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INSIGHT: U.S. Investigation of Digital Services Taxes—Will It Affect Multilateral Negotiations at OECD?

BY JEFFERSON VANDERWOLK

On June 2, 2020 the U.S. Trade Representative (USTR) announced new investigations under Section 301 of the Trade Act of 1974 regarding digital services taxes (DSTs) that have been enacted or proposed in a number of countries—namely, Austria, Brazil, the Czech Republic, India, Indonesia, Italy, Spain, Turkey, and the U.K. Section 301 authorizes the USTR to recommend retaliatory measures, such as tariffs, if a foreign law is found to be ''unreasonable or discriminatory and burdens or restricts U.S. commerce.'' A foreign law is deemed to be unreasonable if the law, ''while not necessarily in violation of, or inconsistent with, the international legal rights of the U.S., is otherwise unfair and inequitable.''

Last year, the USTR undertook a Section 301 investigation of the French DST and recommended the imposition of tariffs on certain imports of French goods into the U.S. In January of this year, France and the U.S. agreed to hold off on both the tariffs and the DST until the end of 2020, in the hope that multilateral tax policy negotiations led by the Organization for Economic Cooperation and Development (OECD) would produce a global agreement on taxation of multinational corporations, including those that provide digital services.

The multilateral policy process is ongoing, although it has been slowed by the Covid-19 pandemic. The OECD-led Inclusive Framework on Base Erosion and Profit Shifting (BEPS) is facing an October 2020 deadline for reaching agreement on a plan due to be delivered to the G20 leaders at their meeting in November 2020. The proposed plan is structured in two parts: so-called Pillar 1 involves increasing the taxing rights of market jurisdictions.

Specifically, the G20 and the 137-member Inclusive Framework have endorsed, on a ''without prejudice'' basis, the concept of allowing countries to tax, under new Pillar 1 rules, automated digital services companies whose services are used in the country even if the companies have no offices or employees in the country and collect no revenue from customers there. This would involve new rules that depart from long-established principles of international taxation regarding both nexus (i.e., taxable presence) and profit allocation (which is normally based on the arm's-length principle).

In recent months, the Pillar 1 conversation regarding digital services seems to have moved in a direction that is not favored by the U.S. Initially, the Inclusive Framework agreed that the digital economy could not be ''ring-fenced'', because digital technologies are being used in many different industries. Nevertheless, a number of European countries, including Austria, Italy, and the U.K., moved forward with plans to enact targeted taxes on digital services. The U.S., concerned about the discriminatory effect of such taxes, which would apply disproportionately to U.S.-based companies, encouraged the idea of finding multilateral agreement at the OECD on new rules that would apply broadly across all industries, while precluding unilateral digital services taxes.

The currently proposed approach under Pillar 1 would have a set of new rules targeted at ''automated digital services,'' and a different set of rules aimed more broadly at ''consumer-facing businesses.'' The U.S. and, reportedly, China oppose the ringfencing of automated digital services, but many other countries are touting the idea of taxing online services more heavily in the wake of the pandemic. Against this background came the USTR's recent announcement of its investigation of DSTs.

The economic crisis caused by Covid-19 lockdowns around the world has given new importance to the question of whether special taxes on digital services are appropriate. Some, such as France's finance minister, Bruno Le Maire, have suggested that digital services providers are realizing windfall profits as more people are working from home, although it is not clear that this is true. The idea that digital services should be taxed more heavily has clearly been a motivator for the DST proposals now being investigated by the USTR.

Will the USTR's action influence the course of the Pillar 1 negotiations? Although the USTR is not part of the Treasury Department (which represents the U.S. in the multilateral tax policy talks), it would be reasonable to assume that some degree of coordination exists between them in this area. This is demonstrated by the January agreement that linked proposed tariffs on French goods to the success (or failure) of the multilateral tax policy process. Therefore, one must suppose that the USTR's new DST investigations will indeed affect the Inclusive Framework process, and are intended to do so.

Knowing that the enactment of a DST that disproportionately hits U.S. multinationals may result in painful tariffs on exports to the U.S., the members of the Inclusive Framework will presumably be incentivized to find a compromise on Pillar 1 that is acceptable to the U.S. Based on how the Pillar 1 proposal has developed up to now, it could be expected that such a compromise would not involve special rules targeting only automated digital services, but rather would take a broader approach based on consumer-facing businesses with market-based intangibles, plus, perhaps, a safe-harbor aspect allowing multinationals to opt out of the new rules, as proposed by the U.S. last December.

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