Breaking Bad or Breaking Safely

By:

Yariv Brauner

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Although we live in the times of a pandemic, the top item on the agenda of the international tax regime is the tackling of the challenges presented to the regime by the digital economy. As is well known by now, the global financial crisis ignited discontent with the international tax regime, which primary accelerant had been the notion that multinational enterprises do not pay their fair share of tax. At the very center of the target were the largest MNE (Google, Apple, Microsoft, etc.), essentially all American-based, and all tech companies. The discontent translated into political pressure to change the system, out of which the Base Erosion and Profit Shifting (BEPS) was born in 2012. The BEPS project acknowledged the centrality of the digital taxation issue, assigning it as the project action items number 1.

The project, like the problem it was established to resolve was seemingly universal, and at its launch this feature was acknowledged: economies are interdependent and therefore no country is in a position to independently form its international tax policies. Nonetheless, politics being what it is the project was not run by a legitimate international organization but by the OECD, the rich countries club that had been the caretaker of the international tax regime since World War II. An awkward choice given that the public discontent had been with the regime crafted and maintained by the same organization. A lip service to the universal dimension of the project was paid by the partnership of the OECD with the G20, itself not a legitimate international organization for these purposes, a strategy developed by the OECD over the turn of the Millennium to fend off charges against its illegitimacy. The BEPS project became first and foremost a platform for the OECD to maintain its dominance over the international tax regime, and, second, a vehicle to secure the interests of the strongest economies in the world (mostly OECD members) in more effectively taxing their MNE. The interests of developing countries were completely ignored, and even giants like China and India (members of the G20) could not promote their ideas within the project. More importantly, BEPS did not deliver the most fundamental requirement of more source/market taxation. Similarly, BEPS has not delivered a solution to the challenges presented to the international tax regime by the digital economy. The BEPS final reports of 2015 included a mere report about these challenges, and today, eight years later the project is yet to deliver the promised solution (although it continues to promise one by the end of 2020).

In the meantime, once the BEPS agenda was set by the OECD/G20 members, they invited the rest of the world to implement their agenda, with respect to which the latter had had no voice. This was done in various formats, such as: (a) the conclusion of the multilateral instrument that implements the BEPS (tax) treaty changes, a formal mechanism to swiftly amend a large number of tax treaties, which effectively replaced for these purposes the changes (basically the same changes) to the traditional, informal mechanism known as the OECD Model (in its 2017 version); (b) the establishment of the “inclusive framework” to implement all the other (i.e., non-treaty) BEPS measures, including items that could not generate consensus within the BEPS project itself; and (c) the implementation of Country-by-Country Reporting (CBCR) that could only be effective if implemented universally. Only the inclusive framework opened the door for potentially meaningful contribution of non-BEPS countries, albeit post-agenda setting, yet such contribution has not amounted to much, beyond a couple of “toolkits,” effectively best practice statements with no practical implications.

The same inclusive framework is also now nominally in charge of moving forward the solution for the challenges presented by the digital economy. In a July 2020 report, the inclusive framework seemingly adopts the agenda set by the OECD secretariat (not even the OECD itself, collectively), yes, again, an agenda to which non-BEPS countries have not apparently contributed much. The rapid pace of the work and the heavy costs and expertise requirements made it particularly difficult for poorer countries to participate truly “on equal footing” in the process, leaving them only to accept the set prescription. The Secretariat proposal echoed ideas promoted by France, Germany and the United Kingdom (and to some extent the United States, although now a reluctant participant in this process), ideas that could not gain tract even among BEPS countries because they most likely protect and expand the taxing rights of the wealthiest countries in the world rather than strike a new “deal” for a fair division of tax bases among all stakeholders. The proposal is particularly offensive to the poorer, less sophisticated countries since it introduces unprecedented complexity and administration costs to a system that is already too complex.

One may puzzle over this description since it seems illogical that ideas rejected in more homogenous forums would be acceptable in less homogenous forums, yet this is a known tactic in the evolution of the international tax regime: in the absence of alternatives the OECD secretariat stubbornly and consistently presents single-option agendas and so reduces the resistance power of all other stakeholders. Ironically, at the present the only serious resistance comes from powerful countries within the OECD/G20. In any event, the inclusive framework reports progress on the so-called Pillar Two, which includes expansion of residence state taxing rights, likely in the form of a minimum tax and some complementary measures (such as a switch-over clause), and the tightening of source state tax benefits, likely in the format of denial of deductions, but possibly also by the imposition of a withholding tax. Lesser agreement was achieved over Pillar One that envisions taxation of difficult-to-allocate and therefore difficult to tax profits using weapons that are not currently in the arsenal of states, including formulary taxation (yes, the same arch enemy so hardly fought by the OECD to the present). These weapons have the potential to shift taxing rights to source states, so it is not surprising that they garner less agreement than Pillar Two. “Potential,” I said, yet one cannot use potential at the grocery store. Pillar one introduces unprecedented complexity since its introduces the new weapons on top of the current system, which undoubtedly would raise classification, allocation and apportionment issues far beyond the already difficult such exercises in which one must engage in the current regime (e.g., AOA). The likelihood of poorer source countries coming out on top from this affair is dismal.

Critique comes cheaply, one may retort, but the current state of affairs is not better. Rogue countries (ironically again, led by the purported leaders of the OECD, such as the United Kingdom and France) were able to capture a share of what they believe they "deserve" in the form of taxation of the large tech MNE in various forms of "new" taxes that are supposedly external to the international tax regime and therefore not viewed as its violation. This outcome is undesirable for at least three reasons: (1) it weakens the international tax regime and therefore reverses important achievements of international tax cooperation, achievements that are important to the weaker members of the regime as well as its strongest; (2) it rewards defection and beggar-thy-neighbor actions; and (3) it reduces the chances of consensus. Together with Andres Baez, I have warned that such trend of self-help will only expand unless a genuine cooperative effort was established, and indeed this is what happened, and it took the worst format possible, i.e., primarily so-called digital service taxes (DST) rather than their within-the-system alternative: withholding taxes.[1]

What can be done now? There are two avenues that lead to (relatively) safe grounds at the present. Both states that have sat on the fence till now and countries that took advantage of the situation and enacted DSTs could unilaterally switch to imposition of withholding taxes (at the relatively low rate of 5-10%) on base erosion payments made to cooperating jurisdictions, increasing the rates for non-cooperative taxpayers and jurisdictions. Payments already subject to different treaty regimes may remain subject to those. This step would ensure some taxation of MNE (and therefore is anti-BEPS), some source taxation, and potentially would not lead to double taxation. Based on that countries could negotiate a sensible cooperative solution that could be based on several alternative bases: it could harmonize a withholding tax solution similar to the unilateral solution abovementioned, it could try and find agreement over a virtual PE solution (although I am skeptical about the chances of a universal nexus formula), and it could even be based on formulary taxation, not conceptually different from the one described in Pillar one yet without the hunchback of the current failing rules imposed by the current Pillar one proposal. The key element in all of these is to reach an acceptable, and hence fair, division of the tax bases among the relevant states. The unilateral withholding tax should facilitate negotiation of the collective solution, allowing in the meantime for fair collection of revenue by all stakeholders. The "have-nots" should support this solution since it satisfies their demands for a share of the revenue pie and, at the same time, significantly simplifies administration and compliance. The "haves" should support this solution since it would facilitate their residence taxation (or the formulary equivalent of that), eliminate waste and also relieve their MNE from the significant compliance burden such MNE suffer at the present due to the post-BEPS chaos of DSTs the other potpourri of taxes and compliance requirements that they face.

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[1] Yariv Brauner & Andres Baez Moreno, Taxing the Digital Economy Post-BEPS… Seriously, 58 Colum. Trans. L. J. 121 (2019).