“It became necessary to destroy the town to save it.”

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Since 2013 the OECD has worked on forging a grand coalition (now 136 countries) it calls the “Inclusive Framework” around adopting the outcomes of the OECD’s Base Erosion and Profit Shifting (BEPS) project of 15 reports. In 2005, ten years before the BEPS reports, the OECD published *E-commerce: Transfer Pricing and Business Profits Taxation* to address the challenges arising from the digitalization of multinational enterprises’ business models and the evolution of cross-border e-commerce. But the OECD promoted BEPS as the ‘be-all and end-all’ to resolve double non-taxation and double taxation through calibration of the current international tax system built on arm’s length, double tax agreements (DTAs), and transparency.
Yet in late 2019 four years after adopting its 15 substantial reports of amendments to the current rules, the OECD turned ‘about face’ to pivot toward a new world order that the OECD titles the Unified Approach. Even though Pillar 1 is just a proposal conceived by the OECD’s staff without its own member countries agreeing. Primarily the new world order allocates a percentage of U.S. multinationals’ corporate earnings, a ten percent figure has been tossed around at International Fiscal Association, UN International Tax Committee, and American Bar Association tax meetings, to be divvied up among the rest of the world based on a formulary apportionment methodology. It is also generally accepted that the apportionment step of a U.S. multinational’s allocated earnings (called “Amount A” in the OECD proposal), cannot work within the context of the current global tax system.

It cannot work because the OECD’s Pillar 1 new world order will likely lead to substantial incidences of double and multiple taxation of a U.S. MNE’s income. The only way to avoid this multiple taxation is for all countries to adopt a pro-active dispute resolution system, such as baseball arbitration (see page 12 in the UN International Committee report on the Preliminary Draft of the Chapters on MAP Arbitration and on possible Improvements to MAP of the Handbook on Dispute Avoidance and Resolution). Yet, the developing world has its reasons based on experience with Bilateral Investment Treaty dispute resolution, for not trusting mutual agreement, much less accepting binding arbitration.

For the OECD’s new world order to be a “Unified” approach, at a minimum it requires the U.S. Treasury to agree to give up part of its tax base. That is, U.S. Treasury must agree to let the U.S. MNE allocate the Pillar 1 ‘slice off the top’ portion of group earnings to the rest of the world that claims a new tax right of the U.S. income. The best the U.S. Treasury can hope for is that the rest of the world is satisfied with apportionment among themselves of the 10 percent slice. But a 10 percent slice is just the thin edge of the wedge. Ask for 10 and once agreed, what’s two percent more, five percent more? Why not half of the U.S.’ pie?

But, goes the argument in favor of Pillar 1, if the U.S. does not agree, then the world will adopt digital services tax. I say the U.S., and the world, is better off with a withholding tax based system. Cleaner. A withholding based system will not be trapped in the tar pit of formation and implementation in the development of a new international tax regime, thereafter mired in the lack of institutional knowledge and capacity of resources for audit and MAP. A withholding based system offers a contrasted simplicity in relation to its implementation, including: (a) better procedural certainty for taxpayer and tax authority based upon current withholding regimes for services, (b) better revenue estimation for tax authorities, (c) less complex and expensive audits by tax authorities of taxpayers, (d) better tax risk management for taxpayers, (e) an established procedural system for relief of double taxation, and finally, (f) less cause for requiring MAP.

Among proposals most likely to congeal into a uniform approach for the developing world, a withholding based system already has numerous adherents representing various economic strata. Thus, rather than running away from a withholding based system into a ‘brave new world’, the U.S. and therefore the OECD, should embrace it and shape its current contours of definitional income and source issues and range of rates. Thereafter, the respective OECD and UN committees may leverage economic theory and regulatory impact analyses, as was done in 1923, to modulate the withholding based system via the inclusive process of the OECD and UN MTCs while working within the context of the ALP bedrock of the OECD and UN TPGs to address Article 7 and Article 9 allocation issues resulting from intangible-based residual.

Sounds like the new world order of Pillar 1 and Pillar 2 is necessary because the OECD has determined that BEPS cannot work. But BEPS has been in effect, what, two years? The U.S. Tax Reform of 2017 is BEPS friendly, taking the lead with GILTI and BEAT. CbCR results have yet to be analyzed. The 2017 amendments of the OECD’s Transfer Pricing Guidelines are still filtering into tax authority thinking about value creation and value chains. Point is that we don’t know if BEPS is working or not working because it requires five years to generate sufficient data that can be meaningfully analyzed.

U.S. Treasury Secretary Steven Mnuchin, realizing the ‘bait and switch’, of a balancing of the world order with BEPS to a “U.S. pay for the new world order’ has correctly declined, expressing politely in his December 3, 2019 letter: “…we have serious concerns…”.

If the rest of the world wants to charge a market access fee to source income within its jurisdiction, each country has a sovereign right to do so. That is what withholding tax does. And then countries can negotiate with each other to give up some of that market access fee in exchange for cross border trade and investment. That is what tax treaties are for.

The OECD 2013 Action Plan Report on BEPS states, “No or low taxation is not per se a cause of concern, but it becomes so when it is associated with practices that artificially segregate taxable income from the activities that generate it.” The Unified Approach is a deviation from this well-established tax principle (and genesis of the BEPS project) that income be taxed in the countries wherein value is created. Treasury Secretary Mnuchin’s letter intimates, without specifically stating, that the BEPS reforms such as the BEPS revisions to the OECD Transfer Pricing Guidelines (‘TPG’) and the current tax treaty system built on the arm’s length standard present the best framework to robustly manage base erosion and profit shifting risks for both developed and developing economies from emerging digital business models and e-commerce. In 1923 the League of Nations already set the groundwork for BEPS’ incremental modifications to the application of the arm’s length standard that will re-align it to where value is generated within the modern global digital economy.

The 1923 League of Nations’ Economists Report posited that taxation should be based on a doctrine of economic allegiance. “When we are speaking of the origin of wealth, we refer naturally to the place where the wealth is produced, that is, to the community the economic life of which makes possible the yield or the acquisition of the wealth.” While the economists in 1923 were thinking about labor, this value statement applies just as well today to allocating value to the local market wherein the sales occur. The value can be connected to the local country by expanding its taxing right in the tax agreement to levy tax on business that has a “substantial economic presence”. The U.S. state of Wisconsin’s win in the *Wayfair* case at the U.S. Supreme Court offers the nexus solution in this regard for amendments to the permanent establishment article and commentary in the OECD and UN model tax treaties.

The amount of the global value chain that is allocated to the taxable presence in the local country should remain in the context of the arm’s length standard and the OECD Transfer Pricing Guidelines. If the OECD or the U.S. trading partners want to have a negotiation about formulary apportionment then the U.S. must include the full set of factors relevant for value creation such as the size of its GDP relative to other jurisdictions, the U.S. national expenditure on R&D (including all the companies that burned through billions of investors’ funds and failed, causing loss to the U.S. Treasury) relative to other countries, global defense spending relative among the countries, contributions to international organizations, and of course, market size. The U.S. should not agree on an apportionment based on “sales” unless it also includes R&D spending and the other factors that I mention because it is the combination that generates the U.S. ability to create value and reflects the relative value of the contribution to generate value globally. If a market access fee is what the world requires, then the U.S. needs to account for and collect for its full value contribution as well.

The OECD has done an excellent job building a global tax system of treaties and transfer pricing rules that in general work, and will work much better because of its BEPS project. Unfortunately, the Unified Approach sounds like that infamous Peter Arnett Vietnam War quote: “It became necessary to destroy the town to save it.”[1] The U.S. Treasury Secretary should cut bait and deal with the digital tax issue within the context of trade, investment, and the U.S. tax treaty network. The rest of the world should also cut bait and address their concerns in the context of the system already built to deal with them, withholding tax.

[1] Feb. 8, 1968, the New York Times.

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