps/public-consultation-tax-challenges-of-digitalisation-13-14-march-2019.htm> (accessed 18 Dec. 2019).
- ⁹ OECD, *Secretariat Proposal for a ‘Unified Approach’ Under Pillar One*, Public Consultation Document 9 Oct. 2019–12 Nov. 2019 (OECD Publishing Oct. 2019).

(including a new nexus definition and new attribution of profits rules (simplified residual profit split/formulary residual profit split that guarantees a margin for the market economies/special allocations in unique circumstances), and the 'Pillar Two' proposal, which essentially a minimum tax at the residence country level.¹⁰ Many have already commented on these proposals, noting their many deficiencies, critique that this editorial shares¹¹; the aim of this editorial is however to call for a pause from the technical discussion and note a few fundamental problems with the approach of the OECD that are masked by the whirlwind technical discussion.¹² The short review above demonstrates that the work to date has not been defined with clear aims except seeking 'a' consensus; no step in the process has proven to be a development over a former step, which is not surprising when an explicit non-systematic, unprincipled approach has been advocated. Over seven years from the start of the BEPS project it is still unclear whether the stakeholders are in agreement over the precise purpose of the work on the taxation of the digital economy. Moreover, it seems that the traditional OECD powers increasingly dominate the discourse. It is curious how anyone expects a global consensus on a solution in these circumstances.

This editorial naturally does not share the optimism projected by the OECD about an inclusive framework agreement on the taxation of the digital economy. It does not assert that such an agreement could not be reached, but rather that even if such an agreement based on the 'Pillars' framework will be reached, it would be weak and undesirable. One cannot overlook the preference of the OECD for 'a' solution, whatever it would be so long as 'an' agreement could be presented in the media and to the politicians, rather than a sustainable agreement, which core would be understood and coherently implemented by all stakeholders. This preference of the OECD is nothing but consistent, following Mr Saint-Amans sentiment from the very first days of the BEPS project in favour of 'pragmatic' rather than principled solutions.¹³ It is not surprising therefore that many of the supposed BEPS agreements have been ignored and even explicitly violated throughout and following the project, with key countries 'jumping the gun' to gain competitive advantages while supposedly negotiating a compromise.¹⁴ Agreements were presented yet the actual harmonious change has been thin at best. The outcome of this approach is the continuous leap of the OECD from one proposal to

another (as demonstrated above) and the refrain from making hard choices in the attempt to gain maximum consensus. The immediate consequence is the lack of a clear and coherent proposal.

One may argue that especially the Pillar One proposal is courageous since it clearly advocates divorce from the requirement of physical presence for nexus determination and from the literal arm's length taxation of business. Yet, beyond the general statement the Secretariat Proposal is not a proposal at all, but a vague statement admitting the insufficiency of the current legal framework. It still ringfences parts of the digital economy in direct violation of the first principle the OECD itself set in the past. The exact scope is unclear and no guidance is provided as to how and why a certain definition would be adopted. The proposal says that a new 'nexus' would be based on sales yet fails to provide a justification for the choice or for a future rule. The proposal accepts formulary taxation in some cases with nothing new about how to implement it and in what circumstances. This, as is well known, is a highly controversial part of the proposal but also an issue that had been debated for decades among international tax experts with little progress; the proposal adds nothing to that debate. Finally, the proposal argues that it would add certainty by developing a three-tier profit allocation mechanism, which by now is widely acknowledged, ironically, as the least clear part of the proposal. The reasons for this mechanism are unclear as are the seamlines between the different tiers ('amounts' A-C). The most important part in terms of certainty, which seems to be the dispute resolution device that should deliver finality to taxpayers, is completely void of content. We are all aware of the struggles of the Mutual Agreement procedure (MAP) and the slow progress made on mandatory arbitration. The seemed confidence of the OECD on the matter when no details are added to the former progress on mandatory arbitration is simply puzzling. Secretary Mnuchin's letter best demonstrates the lack of concrete thinking in the process and even more so the lack of agreement when he proposed the conversion of the Pillar One proposal to a safe harbour mechanism, which, first, is puzzling itself as to what 'safe harbour' means in this context (this term is usually used in the context of taxpayer election), but most importantly as to the sincerity of the intent to reach a global standard.

Notes

¹⁰ OECD, *Global Anti-Base Erosion Proposal ('GloBE') – Pillar Two*, Public Consultation Document 8 Nov. 2019–2 Dec. 2019 (OECD Publishing Nov. 2019).

¹¹ See e.g. A. Baez Moreno & Y. Brauner, *Taxing the Digital Economy Post BEPS ... Seriously*, University of Florida Levin College of Law Research Paper no. 19–16 (2019), forthcoming *Columbia Journal of Transnational Law*.

¹² It should be apparent to everybody that the entire body of work is conducted by the OECD – not a legitimate international standard-setter, despite the attempt to present it as a product of the inclusive framework. This is most apparent in the Pillar One proposal that is even named the 'Secretariat Proposal'.

¹³ See e.g. the introduction by Pascal Saint-Amans (Director, Centre for Tax Policy and Administration, OECD) of its work on BEPS, on 16 Apr. 2013 in a conference hosted by Oxford University, <https://www.youtube.com/watch?v=b9VhFGU5mvI> (accessed 18 Dec. 2019).

¹⁴ For instance, the French unilateral adoption of a Digital Services Tax (DST). See e.g. T. Sprackland & S. Soong Johnston, *French DST Signed Into Law Despite U.S., Competition Concerns*, 95 *Tax Notes Int'l* 444, 444–445 (26 July 2019).

A second fundamental problem with the recent 'Pillars' documents is that they continue with the unclear focus of the entire project. Most notably, the Pillar One document practically presents a new method for the taxation of business in general that allocates the 'upside' based on a formula, which details are still unclear, that should take the location of sales seriously into account. As have been noted by many, this is a revolutionary step if taken seriously, but it is wrapped as a solution for only a part of the economy. As already mentioned, proposals for business tax reform based on formulae and even more specifically based on destination are not new to the international tax agenda, the most recent example being the Destination Based Cash Flow Tax (DBCFT). A consensus could not be built for multilateral adoption of these proposals before, much because of the opposition of the OECD itself. It is unclear why would a vague version of the same proposals limited to a part of the economy would fare better in the current context.

A third fundamental problem is the increasing distancing of the recent documents from the original problems that led to the issue being a 'key pressure area', i.e. the demand of the source or market economies for more taxation, a demand that is best exemplified by the insistence of the Indian government on a solution different from those presented by the OECD. Why would the source or market economies agree to a set of solutions that is very unlikely (at best) to result in more revenue for such countries? Pillar one seems to allocate a guaranteed portion of the profits to the location of sales yet absent a clear new allocation norm it is doubtful that the less powerful economies would benefit from the reform. This is the case especially when Pillar One is complemented by

Pillar Two that more clearly allocates new or more taxing rights only to the residence countries in the disguise of an anti BEPS minimum tax. Note that adoption of Pillar Two and a stalling of Pillar One would result in the exact opposite of the above goal. In addition to the substantive challenge in terms of international redistribution, the complexity of the OECD proposals and their vagueness will always leave the less powerful countries in an inferior position vis-à-vis the most powerful economies, a situation compounded by the weakness of international tax dispute resolution.

The haste of the BEPS and post-BEPS work on the taxation of the digital economy has led to ineffective participation of the less powerful economies in the process, beginning with their non-participation in the setting of the agenda, the tight schedule and the focus on the technical, so-called pragmatic solution that masked the potentially undesirable impact of the project's outcome on such countries. All that in a forum that so ironically is called the inclusive framework. Developing countries received voice, but no influence as is apparent from the recent proposals that could not be in their best interests. These deficiencies should concern not only the developing countries, however, since all countries should do their homework and understand the potential impacts of the various options on their economies in order to make the right choices for their constituencies. A common understanding what fair or legitimate allocation of taxing rights among countries mean can go a long way towards achieving these goals.

Yariv Brauner
brauner@law.ufl.edu