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The OECD/Inclusive Framework's Digitalization Project: Politics Over Policymaking

By Jeff VanderWolk

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Many parties outside of the U.S. argue the leading digital services businesses—most of which are U.S.-based—are not paying their "fair share" of taxes in jurisdictions where the services are used and want to impose a special tax on those services. Jeff VanderWolk notes that heavier taxes are usually applied to activities that cause harm to society, and questions whether it makes sense to penalize the services that have played a large part in keeping businesses, education, and social lives functioning during the pandemic.

The election of Joe Biden to be the next president of the U.S. has given new hope to European government officials who are pushing for a global agreement that would enlarge the taxing rights of market countries with respect to the profits of highly digitalized nonresident businesses. The Trump Administration, like the Obama Administration before it, evinced little enthusiasm for the project, which would hit U.S.-based multinationals in the technology sector hardest.

Government officials such as Bruno Le Maire, the French finance minister, have recently expressed optimism that, under President-elect Biden, the U.S. will agree by the middle of next year on a global approach to ensure that all businesses pay their "fair share" of tax wherever they operate. Similarly, the Canadian finance minister, Chrystia Freeland, recently unveiled proposals that include a special tax on cross-border digital services if no global deal is reached, to ensure that the relevant multinationals pay their "fair share" of tax in Canada. The G20 leaders, who met in late November, are, of course, in favor of fair taxation. Who isn't?

The problem is that fairness, like beauty, is in the eye of the beholder. When it comes to taxes, different ideas of what's fair will always exist. The political processes of the taxing jurisdiction produce that jurisdiction's tax laws, and those who are subject to the laws are obliged to comply. Whether or not every compliant taxpayer is paying his or her fair share is a political question, not a moral or legal one.

On the global level, political processes are limited. Tax policy is determined by national and sub-national governments. International tax law exists only in tax treaties, which are almost always bilateral agreements, regulating the taxing rights of two countries with respect to each other's taxpayers. Virtually all tax treaties reflect the agreement of the negotiating countries on two tax concepts that have been universally accepted, until very recently, as being fair to both sides. One is the permanent establishment concept: a business based in Country A is not taxable in Country B unless it carries on business in Country B through a permanent establishment or an agent in Country B. The other is the arm's-length principle: the profits allocable to an entity's dealings with commonly controlled entities must be consistent with the profits that would have arisen if those dealings had been at arm's-length.

In recent years, these concepts have been under attack, as political forces in various countries have been mobilized behind the idea that nonresident businesses are able to carry on business in the country without paying their "fair share" of tax, despite complying with the country's tax laws. The U.K. government, in the run-up to the general election of 2015, championed a new type of tax on nonresident businesses that the British press called the Google Tax (its actual name was the Diverted Profits Tax). Australia followed suit in 2016 with its Multinational Anti-Avoidance Law (MAAL). India pioneered the digital services tax concept in 2016 with its equalization levy on payments to nonresident businesses for online advertising services. In 2017 the U.S. adopted the base erosion and anti-abuse tax (BEAT), and digital services tax proposals began to be considered in a slew of countries in Europe and beyond. All of these new taxes are designed to operate outside the scope of tax treaties.

The OECD, which for decades has encouraged not only its member countries but all countries worldwide to use its model tax treaty, embodying the permanent establishment concept and the arm's-length principle, carried out the Base Erosion and Profit Shifting (BEPS) project (2013-2015) to address the perceived ability of multinational businesses to engage in aggressive tax planning and thereby report a disproportionate amount of profit in tax haven jurisdictions. The BEPS project's recommendations included measures aimed at broadening the permanent establishment concept and strengthening the arm's-length pricing guidelines, particularly for transactions involving intellectual property.

Since 2018 the OECD has been leading a project, sometimes called BEPS 2.0, that is aimed at radically changing international tax norms by abandoning both the permanent establishment requirement and the arm's-length principle, in certain circumstances. More than 135 countries—the Inclusive Framework on BEPS—are participating. The project is an unprecedented attempt to make tax law at the global level despite the lack of a global government.

The Inclusive Framework on BEPS announced in October that it will pursue its work on the project until at least the middle of 2021 and probably beyond. The OECD acknowledges that several core issues arising from the proposals need to be resolved through political negotiations among all of the participating nations. Tax policy principles have largely vanished from the discussion. The participants are now essentially talking simply about what they think is, or is not, fair. Meanwhile, multinational businesses have been scrambling to comply with all of the new rules that have already been enacted in the past few years.

Observers have noted the irony of OECD leadership of a project aimed at increasing taxes on cross-border trade and investment, given that the OECD was founded for the purpose of encouraging cross-border trade and investment. It is doubly ironic that the project targets businesses providing online services, given that these businesses have been instrumental in keeping the global economy alive and governments functioning (not to mention education, social life, etc.) during the pandemic year of 2020. Good tax policy calls for heavier taxation of activities that cause harm to society, such as environmental degradation or direct harm to human health. Digital technology, however, in the words of the OECD itself, "spurs innovation, generates efficiencies, and improves services while boosting more inclusive and sustainable growth and enhancing well-being." That doesn't sound like something we want to discourage through special taxes.

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