Pandemic Complicates OECD Digital Tax Overhaul

By **Joyce Beebe** (May 13, 2020, 2:05 PM EDT)

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Last week, the Organization for Economic Cooperation and Development, or OECD, announced that the deadline for 140 countries to reach an agreement on key policy features of its digital economy tax rewrite would be moved from early July to mid-October.

The organization maintained its goal of providing an implementation plan before the end of the year; however, it recognized the coming agreement and implementation plan will not address all open issues. Instead, some elements may be determined after 2020 under a staged approach.

As the COVID-19 pandemic intensifies and the global economy declines, a change in the timeline is not surprising. However, the delay not only reflects policymakers' hesitance to divert resources from the health crisis to the OECD's digital tax proposals, it also highlights unique challenges that countries have not previously contemplated.

The first challenge is the treatment of losses. Under the OECD's pillar one proposal[1] and its subsequent statement[2] regarding the reallocation of international taxing rights, consumer-facing companies (e.g., those licensing trademarked consumer products or commercial know-how) and automated digital services (e.g., search engines, social media, online advertising services) are the two business categories subject to the deemed residual profit allocation, known as "amount A" in the proposal. To date, most pillar one discussions center on the definition, calculation and treatment of deemed residual profits; the OECD is silent on the treatment of losses.

Prior to the pandemic, a group of countries alleged that tech giants — such as Google Inc., Amazon.com Inc., Facebook Inc. and Apple Inc. — are not paying enough taxes in countries where their consumers or users are located. This group, led by France, therefore asked that big tech companies' profits be reallocated to market jurisdictions through the OECD's tax rewrite so that market countries can collect more tax revenue.

At the same time, the U.S. has repeatedly stated that in an increasingly digital world, many businesses are becoming more technologically driven. As such, any tax rewrite should go beyond taxing tech giants and apply to a more comprehensive set of companies.

Then came COVID-19. Some automated digital service companies, including Amazon, Apple and Netflix Inc., continue to prosper but many others that are subject to the amount A allocation may not generate residual profits; some may even have losses.

The discussion of business losses is particularly relevant for consumer-facing companies that primarily derive revenue from marketing intangibles such as brand names and trademarks. The issue is also pertinent to business franchises, such as entities operating under licensing arrangements in the restaurant and hotel sectors, which are heavily affected by COVID-19.

Although not all companies subject to amount A are affected equally during COVID-19, they still want clarification as to how losses will be handled. Under the current design, if a U.S. company's residual profits are allocated to three other market jurisdictions — say, France,

the United Kingdom and Germany — the company may expect its losses will be treated somewhat symmetrically.

In other words, the market jurisdictions will share some losses instead of attributing all losses to the U.S. In addition, a comprehensive plan would include loss carryforward guidelines, such as whether the company can use losses or the portion of profit below routine return to offset certain future payments under amount A.

The second issue involves an ideological debate between pro-growth and revenue-focused policies during the eventual COVID-19 recovery. After the pandemic recedes, governments around the world will focus on reviving their economies. How the digital tax negotiations move forward at that time will in part depend on how tech companies are perceived. Were they more like white knights that helped everyone during the crisis or profiteers that took advantage of the situation?

Some countries, including France, view tech giants' profitability during the pandemic as evidence that digital tax negotiations should be accelerated[3] and tech companies' windfalls should be taxed away. To some governments, including Indonesia, tech companies not only should pay, they also have the ability to pay.

COVID-19 reduces government tax revenue but the costs of stimulus packages need to be repaid.[4] It is therefore natural for these governments to focus on profitable tech companies. Some practitioners argue that, even without additional government actions, there may be intensified public pressure for profitable tech companies to share part of the costs to rebuild; taxing these companies would just be a starting point.

The pro-growth group views the situation differently. During COVID-19, almost everyone has benefited from technologies offered by tech companies. For instance, Zoom Video Communications Inc., Apple and Google enable productivity for work-from-home labors and make distance learning a reality for students. Amazon, Facebook and Netflix allow home delivery, connectivity and entertainment during shelter-in-place periods.

The extensive use of technology makes people approach work and think about their workspaces differently; tech companies could be the ones spearheading the economic recovery.

The pro-growth group also does not believe digital tax can raise sufficient revenue to repay the cost incurred by stimulus package. The OECD's February 2020 preliminary impact assessment shows the global corporate income tax revenue will increase by about 4% if both pillars are implemented,[5] which translates to $100 billion in global tax revenues per year.

Pillar one, as a reallocation plan, will raise less than 10% of the additional revenue, or less than $10 billion per year. The vast majority of revenue gains will come from pillar two, a global minimum tax proposal. In comparison, major European Union countries have each committed hundreds of billions of dollars in stimulus funds and digital taxes are not enough to replenish these countries' coffers.[6]

Some observers also point out the estimates are based on 2016 data, which did not include several major U.S. and EU tax rule changes aimed at reducing cross-border tax avoidance.[7] In other words, if 2019 data were available, the corporate income tax revenue gain will be less than $100 billion. In addition, the revenue estimate does not factor in the negative economic impact caused by COVID-19; the $100 billion estimate published

merely three months ago will likely be much lower in 2020, and be much less sufficient to pay for the stimulus package.

Third, the threat of digital services tax, or DST, is still on the horizon, if not more imminent. Last year, France decided to impose a 3% tax on large tech companies' digital revenue and the U.S. retaliated by levying a 100% tariff on $2.4 billion of French goods.[8] In January 2020, the duel between the two countries came to a temporary halt: The U.S. will hold its import duties and France will continue to accrue but not collect the DST until December 2020, giving the OECD time to come up with a plan.

COVID-19 does not stop unilateral measures from emerging. Most recently, in late April, U.K.'s major parties in Parliament approved the DST and moved it closer to becoming law. Such unilateral measures have not only caused much tension between countries, but have also pressured the OECD to maintain the goal of its timeline.

Conclusion

COVID-19 created unique challenges for the digital tax overhaul and brought new dynamics to negotiations. Even before the pandemic, the only statement all countries could agree on was that everyone wants "multinational, consensus-based solutions." However, the devil is in the detail regarding what those solutions constitute. What may the potential compromises look like?

The U.S. has never stopped asserting its opposition to ring-fencing digital companies, whereas market jurisdictions would really like to see tech giants be subject to tax in their countries. The bifurcation between automated digital services and consumer-facing companies appears to be a step toward such a compromise, as tech giants will fall into the automated digital services category, and consumer intellectual property licensing companies and franchisers are more likely to belong to the latter group.

In terms of the amount A residual profit, Pascal Saint-Amans, director of the OECD's Center for Tax Policy and Administration, remarked in May that there is an emerging view that "amount A should focus on digital companies,"[9] which could be interpreted as excluding the consumer-facing companies and only including automated digital services.

In addition, in December 2019, the U.S. proposed to make pillar one a safe-harbor regime that companies can opt into to ensure certainty of tax treatment. Although the proposal has not been viewed favorably, under the time pressure, the OECD may give it serious consideration. In pursuit of immediate tax revenue, some countries may accept a compromised scope in pillar one in order to get the revenue generated by pillar two. Although the pandemic invalidates the $100 billion revenue amount, pillar two still generates most of the revenue.

A wild card is obviously whether these provisions are enough to satisfy the market jurisdictions and avoid the unilateral DSTs. Although it is uncertain whether the recovery will be U-shaped, V-shaped, L-shaped or W-shaped, it is certain that France will not wait another two years before collecting DST.[10] Whether tech giants are subject to the residual profits allocations or not, it is clear that tariffs, double taxation and retaliatory levies will not help economic recovery in the post COVID-19 world.

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