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Digital Taxes May Take On Permanence Despite Global Accord

By **Natalie Olivo**

Law360 (July 28, 2021, 6:36 PM EDT) -- Countries are finalizing a corporate tax overhaul that's intended to discourage jurisdictions from enacting their own digital services taxes, but unilateral measures are likely to stick around during the complicated and potentially lengthy implementation process — and perhaps even afterward.

The Organization for Economic Cooperation and Development earlier this month announced that more than 130 jurisdictions have agreed on a comprehensive rewrite of international tax rules, including a reallocation of large multinational corporations' residual profits to jurisdictions where they have customers but no physical presence. These new taxing rights will pave the way for countries to remove their digital services taxes, according to the OECD, which is aiming for the overhaul to take effect in 2023.

A goal of 2023 may be optimistic, in part because the rewrite requires countries to hash out a multilateral tax treaty that would override existing bilateral accords, which base income taxing rights on the century-old concept of physical presence. Specialists say countries likely will hold on to their unilateral measures during this potentially drawn-out implementation process, and possibly even longer if jurisdictions see their digital taxes as transactional levies that can exist alongside the new tax rules in some cases.

The removal of digital services taxes, or DSTs, and the agreement on new taxing rights both fall under the first pillar of the OECD's proposal. This is still only an agreement in concept, according to Randy Buchanan, a partner at Eversheds Sutherland.

"I think there are still a lot of details that would have to be hammered out about how to actually implement Pillar One," he said. "Certainly between now and then, I don't think anybody's going to get rid of their DSTs."

The Path to Pillar One

Negotiations began four years ago at the OECD, which has stated that current international tax rules — first written in the 1920s — fail to fairly allocate taxing rights now that many companies can earn substantial profits in a country without needing a physical presence.

As the OECD worked with jurisdictions to develop new rules, some countries moved forward with their own unilateral digital measures. France in July 2019 became the first country to enact a DST, which involves a 3% levy on revenue from digital services, such as online advertising, provided remotely by large companies.

Former President Donald Trump's administration argued that the measure unfairly targeted American tech companies and initially threatened tariffs before delaying them during pending investigations into similar digital services taxes. President Joe Biden's administration later suspended tariffs against six countries — Italy, Spain, Turkey, the U.K., India and Austria — as discussions continued at the OECD.

Meanwhile, the OECD is leading the final stages of negotiations for a two-pronged approach — Pillar One and Pillar Two — that would create new taxing rights while also seeking agreement on a global minimum tax. Pillar One wouldn't single out digital transactions but would instead focus on profits, applying to companies with a global turnover above €20 billion ($23.7 billion) and profitability above a 10% margin, according to the OECD, which said final rules will be released in October.

Officials from several countries, including France and Canada, have already stated they will keep collecting on their DSTs until Pillar One rules are in place. Whether countries could be expected to remove their DSTs after Pillar One is implemented may depend in part on what "implementation" actually means.

It would be a heavy lift to ask a country not to impose DSTs under certain circumstances because it was determined that implementation standards haven't been met, according to Loren Ponds, a member of Miller & Chevalier Chtd.

"We're seeing the importance of what implementation means," she said.

There's a question of whether the term refers to broad-based implementation — meaning there's a framework with rules — or if implementation means countries have adopted these rules after they've signed on, she said.

There are also questions, Ponds said, about "how much adoption, to what degree and by whom does implementation really get measured?"

A Complicated Way Forward

After countries finalize a Pillar One agreement, they'll need to face the existing bilateral treaty network that relies on the concept of physical presence when it comes to taxing profits. In response to these treaty barriers, the OECD has outlined a so-called multilateral instrument that will be ready for countries to sign in 2022, a year before Pillar One is intended to be applied domestically in countries across the globe.

In the U.S. alone, a multilateral accord faces obstacles in the Senate, where two-thirds of the chamber must ratify treaty changes — a requirement that has caused long-term delays in the past.

U.S. Treasury Secretary Janet Yellen recently addressed the slower pace of Pillar One compared to Pillar Two, which involves a global minimum effective corporate tax rate of 15%. Speaking during a news conference on July 11, she said Pillar One "will be on a slightly slower track" and that Treasury "will work with Congress."

Although Yellen has signaled support for a global deal at the OECD, the U.S. government's role in the agreement would essentially remain static unless both chambers of Congress legislated the measures and the Senate separately approved a multilateral instrument.

According to Buchanan at Eversheds Sutherland, it's probably not realistic to expect the Senate to ratify a multilateral instrument in the near future. There may be similar implementation hurdles in other countries, he said.

"Even if you get agreement about how you want it to look, it just seems like it's a long road," he said.

As Ponds saw it, it's too early to tell how Pillar One would be implemented from a congressional standpoint, given that the 2023 timeline seems ambitious. Legislation and treaty ratification could occur under a future Congress, she said.

Based on present issues today, however, Ponds noted that the U.S. has not been a party to any other multilateral instrument thus far and there's been difficulty ratifying treaties in the Senate under its current composition.

"And that's apart from any of the legislative changes that we'd have to enact," she said.

Meanwhile, the possibility of lingering unilateral measures in the absence of global Pillar One implementation was discussed during a webinar hosted earlier this month by the Atlantic Council, a think tank based in Washington, D.C. Speaking during the virtual event, a former Treasury official predicted that many countries would be reluctant to stop collecting their DSTs "given that it's not clear that the U.S. will actually implement Pillar One in the near future."

The Staying Power of Digital Taxes

Even if Pillar One rules eventually take hold, some nations may decide to keep their unilateral measures. The potential permanence stems in part from the mechanics: While Pillar One involves taxing profits, DSTs are based on transactions and thus bear similarities to sales taxes in the U.S. or value-added taxes elsewhere.

As an indication that digital taxes are similar in nature to a VAT, major tech companies have announced plans to pass the cost of digital measures on to their consumers as fees. Google, for example, recently notified advertisers that it would add a 2% surcharge for advertisements purchased on its platform that target users in Italy, citing "the cost of complying with digital services tax legislation."

As Buchanan saw it, companies' decision to pass on DST costs makes the measure look like a VAT, where a tax is collected at different stages of the supply chain and costs are passed down.

Most countries have income tax systems and VAT systems that operate side by side — similar to individual states' income and sales taxes in the U.S. — and they're viewed as serving two different functions, he said. That could ultimately be the position that countries take with Pillar One and DSTs, Buchanan said.

"The stated goal of the OECD is that you won't end up in that situation," he said. "It should be when Pillar One's in place, you get rid of all those DSTs. I'm just a little cynical about whether it's really going to play out that way in the end."

As some see it, countries may keep their DSTs specifically for remote companies that fall outside the scope of Pillar One. According to the OECD, these new tax rules would apply to only about 100 of the largest and most profitable multinational corporations.

It has yet to be addressed why a country would carry out a broad repeal of DSTs when only about 100 companies are in the scope of Pillar One, according to Michael Lebovitz, a partner at Mayer Brown LLP. Some countries likely won't get a significant amount of revenue under Pillar One, and yet they may be required to repeal their DST for all companies, he said.

"That's a tough political and economic choice," Lebovitz said.

DSTs are also easier to collect because they're similar to a VAT or sales tax, he said.

"You're not reliant on the profitability of a company to collect tax revenue," Lebovitz said. "You're collecting tax revenue based on sales."

In a similar vein, Mayer Brown partner Jenny Austin said it's unlikely that a company would face both Pillar One rules and DSTs in a given country. Rather, countries may apply digital measures to companies that aren't affected by Pillar One, she said.

"I don't think you're going to have global agreement on Pillar One if DSTs exist, where a company is going to be subject to Pillar One and subject to a DST," Austin said.

She added that DSTs may instead be a catch-all: If a company isn't within Pillar One, a country may ask, "Is there some other way that we can tax you?"

As others see it, the general concept of a digital services tax isn't likely to permanently disappear.

According to Ponds, even under the best-case scenario — Pillar One and Pillar Two are implemented worldwide and everyone's on board — it's somewhat naive to think that this is the last companies will ever see of any kind of articulation of a digital services tax.

"There will be the next iteration," she said. "It could be decades from now, but this won't be the end of this discussion."

--Additional reporting by Alex Lawson, Joseph Boris and Kevin Pinner. Editing by Tim Ruel and Vincent Sherry.
