TRUE ALERT

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Will the US Withdrawal From the OECD Project on Digital Services Taxation Lead to a Trade War and a Missed Deadline?

Multilateral tax negotiations, which have been ongoing at the Organization for Economic Cooperation and Development (OECD) with the goal of producing a global agreement on the taxation of multinational corporations, including those that provide digital services, have been impacted by the COVID-19 pandemic. The 2020 timeline has been modified, but the deadline of producing an agreement continues to be the end of 2020.

New actions taken by the US Trade Representative with respect to unilateral digital services taxes (DSTs) that have been proposed or enacted by several countries have now raised additional questions about the ability of the OECD/G20 137-member Inclusive Framework to meet that deadline. At June 17th hearings before the House Ways & Means Committee and the Senate Finance Committee, USTR Robert Lighthizer confirmed reports that Treasury Secretary Mnuchin had informed several other negotiating partners that the US was withdrawing from the OECD talks. Although he suggested US support for a global negotiated agreement still exists, this action could now lead to a trade war as countries move ahead with unilateral DSTs, and the US responds with retaliatory tariffs.

This True Alert is the first in a series of alerts that will review the OECD project. **This Alert will summarize the OECD activity to date on this project and review the current challenges to completion** according to the current schedule from the COVID-19 pandemic and the US trade investigations.

Background

The OECD initiated the Base Erosion and Profit Shifting (BEPS) project in 2013 with the publication of the OECD's Action Plan on Base Erosion and Profit Shifting. The plan laid out a multilateral process for the OECD to review and address policies that allow multinational businesses to use tax planning practices to pay minimal or no tax on income.

The BEPS project resulted in the adoption of several anti-tax avoidance measures, including controlled foreign corporation (CFC) rules, thin-capitalization rules, and cross-country reporting requirements, but one project as yet unfinished is the taxation of the digital economy.

Members of the OECD/G20 Inclusive Framework on BEPS (Inclusive Framework), which includes 137 participating member countries with not only developed countries who are OECD members but many developing countries, **have been working for several years on a comprehensive, consensus based solution to the challenges arising from digitalization with a commitment to deliver a solution by the end of 2020.**

The first OECD policy note and initial consultation document described a two-prong approach to changing the rules of the current international tax system, specifically Pillar One that introduced new profit allocation and nexus rules, and Pillar Two to deal with additional base erosion and profit shifting measures.

A Programme of Work (PoW) issued in May of 2019 by the OECD described the "Unified Approach" on Pillar One proposed by the OECD Secretariat, which suggested a path forward for reallocating some profits and corresponding taxing rights. The purpose of the issuance of the Unified Approach was to combine elements of the previous proposals in order to move discussions to a consensus in January of 2020 so that a high-level agreement could be announced. The PoW also explored technical design implementation issues that must be refined to develop a comprehensive and consensus-based solution.

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A Public Consultation on the Unified Approach under Pillar One was held in November of 2019, and a public consultation on the Global Anti-Base Erosion (GloBE) Proposal under Pillar Two was held in December of 2019. In January 2020, a Statement was issued by the OECD/G20 Inclusive Framework on BEPS on the Two-Pillar Approach to Address the Tax Challenges Arising from the Digitalization of the Economy (Statement). **This Statement broadened the scope of Pillar One beyond "consumer facing businesses," to also include "automated digital services," whether consumer-facing or not (including, e.g. cloud-based computing and other digital business-to-business transactions), which represented a more digital-focused proposal despite the US argument that the new tax rules should not discriminate against the technology sector.**

Recently at a May conference, Pascal Saint-Amans, Director of the OECD's Center for Tax Policy and Administration, said: "What seems for sure is that digital is still the focus, not to say the target. Having something tangible on digital [as part of the OECD agreement] will be highly expected."

Status & Timeline

The **next full Inclusive Framework meeting, which was scheduled for July, has now been postponed to October** due to the COVID-19 pandemic, but the Inclusive Framework has a schedule to meet virtually starting the week of June 15th. **The delay has resulted in speculation that the OECD will not meet its deadline of reaching a global agreement by the end of the year, but the Inclusive Framework continues to have a stated goal of meeting that deadline.**

In an April 2020 OECD report given to the G20 Finance Ministers, the OECD suggested that they believe efforts to change corporate tax law to ensure that digital companies are taxed fairly and establish a minimum tax rate are likely to become more important after the pandemic because countries will need to rebalance their tax burdens as their economies return to normal. They are likely to place a higher priority on addressing the tax challenges of a digitalized economy and ensuring multinational companies pay a minimum level of tax, which some parties believe could provide new impetus to efforts to reach agreement.

The G20 group issued a communique after the meeting stating it was committed to using all tools to steady economies and ensure a quick recovery "while continuing to tackle the global challenges, notably those related to addressing the tax challenges arising from the digitalization of the economy and enhancing access to opportunities."

The goal of the next OECD meeting is for countries to sign off on a complete political agreement covering Pillar One, with that schedule to happen just before the meeting of the G20 leaders in November. **Saint-Amans has recently acknowledged that the project may now take longer than initially planned** and has stated that it may be a staged process with some decisions shifting into 2021.

Once a global agreement is reached, the Inclusive Framework will still have to work out the implementation rules. **Member countries are expected to make changes to their current laws and/or treaty agreements in order to implement the new rules. In the US, this will involve work by the Congress to rewrite the US international rules and agree to treaty changes, which may prove to be challenging.**

The OECD Committee on Fiscal Affairs (CFA) working parties have prepared detailed technical notes on the "building blocks" of Pillars One and Two. It is expected that the technical work will be shared with the public for comment this summer.

US Withdrawal from the OECD Project/US Trade Investigations

At June 17th hearings before the House Ways & Means Committee and the Senate Finance Committee, USTR Robert Lighthizer confirmed reports that Treasury Secretary Mnuchin had informed several other negotiating partners that the US was withdrawing from the OECD talks. This action could now lead to a trade war as countries move ahead with unilateral DSTs and the US responds with retaliatory tariffs.

The US comments reportedly came after the Financial Times reported that Secretary Mnuchin had called for suspension of the talks in a June 12th letter to his counterparts in four European countries including France, Spain, the UK, and Italy, all of whom have unilateral DSTs, with threats of retaliatory action included in the letter. Lighthizer told committee members that he still believes an international regime is needed to deal with taxation, but that the talks with the European countries were not productive, stating "We were making no headway and the Secretary made the decision that rather than have them go off on their own, you would just say we're no longer involved in the negotiations." At the Ways & Means hearing, however, he did suggest support for a global agreement stating, "The answer is that we need an international regime that doesn't focus on certain sides and certain industries, but where we generally agree on how we're going to tax people internationally. I think there's clearly room for a negotiated settlement."

The OECD issued a statement in response on June 18th stating that the OECD will maintain its schedule of meetings to offer all members of the Inclusive Framework a place in the design of a multilateral approach. OECD Secretary-General Angel Gurria responded with these comments:

"Addressing the tax challenges arising from the digitalisation of the economy is long overdue. All members of the Inclusive Framework should remain engaged in the negotiations towards the goal of reaching

a global solution by year end, drawing on all the technical work that has been done during the last three years, including throughout the COVID-19 crisis. Absent a multilateral solution, more countries will take unilateral measures and those that have them already may no longer continue to hold them back. This, in turn, would trigger tax disputes and, inevitably, heightened trade tensions. A trade war, especially at this point in time, where the world economy is going through a historical downturn, would hurt the economy, jobs and confidence even further. A multilateral solution based on the work of the 137 members of the Inclusive Framework at the OECD is clearly the best way forward."

The European Commissioner for Economy, Paolo Gentiloni, issued a statement on behalf of the four countries addressed in the letter stating that the European Commission will support any EU country that moves forward with a DST in response to the threats of retaliatory US tariffs. His letter also stated "The European Commission wants a global solution to bring corporate taxation into the 21st century – and we believe the OECD's two-pillar approach is the right one. But if that proves impossible this year we have been clear that we will come forward with a new proposal at EU level." In light of the fact that the Treasury letter was addressed to the four European countries and not the OECD, it could be seen as a warning shot related to the unilateral DSTs rather than an intention of the US to completely abandon the negotiations.

The EU considered a digital services tax in 2018, but that effort failed when they could not reach unanimity, which is required in the EU on tax issues. More recently, EU leaders have proposed the idea as part of the recovery from the COVID-19 pandemic.

This June 17th US announcement followed action on June 2, 2020, when the Office of the US Trade Representative (USTR) announced that it had initiated an investigation into digital services taxes (DSTs) proposed or adopted in nine countries and the European Union (EU). The countries included in the investigation are Austria, Brazil, the Czech Republic, India, Indonesia, Italy, Spain, Turkey, and the UK. The USTR has requested comments from stakeholders by July 15th, but it has not set a time for a public hearing.

The investigations are being conducted under §301 of the 1974 Trade Act, which gives the USTR broad authority to examine and respond to a foreign country's action that may be unfair or discriminatory and may negatively affect US commerce. In 2019, the USTR undertook a similar investigation of the French DST and found that tax to be discriminatory towards US companies. After the US threatened retaliatory tariffs of up to 100 percent on several French imports including wine, cheese and handbags, France agree to delay the collection of taxes until the end of 2020 and the tariffs have not been imposed. The agreement expires in December of 2020, however, so that if no global agreement is reached, France will be able to collect taxes for 2020, and the US may decide to move ahead with imposing tariffs on some French goods.

The USTR said that in assessing the 10 tax schemes, it will focus on whether the taxes discriminate against US companies, whether they apply retroactively, and departures from US tax norms. The USTR noted that digital service taxes may diverge from norms reflected in the US and international tax systems by being extraterritorial, taxing revenue not income, and penalizing technology companies for commercial success.

Unilateral DSTs

Despite the US trade investigation and threat of tariffs, **unilateral DSTs have continued to develop in 2020 in proposed and enacted form.** In announcing the investigations, USTR Robert Lighthizer commented: "President Trump is concerned that many of our trading partners are adopting tax schemes designed to unfairly target our companies. We are prepared to take all appropriate action to defend our businesses and workers against any such discrimination."

Some of the trading partners targeted in the investigation have responded that they intend to proceed with their DST's despite the threat of tariffs, including the EU, the UK, and the Czech Republic. The EU said that it would respond to any US trade sanctions with similar proposals with an EU spokesman stating that "In this, as in all other trade-related matters, the European Union will react as one" (as reinforced by the June 18th EC letter noted above).

The UK DST went into effect on April 1, 2020, but no taxes are to be collected until 2021, while work on a global agreement proceeds. A UK Treasury spokesman stated: "Our digital services tax ensures that digital businesses pay tax in the UK that reflects the value they derive from UK users, and is compatible with the UK's international obligations." The Czech Finance Minister said that tax policy is a "sovereign matter of every state" and confirmed that their DST will go into effect in January of 2021 in order to address the "imbalance between companies operating on the basis of traditional business models and companies that operate under completely new business models of the digital economy."

In addition to the 9 countries and the EU who are targeted by the USTR investigation, other countries are considering DSTs including Thailand, Kenya and Nigeria.

With respect to France, Bruno Le Maire, the French Finance Minister, stated recently that France will proceed with its planned digital service tax only if the OECD fails to agree on a global plan by 2021. He says that France is firmly committed to the OECD's effort to design tax rules for the digital economy, but they continue to look to the end of 2020 as a deadline for the global plan to be confirmed.

SFC Chair Grassley (R-IA) and Ranking Democrat Wyden (D-OR) issued a joint statement of support on June 2nd in response to the USTR announcement of the investigations stating, "The United States Trade Representative is appropriately examining digital services taxes that have been adopted or are being considered by US trading partners. We support USTR's use of the Section 301 investigation process to examine these discriminatory unilateral measures." House Ways & Means Committee Chair Neal (D-MA) said the following: "My position on this matter hasn't changed – I continue to oppose unilateral digital services taxes and support a multilateral solution. I hope Treasury can continue to engage with the OECD and work towards an outcome that protects US workers and businesses. I also intend for the committee to remain in close contact with USTR and Treasury regarding this issue. I hope that USTR is able to diversify its tools for enforcement and use them strategically in service of an optimal outcome."

Pillar One

According to OECD project materials, Pillar One, which consists of the reallocation of taxing rights, is intended to do the following:

- Addresses the question of business presence and activities without physical presence
- Will determine where tax should be paid and on what basis
- Will determine what portion of profits could or should be taxed in the jurisdictions where customers and/or users are located

The Pillar One Unified Approach, which the OECD published in October 2019, proposes a 3-tiered profit allocation method applied to consumer-facing businesses and automated digital services companies on three groupwide profit categories in market jurisdictions, known as A, B, and C.

- Amount A would represent a new taxing right for market jurisdictions, based on a new nexus linked to sales and allocation of an affected company's non-routine profits, also known as residual profits.
- Amount B would provide fixed remuneration for baseline marketing and distribution activities occurring in market jurisdictions.
- Amount C would reflect local group functions beyond routine activities in Amount B and would be determined under the arm's length principle.

The Inclusive Framework and the G20 have endorsed the Unified Approach concept of allowing countries to tax, under new 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 in the country. This will require new rules that depart from long-established principles of international taxation regarding both nexus (taxable presence) and profit allocation (generally using the arm's length principle).

One of the key issues and an area of disagreement with the Inclusive Framework is whether the digital economy should be "ring-fenced" within the context of Pillar One. Initially, there was agreement within the Inclusive Framework that it would not be ring-fenced based on the conclusion that digital services are used in many industries. In 2019, however, many countries began proposing and enacting unilateral DSTs. The US reacted by taking the position that the rules should apply across the board to all industries.

The current Unified Approach has a set of rules targeted at "automated digital services," and a different set of rules aimed at "consumer-facing businesses," which is presumably broader. **The US (and reportedly China) oppose the ring-fencing of digital services, and in December 2019, the US stated that it would only accept Pillar One as a "safe harbor," which would mean that it would be elective for companies, not mandatory – a position that has not been well received by other countries.** In testimony before the House Ways & Means Committee in early March, Treasury Secretary Mnuchin said "we are working on a proposal of a safe harbor that creates certainty for US companies."

The Inclusive Framework countries agreed to defer a decision on the US proposed amendment to Pillar One until after the framework of the proposal was agreed upon. The need for that agreement is coming soon if the work is to be completed by the end of 2020.

Pillar Two

Pillar Two is designed to address base erosion and to ensure that all companies pay some minimum level of tax. According to OECD project materials, Pillar Two is intended to do the following:

- Will help to stop the shifting of profits to low or no tax jurisdiction facilitated by new technologies
- Will ensure a minimum level of tax is paid by multinational enterprises (MNEs)
- Levels the playing field between traditional and digital companies

Under Pillar Two, a new GloBE proposal would enact a global minimum tax similar to the U.S. global intangible low-taxed income (GILTI) provisions, and a tax on base-erosion payments similar to the U.S. base-erosion and anti-abuse tax (BEAT) provisions. Pillar Two addresses a concern that, regardless of an individual country's efforts, multinational enterprises could still locate profits in a low-tax jurisdiction. To ensure that such income is taxed at a minimum tax rate, Pillar Two creates a mechanism whereby a country would need to determine whether subsidiaries under its taxing jurisdiction are subject to a minimum effective tax rate and would then apply a tax to the extent of the difference in tax rates.

Pillar Two also proposes a tax on base-eroding payments, where deductions would be disallowed or withholding tax applied if the related-party recipient was not subject to a minimum tax on the payment. Additionally, tax treaty benefits would be disallowed where the recipient was not subject to a minimum level of tax.

Unlike Pillar One, the Pillar Two minimum tax is voluntary so total political agreement is not required. Many countries have become more interested in the Pillar Two proposals in light of the COVID-19 crisis, since the OECD has estimated that global tax revenues will increase significantly with the implementation of both Pillars One and Two – but with 90% of that estimated revenue to come from Pillar Two.

In his Ways & Means Committee testimony in March, Treasury Secretary Mnuchin said that **Treasury supports the Pillar Two proposal.** One outstanding issue, however, is whether the US GILTI system would be grandfathered under the new OECD rules.

Prospects for a Global Agreement by Year End 2020

Challenges to the prospects for agreement by the end of 2020 within the Inclusive Framework on Pillar One and Pillar Two of the project are significant especially now with the US withdrawal from negotiations and the threat of a trade war over unilateral DSTs. The COVID-19 pandemic will continue to affect the practical logistics of negotiating and meeting to work through issues and technical details. The pandemic will also continue to demand the attention of government personnel trying to deal with the severe economic impacts of the crisis.

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