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# INSIGHT: The Anatomy of an Impasse—Taxation of the Digital Economy

BY JEFFERSON VANDERWOLK

As all of the international tax policy world knows by now, U.S. Treasury Secretary Stephen Mnuchin informed the finance ministers of France, Italy, Spain, and the U.K. in mid-June that, in his view, the multilateral negotiations on proposed tax law changes regarding cross-border business income had reached an "impasse." The four European countries want to increase the taxing rights of market jurisdictions over large global multinationals providing automated digital services. The U.S., home to most of the companies that would be affected, opposes any new rules that would single out for increased taxation, either explicitly or in effect, companies of a particular industry or country.

Thus the multilateral negotiations have come to a halt. What will happen next? It appears that the antagonists will most likely wait until next year to resume the debate on substantive issues, after the U.S. elections in November. The 137-member Inclusive Framework on Base Erosion and Profit Shifting (BEPS) will probably issue an interim report to the G20 in October on the status of the negotiations, rather than the final report it had hoped to be able to produce.

When one is at an impasse, the first question is how to get beyond it to the place one wants to go. An equally important question, however, is how one arrived at the impasse. The Inclusive Framework countries should spend some time on both questions during the next few months.

The "how did we get stuck here" question should be easier to answer, with the benefit of hindsight. When the journey has been ongoing for several years, however, not everyone who is currently involved will be fully aware of how things developed along the way. In this particular case, the journey began seven years ago with the OECD's publication of its 15-point BEPS Action Plan in July 2013 -- three years before the Inclusive Framework even existed. It's worth reviewing how we got from there to the impasse, seven years on.

The BEPS Action Plan was aimed at preventing, or at least minimizing, legal tax avoidance by multinational corporations. The goal was to agree on updated, consistent corporate income tax rules in all major economies that would ensure alignment between where companies pay taxes and where they earn their profits. Action 1 was to consider whether new rules were needed with respect to "the digital economy."

In fairly short order, the participants in the BEPS Project -- the OECD member countries and non-OECD G20 countries -- agreed that there was no identifiable "digital economy" that could be ring-fenced in opposition to the remainder of the economy as a whole, due to widespread and ever-expanding use of digital technology in almost all sectors. The final report on Action 1, in October 2015, recommended further investigation of new internet-based business models and a resumption of the tax policy discussion in five years' time, i.e. 2020.

In mid-2016, the Inclusive Framework (IF) was created, opening up participation in the OECD's tax policy work to any country willing to agree to implement the four "minimum standards" of updated international taxation that had resulted from the BEPS Project. At the same time, the participants launched a new Taskforce on the Digital Economy to pursue the steps suggested in the Action 1 final report.

The Taskforce agreed in 2017, at the urging of Germany (which had the presidency of the G20 at the time), to deliver an interim report on its work by the middle of 2018. At the same time, the U.K. and a number of other countries began to develop unilateral digital services tax (DST) proposals. In March 2018 the European Commission weighed in with a proposed EU-wide DST. The

OECD's Taskforce immediately issued its interim report, earlier than expected, so as to respond to the EC proposal.

The interim report (on "digitalization" rather than "the digital economy") said that the IF countries were, broadly speaking, in three different camps. One group, led by the U.K., believed that DST-type rules targeting search engines, social media, and online platforms were most appropriate. A second group, led by the U.S., favored broader rules applicable to all multinationals with marketing intangibles, while a third group thought that it was too early to decide whether any new rules related to digitalization were needed. (Some commentators wondered about the link between marketing intangibles and digitalization, which was not clearly explained in the report.)

Sometime in mid-2018, Germany and France proposed that any new rules related to digitalized business should include a global minimum tax regime to ensure that multinationals would pay tax on all of their income at a specified effective rate (to be determined later), either in their home countries or in other countries where they operate.

In January 2019, the IF issued a Policy Note on the Taskforce's work plan, stating that proposals grouped in two "pillars" would be studied. The first pillar would consider new rules on taxable nexus and the allocation of profits to a jurisdiction; the second pillar would be global minimum tax rules. It was noted that Pillar 1 had three competing approaches: the U.K.'s targeted approach, the U.S.'s broader approach, and a global formulary apportionment approach advocated by India and other developing nations. (This time, commentators wondered about the connection between a global minimum tax and the digitalization-related nexus and allocation issues that had been the subject of all previous reports.)

Following a quickly organized public consultation on Pillar 1 in March 2019, the IF issued a Program of Work for the Taskforce at the end of May 2019, formalizing and elaborating on the earlier Policy Note. Then, in October, the OECD Secretariat unveiled a proposed "unified approach" to the Pillar 1 nexus and allocation issues, calling for formulary allocation of above-normal profits to market countries (Amount A), a fixed taxable return on routine marketing and distribution activities (Amount B), and mandatory binding dispute resolution rules for income from other activities (Amount C), plus new nexus rules based on revenue thresholds.

In early December, U.S. Treasury Secretary Stephen Mnuchin informed the OECD Secretary-General that the U.S. was unlikely to agree to any proposals departing from either the arm's-length principle of transfer pricing or the physical presence standard of nexus, unless the agreement included a "safe harbor" option that would allow companies to be taxed under existing tax rules only.

The IF agreed, in late January 2020, to pursue negotiations on a final agreement based on the proposed unified approach to Pillar 1 and the proposed Pillar 2 global minimum tax. In addition, the IF agreed to consider the U.S. "safe harbor" proposal, and stipulated that all countries would withdraw unilateral measures (meaning DSTs) when an agreement was reached. A revised program of work was issued, outlining new concepts to be considered, including two categories of business that would be within the scope of the Amount A reallocation rules: automated digital services, and consumer-facing businesses.

The next step brought us to the impasse. At some point in May or early June, the finance ministers of France, Italy, Spain, and the U.K. proposed to Secretary Mnuchin a phased-in approach to the implementation of new Amount A allocation rules and nexus rules, starting with automated digital services businesses only. As we know, Mnuchin rejected the proposal and suggested a pause in the negotiations.

A crucial element of the broader context in which this "journey" has occurred is the U.S. Trade Representative's decision, first in the summer of 2019 and again in June 2020, to threaten the imposition of tariffs on imports from countries that impose a DST on U.S. businesses. This issue will come to a head at the end of 2020, unless France and the U.S. agree to extend their current "ceasefire" agreement and other countries, such as Italy and the U.K., also agree to defer the imposition of their DSTs.

The above, in a nutshell, is how the impasse was reached. Clearly, the targeted, DST-type approach to Pillar 1 is a non-starter for the U.S. (just as a targeted consumer-facing approach, standing alone, would presumably be a non-starter for the Europeans). The IF and its brain trust, the OECD Secretariat, now need to go back to the drawing board if they want to find a way forward.

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