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INSIGHT: The OECD's Two Tax Pillars on Digitalization—A Multilateral Project in Search of a Shared Purpose

BY JEFFERSON VANDERWOLK

It now seems fairly clear that consensus will not be reached anytime soon on various aspects of the Organization for Economic Cooperation and Development's draft "blueprints" for Pillars 1 and 2 of the multilateral program of work regarding the tax challenges of digitalization. The project, undertaken by the OECD-led, 137-member Inclusive Framework on Base Erosion and Profit Shifting, has been going for about three years now. The original plan was to finish it by the end of this year, but progress has been slowed both by the pandemic and by political disagreements.

The next steps will be the publication of the draft blueprints in October, followed by a public consultation in November and December. The U.S., contrary to what many believe, will continue to participate in the process. However, the U.S. is unlikely to agree to the current proposals without significant changes, regardless of the outcome of the U.S. elections in November.

The political drivers behind the project are such that the show will go on, perhaps for all of 2021 or even longer. The Covid-19 pandemic has only increased the political pressure to increase taxes on the U.S. tech giants, who are assumed to be profiting from the boom in videoconferencing and online shopping. (Their contribution to keeping the economy alive, meanwhile, is rarely mentioned.)

A peculiar feature of the project is that it has developed to the point where we now have two very long and complex proposals (i.e., the contents of the draft blueprints for Pillar 1, on re-allocation of profits to market countries, and Pillar 2, on a global minimum tax regime), yet there does not appear to be an underlying shared purpose for them among the member countries of the Inclusive Framework.

The digitalization project is an outgrowth of the BEPS Project's Action 1 (the Digital Economy), which yielded no consensus-based recommendations on direct taxation when the BEPS final reports were issued in late 2015. (The use of indirect taxes such as VAT and GST was recommended, however, and many countries have adopted that approach.) The current project was given life in the fall of 2017 when the U.S. delegate to the OECD's Committee on Fiscal Affairs (and the Inclusive Framework's steering group) indicated that the U.S. would be willing to discuss the possibility of limited, globally-agreed changes to the existing international income tax framework, in the interest of averting potentially chaotic adoption of unilateral measures by individual countries. That such unilateral measures would be aimed primarily at U.S. multinationals in the tech sector was undoubtedly the prime motivator for the U.S.'s willingness to discuss the issues in a multilateral setting, where the U.S. had always been a leading force in the past.

In March 2018—two and a half years ago—the OECD issued a 218-page interim report on the tax challenges of digitalization. The report said that the members of the Inclusive Framework had differing views, falling into three camps. One group, led by the U.K., thought that only search engines, social media, and online intermediation platforms needed to be dealt with. A second group, led by the U.S., thought that the focus should be on a limited re-allocation of non-routine profits attributable to marketing intangibles, regardless of what industry sector the taxpayer was in. The third group felt that it would be wise to wait and see whether the implementation of the BEPS Project recommendations would obviate the need to consider additional measures. All agreed that, as noted in the 2015 report on Action 1, the ''digital economy'' was becoming the entire economy and could not be ring-fenced for tax purposes.

In January 2019, the Inclusive Framework adopted its two-pillar program of work on the tax challenges of digitalization. The first pillar contained three competing proposals for the basis on which multinationals' profits would be re-allocated. Two of them mirrored the U.K.-led and U.S.-led approaches described in the interim report. The third was a global formulary apportionment proposal advanced by India and other developing countries.

The second pillar consisted of a single proposal for a global minimum tax, which would apply to all multinationals regardless of digitalization. Germany and France had proposed this as a condition of agreeing to any re-allocation of profits under the first pillar. The OECD suggested that the proposal was inspired by the U.S.'s global intangible low-taxed income (GILTI) rules and would most likely be uncontroversial. Many commentators thought that the proposal was an awkward and somewhat perplexing adjunct to the first pillar, given the inevitable complexity and risk of multiple taxation that would come from trying to implement a global minimum tax regime on a universal basis.

The OECD eliminated the competing proposals in the first pillar by advancing a proposed unified approach to profit re-allocation in September 2019, one year ago. This approach, which survives in the current blueprint for Pillar 1, defines two categories of business—automated digital services and consumer-facing businesses—whose profits would be re-allocated to certain market jurisdictions under a formula. It also proposes a fixed taxable return on defined routine marketing and distribution activities, in place of case-by-case arm's-length pricing, and a new, multilateral system of resolving tax disputes between countries regarding the profits of a single multinational taxpayer.

In December 2019, U.S. Treasury Secretary Stephen Mnuchin wrote to the Secretary-General of the OECD, saying that the U.S. was not prepared to agree to the proposed unified approach as a mandatory set of rules, and suggested that perhaps the new rules should be an optional ''safe harbor'' alongside the existing tax rules. This suggestion was characterized as nonsensical by some of his European counterparts, and was mocked by the OECD's top tax official as equivalent to suggesting that death be made optional.

Nevertheless, when the Inclusive Framework agreed in January 2020 to proceed, on a ''without prejudice'' basis, with the proposed unified approach plus the global minimum tax proposal, it added that it would consider the U.S.'s suggestion of an optional safe-harbor approach—but only after all of the details of the two pillars had been worked out.

In recent weeks, some signs of an incipient blame-game have begun to emerge. France's finance minister, Bruno Lemaire, said that the U.S. is blocking any progress on the project. The OECD's top tax official, Pascal Saint-Amans, has said that the project could succeed if ''leadership'' were shown by the U.S. and the larger European countries. Of course—if they were leading in the same direction. The problem is that they, and other countries involved in the work, such as India, China, and others, do not agree on where to go.

Fundamentally, the clash is between the U.S., which has supported the development of its robust technology sector through tax deductions for R&D, and the larger European countries, whose governments are under political pressure to tax the U.S. tech giants, thereby appropriating part of the return on the U.S.'s investment. This conflict is unlikely to be resolved, in the short term, in the context of an international tax policy project involving 137 sovereign taxing jurisdictions who are being asked to agree to radically new, and mind-bogglingly complex, methods of taxing multinational business profits.