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The Treasury Should Disengage from the OECD Digital Tax Process

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KEY TAKEAWAYS

Long-standing international tax principles that link physical business location to taxing rights have kept taxes low and facilitated global trade.

The new OECD digital-tax work program will destabilize the international tax order and lead to higher taxes on American businesses, hurting workers and consumers.

The U.S. should refuse to participate in the OECD process to abandon the physical-presence requirement for business taxation.

The Organization for Economic Co-operation and Development's (OECD's) projects on base erosion and profit shifting (BEPS) and digital taxation are providing legitimacy to the global campaign for higher business taxes. Under President Barack Obama, the U.S. Treasury was rightfully skeptical of the OECD process to rewrite the international tax regime. The Treasury is now actively participating in OECD discussions to abandon physical presence as a necessary precondition for paying taxes and to allocate a portion of digital corporate profits through a new formulary system, thus increasing global taxes on businesses.

The growing prevalence of digital services taxes, with France being the most notable example, has motivated a sweeping OECD agenda for a new globally harmonized business tax system. Business leaders and the U.S. Treasury are allowing U.S. and OECD

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bureaucrats intent on raising taxes to upend the current international tax order. The currently proposed framework will further destabilize the rules governing international corporate taxes, and will lead to higher taxes on American businesses, hurting workers and consumers. The OECD process has the ambitious deadline of securing a consensus rework of the international tax system by 2020. Treasury Secretary Steven Mnuchin should disengage from the OECD process, and Congress should reject any plan that overturns the physical-presence requirement for business taxation.

The OECD Work Program

In spring 2019, the OECD released a work program outlining an accelerated rewrite of the international tax rules to address growing concerns about how best to tax businesses in the digital economy.[1] The first pillar of the work program addresses a country's taxing rights to global profits, and the second pillar extends work from the 2015 BEPS project on designing a global minimum tax to eliminate tax competition.[2] In October 2019, the OECD released a public consultation proposal adding further details to the pillar one proposal.[3]

Like the 2015 project before it, the OECD program is motivated by European governments' desire to expand their tax base in an attempt to increase tax revenue. The first iteration of the BEPS project was animated by the frequent claim that large, international corporations did not pay high-enough tax rates. Today, the motivation has morphed into a debate about the allocation of taxing rights and claims that large technology firms are not paying enough taxes in certain jurisdictions. This belief is manifested in the OECD's primary argument, that "the allocation of taxing rights can no longer be exclusively circumscribed by reference to physical presence."[4]

While statutory tax rates are consistently higher than effective tax rates due to both intentional and unintentional features in the tax system, the fundamental principle of physical location determining tax obligations is not broken. Nor do businesses, technology companies, or otherwise get away with paying no or little tax.[5] This is not to say that digitization does not pose serious challenges to the current separate accounting and transfer pricing system. A limited formulary safe harbor is certainly worth considering as a way to simplify the system. However, applying laws and taxing powers to businesses outside a country's borders violates fundamental principles that prevent foreign countries from violating the sovereignty of others.[6]

The OECD Is Empowering Bad Actors

Pillar one of the OECD work program proposes a new method for allocating a portion of the profits of consumer-facing businesses based largely on sales, rather than business location.[7] Such a change would move away from the long-standing principles of international tax that rely on the physical presence or permanent establishment of the business in the taxing country and separate accounting. The separate accounting system makes corporations pretend that each jurisdiction is a legally different company, and that any transfer of value (tangible or intangible) is sold or purchased as if on the open market or "at arm's length."[8]

The OECD consensus plan seeks to overlay, on top of the existing separate accounting rules, a new formula-based system to distribute estimated residual digital profits. This seemingly small addition to the existing tax system will open the door to a more radical rewrite of business taxation and add new levels of complexity to an already overly complex system, while not fully addressing the concerns of the countries that are pushing the OECD process forward.

The current urgency of the OECD process is driven by the concern that countries around the world will begin to implement digital levies unilaterally, following in the footsteps of the French digital services tax and India's equalization levy on online advertising and revised permanent establishment rules.[9] By allowing such actions by a few countries to motivate an overhaul of the existing location-based tax system, the OECD is encouraging countries to use bad domestic policies to force their global agenda in the future.

Countries pushing for expanded taxing rights are motivated by two different goals. (1) Most prominently, certain European politicians seek to tap into an anti-U.S. and anti–big business sentiment by finding new ways to levy higher domestic taxes on foreign firms. Following the failure of the EU digital services tax proposal to gain consensus, France has taken the lead with a unilateral turnover tax on digital revenues.[10] (2) The more fundamental challenge to the existing system comes from jurisdictions that seek to expand their tax base and, thus, revenue. Countries like India can accomplish this by linking business profits to the large numbers of consumers who use online services provided by businesses with little direct connection to the country and thus register relatively little traditional taxable income.[11]

The ongoing OECD process is no longer about base erosion or profit shifting per se, and has become an entirely political debate about the appropriate division of taxing rights.[12] The OECD's current process is attempting to bridge two fundamentally opposed ideologies of taxing rights. Should corporate income be subject to tax where the consumer resides irrespective of the businesses' choices, or where the business activity and value creation takes place?

Reallocating taxing rights by undermining physical permanent establishment is not a moderate compromise solution. Application of a country's laws should require the business to have some physical connection with the country. Without this protection, the OECD proposal will set the path for the wholesale reallocation of taxing rights, which will ultimately be ad hoc, proliferate double taxation, and allow tax rates to rise.

Reallocating Taxing Rights: No Small Change

The OECD's goal to "stabilize" the international tax system is incompatible with abandoning the requirement for physical presence. Any consensus solution to allocate a portion of profits based on consumers or users will likely be an unstable compromise that will quickly precipitate a world of unilateral expansions of the OECD system.

Historically, multilateral consensus around standardized apportionment formulas have given way to unilateral revisions.[13] Apportionment, even when not standardized, can simplify the complex separate accounting system, and, when constrained by physical presence may even facilitate tax competition. However, when disconnected from business location, countries are able to export their tax burden to firms and entrepreneurs outside their borders. Individual governments tend to look for ways to expand their tax base, and destination-based apportionment, without regard for business location, makes this easier.

Following the OECD's limited reforms for certain digital profits, populous consumer countries will still want a more comprehensive reallocation of taxing rights to the end user, and origin countries will want to protect the tax connection to employment, investment, and physical location. However, once the existing connection to business location is undermined, there is no logical place to stop the reallocation of profits by some other system. Countries that think they can increase their revenues through the change will always want to expand the portion of profits allocated based on end users.

The OECD dispute-resolution mechanisms that would serve as the backstop to keep countries from abusing the new OECD-provided data and framework are insufficient to stop newly empowered unilateral actors from expanding their seizure of profits. The OECD process relies on soft diplomatic power and international norms to maintain a functioning dispute system and police the current transfer-pricing regime. The current unilateral actions taken by France, and India, and threatened by others, show how fragile any new system will be. As soon as a few countries decide they want to move more fully to a user-based formula, they will have a powerful precedent to act outside the new OECD framework. The dispute resolution system and treaty network is only as strong as the parties' commitment to it.

A successful OECD process resulting in a new apportionment system for residual digital profits will only be a temporary equilibrium. The instability of the current system will only get worse. The power of unilateral action as a cudgel for reform has proven effective, and countries that want taxing rights to be allocated entirely to users or consumers will be emboldened to use the new OECD-provided tools for consumer based taxation to more easily determine a novel tax base and act on their own again.

A fully unraveled OECD process that leads to a destination-based corporate income tax apportionment regime could remove the incentive to keep corporate tax rates low and reward countries that lack innovative and entrepreneurial business sectors due to bad policy choices. In most models, destination-based taxes are less susceptible to the competitive pressures of capital-mobility and business-location decisions, allowing business tax rates to rise.[14] Coveting American industry, and the tax base that comes with it, is not a legitimate reason for overturning the international tax order. Abandoning physical permanent establishment would reward poor policy choices, such as digital services taxes on gross receipts, by giving countries a new tax base simply because they have an Internet-connected citizenry.[15]

In the more likely outcome that no consensus is reached through the OECD process, the traditional consensus that business location matters will still be eroded, as businesses and countries, including the U.S., have already conceded that a new system is needed, possibly emboldening further unilateral digital taxes as a way to continue to force international change.

The OECD Used to Have a Mandate Worth Defending

As international trade grew through the 1950s and 1960s, multiple countries claimed taxing rights to the same corporate profits. Countries around the world regularly extended their tax systems beyond their borders to tax profits originating in other countries. Multiple taxing claims resulted in pervasive double taxation of corporate profits, an unfortunate barrier to global trade.[16]

The minimization of international double taxation of corporate profits took concerted efforts and a series of multilateral tax treaties to institutionalize a system that rests on the physical presence of the business and separate accounting.[17] The focus of the international tax system has shifted from the narrow task of eliminating double taxation to ensuring total, uniform taxation of corporate profits.[18] This new, broader mandate, embodied in the current work program, is not worth supporting and will ultimately seed the demise of the international tax order, which has kept taxes low and facilitated global trade.

Given the United States' outsized influence on the OECD process, the evolution of the institution away from the original mission has often been allowed, if not led, by the U.S.[19] As a first step in distancing the U.S. from the current OECD process, Congress and the Administration must lead by example.

A crucial step in ensuring uniform taxation of all global profits, and ultimately the location of consumers for a new apportionment system, is information collection and sharing. The OECD's successful expansion of private tax information sharing has been implemented through a new protocol amending the Multilateral Convention on Mutual Administrative Assistance in Tax Matters, among several others.[20] The protocol undermines due process and exposes lawful U.S. taxpayers to foreign expropriation when their private financial data is shared with hundreds of countries around the world, some of which are hostile to the United States. The OECD program is based on the U.S. Foreign Accounts Tax Compliance Act (FATCA), which serves a similar purpose of collecting tax information on Americans living abroad.[21]

Congress still has not ratified the OECD's new protocol, which would authorize the Treasury to automatically share bulk taxpayer information with governments around the world; although the Treasury has implemented through regulation the OECD country-by-country reporting program for corporate tax data.[22] The U.S. should help lead the OECD back to its core competencies by first publically disengaging from the current digital tax process, explicitly rescinding U.S. participation in OECD information-sharing programs, and then unwinding programs like FATCA that have implicitly given other countries permission to overstep their taxing powers.[23]

The Treasury Should Disengage—and Encourage the OECD to Return to its Original Mission

Business and world leaders fear a world in which every country implements new and different taxes on digital services, with increasing complexity and double taxation. While such a future should be discouraged, the currently discussed OECD solutions will not prevent such a world and may accelerate the shift to destination-based corporate profit allocation, empowering revenue-hungry countries around the world to expand their tax base and raise tax rates. It is encouraging that countries threatening unilateral action are so committed to an international solution, signaling their lack of confidence in their ability to sustainably raise taxes on their citizens without the help of the United States and the OECD. World leaders are allowing a fictionalized world of unilateral action to smooth the way for upending the link between location and taxes.

Recommendations for the U.S.

- **The U.S. Treasury should disengage** from the current OECD digital tax work program and condition future OECD tax work funding on returning to the original mission of coordinating the reduction of double taxation of income.

- **Congress should reject any OECD proposal that undermines** physical permanent establishment.

- **The State Department and the Department of the Treasury should instruct the U.S. Mission to the OECD to rescind** U.S. participation in the OECD country-by-country reporting requirements and to remove the United States as a signatory to the protocol amending the Multilateral Convention on Mutual Administrative Assistance in Tax Matters.

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Endnotes

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