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In this article, Harrington examines the OECD's two-pillar approach to taxing the digital economy and how some of its components, especially from pillar 1, could become building blocks for international tax change, whether specific to a jurisdiction or more broadly adopted.

The views expressed in this article are those of the author and do not necessarily reflect the official position of Dentons.

The OECD inclusive framework on base erosion and profit shifting has released detailed blueprints of its pillars 1 and 2 proposals. For those late to the international tax party, pillar 1 is "focused on new nexus and profit allocation rules to ensure that, in an increasingly digital age, the allocation of taxing rights with respect to business profits is no longer exclusively circumscribed by reference to physical presence." The goal of pillar 2 is to develop "a systematic solution designed to ensure that all internationally operating businesses pay a minimum level of tax." Comments from the public were due by December 14, with a public consultation to be held January 14-15, 2021.

As reflected in the blueprints, the OECD secretariat and inclusive framework members have worked to identify the technical issues raised by pillars 1 and 2 and suggest potential ways to address them. The political and technical issues are intertwined, however, so only so much technical progress can be made without political guidance, and vice versa.

That paradox makes constructive comments on the blueprints difficult: The blueprints are an elaborate guide for construction of an edifice whose use and size are uncertain, not just to the reader but even, one suspects, to its authors. They include a grand design but also subtly hint that they could be scaled down should prospective buyers be interested in something more modest.

For an area ostensibly focused on the electronic, the OECD work is rife with construction analogies, referring at various times to architecture, frameworks, blueprints, pillars, and so forth. So no one should fault me for introducing another structural metaphor: a cave-in or collapse. Indeed, the reference to two pillars has always reminded me of the story of Samson.[1]

Samson, as you may recall, was a man of great physical strength who was captured by his enemies thanks to Delilah's perfidy and his guilelessness. Having been blinded and made a slave by the Philistines, he was put on show in their temple. Asking God for strength once again, Samson grabs the two middle pillars of the temple and pulls the temple down, destroying the temple and all those present.

To be clear, the inclusive framework's work on pillars 1 and 2 reminds me of the story of Samson not because I think its participants are a group of Philistines (far from it, although I take the Fifth on whether I think some of the project's targets are, like Samson, powerful yet blind). Rather, the ideas in the blueprints have been seeking an outlet for years — in some cases, decades. If those ideas are

[1] Had there been three pillars, it would have reminded me of Ellen Harvey's delightful "The Alien's Guide to the Ruins of Washington" exhibit at the old Corcoran Gallery in Washington. *See, e.g.*, Robin Cembalest, "D.C. for ETs: Sci-Fi Archeology at the Corcoran," ARTnews, Aug. 8, 2013.

not successfully implemented in this format, they will reappear in another in the near future. Or, to continue the construction analogy, those ideas, like a building in disrepair, will be repurposed, either in their entirety or in pieces.

The allure of coordinated development of pillars 1 and 2 is safety in numbers, with implementing jurisdictions not wanting to be put at a competitive disadvantage relative to non-implementing jurisdictions. But coordinated effort can be maintained only as long as the common goal is attainable. If the pillars collapse because of the inability to obtain consensus, each has components that may be used by the inclusive framework. What looks like rubble to some are building blocks to others.

I. Some Assembly Required

Candidly, I don't think the blueprints themselves are going to give any member of the inclusive framework new big-picture ideas. Indeed, the collaborative process of developing the blueprints and the diversity of the participants means that nearly all relevant ideas have been described in, or omitted from, the blueprints. The blueprints may be valuable to those seeking alternative uses by examining how to address some of the problems that would arise in implementing the more ambitious ideas. Problems that might have initially seemed insoluble to jurisdictions approaching them in a unilateral or uncoordinated manner might not seem so daunting, given the potential solutions — or at least the mitigating steps — in the blueprints.

It's no criticism to describe the blueprints as ambitious. Any comprehensive answer to the problems the inclusive framework is seeking to solve must be grandly ambitious. Indeed, most of the complexity in the blueprints comes from trying to make the proposed rules work in a coordinated manner so that multiple countries can apply them to a multinational group without there being multiple taxation or nontaxation. It's impossible to create a proposal that works simultaneously for a large and diverse group of jurisdictions without its looking at least a little like a labyrinth. On the other hand, if a jurisdiction drafts its own proposal, it need not include all the components of a grand edifice, particularly not those features incorporated at someone else's insistence. That kind of smaller, custom-built building will depend on the components of the blueprints the jurisdiction is able to identify, accumulate, and transfer to the desired location; their former role in the old master design is irrelevant.

II. Architectural Features

Conceptually, the pillar 1 blueprint sets forth a justification and method for new nexus rules that would increase the number of and extent to which jurisdictions can be viewed as source countries. Granted, pillar 1 clearly limits the nexus rules to particular instances, but those limitations are self-imposed. There is no principled reason to limit the nexus, revenue sourcing, and broadened calculation of tax base rules to only the circumstances in the pillar 1 blueprint. I'm not advocating an expansion like that, but anyone seeking to improve the blueprint should be aware that the modifications they suggest could wind up being used for a different purpose than perhaps intended. That is not a bait and switch but an inherent consequence of having many different perspectives seeking common ground. Put another way, I doubt any participant would describe the blueprints as perfect; a member of the inclusive framework using the blueprints for more than their stated purpose could view that as simply broadening the scope, rather than committing a fundamental violation of purpose.

The creativity in the pillar 1 blueprint can be taken in two different directions. One is that it gives states justifications, fair or not, for having special rules for some companies or industries, even if the rules they eventually adopt differ from those proposed. The pillar 1 blueprint defines automated digital services and consumer-facing businesses and provides special tax rules for them. If a jurisdiction is challenged on why it singled out particular companies, it can just copy and paste language from chapters 2.1 (overview) and 2.2 (activity tests) of the pillar 1 blueprint as needed.

Second, countries interested in formulary apportionment but not willing to abandon the arm's-length principle now have amounts A and B as models. The pillar 1 blueprint would create a new taxing right for market jurisdictions over a share of residual profit calculated at the group or segment level (amount A) and a fixed return for specific baseline marketing and distribution activities taking place physically in a market jurisdiction (amount B), ostensibly in line with the arm's-length principle. The new quantum rules for amount A are based on group revenue, which for some jurisdictions will be more favorable than that limited to the group entity with actual nexus to the jurisdiction. Although amount A was designed with a limited set of circumstances in mind, and the blueprint states that the new rules for amount A are not intended to alter nexus for other purposes, jurisdictions may feel no need to heed those warnings for the particular structure they are building. After all, they are picking through the rubble, not following the blueprints. In any case, the pillar 1 blueprint already anticipates some variation, such as lower nexus standards for smaller developing economies.

A. Nexus, Anyone?

The expanded nexus in the pillar 1 blueprint will be of most interest for those wanting to add to their tax systems. The blueprint's broadening of nexus and source rules is a major departure from the historical grounding of income tax nexus. The rationale and suggested approaches in chapter 3 (nexus) and chapter 4 (revenue sourcing rules) read more like that of a consumption tax than an income tax.

Although the distinction between income and consumption taxes is clear in principle, the line can be somewhat arbitrary in fact, given that most income and consumption taxes depart — sometimes markedly — from textbook design. But the distinction, and the characterization of a particular tax, remains important for determining whether an income tax treaty or domestic measures to avoid double taxation apply. Proposed U.S. regulations reflect an unwillingness to treat as an income tax, at least for foreign tax credit purposes, a tax that permits a jurisdiction to tax income the United States does not view as earned or derived from sources in that jurisdiction, even if it is unquestionably imposed on net income.[2] Only time will tell whether the United States is an outlier in that regard or simply the first to lay down a marker. Still, expanding nexus standards beyond those traditionally permitted to an income tax will have indirect consequences well beyond simply providing more revenue for source countries. It raises, as the U.S. proposed FTC rules suggest, questions about whether taxpayers that are subject to those taxes will be eligible for double taxation relief traditionally provided by the home jurisdiction's income tax. It will also affect nontax rules, such as for trade, if income and consumption taxes are subject to different standards, such as when a rebate of tax is considered an export incentive.

In short, one might not like where an arbitrary line is drawn, but moving, blurring, or erasing it will have long-term ripple effects. The existence of a line is sometimes more important than its location.

B. The Arm's-Length Suggestion

The second biggest item is the pillar 1 blueprint's willingness to replace the arm's-length principle with, if not formulary apportionment, a close relative. Departure from the arm's-length principle is not unprecedented, even among general adherents — as anyone who has encountered the U.S. commensurate with income rules[3] regarding intangible property can attest.

Indeed, amount B is arguably analogous to the commensurate with income standard, even if the mechanics are different. Amount B is intended to standardize the remuneration of related-party distributors that perform baseline marketing and distribution activities in a manner aligned with the arm's-length principle. In other words, amount B, like the commensurate with income standard, is intended to supplement the application of the arm's-length standard rather than supplant it. As the blueprint notes, members of the inclusive framework range from those who view amount B warily, wanting to see it implemented as a pilot program, to those who would apply it more broadly to commissionaires, sales agents, and others. Although the blueprint assumes it will be limited to the circumstances described, amount B can be seen as at least tacit approval for applying a fixed return in lieu of

[2] *See* prop. reg. sections 1.901-2(c) and 1.903-1(c)(2)(iii).

[3] *See* section 482 and its associated regulations.

specific application of the arm's-length principle, as long as the return and base in amount B broadly represent a simplified version of arm's-length principles.

Amount A, of course, cannot be rationalized as a simplified version of the arm's-length principle, not merely because the terms "simple" and "amount A" don't belong in the same sentence. Rather, amount A's goal is to identify how much group income a jurisdiction should be able to tax. Amount A does not seek to measure, even as a proxy, the income a taxpayer would have earned in a jurisdiction. Although amount A is supposed to be limited to consumer-facing businesses or entities engaged in automated digital services, its instructions are likely to be separated from the component pieces if the roof caves in. Moreover, a jurisdiction seeking to apply formulary apportionment, whether broadly or to particular activities, will be tempted to cite selectively the pillar 1 blueprint for justification. There is no reason to speculate further on all the ways the amount A discussion in the pillar 1 blueprint can be used; jurisdictions planning to use it as a cornerstone have ideas enough.

C. Creating Your Own Style

Beyond the big-picture ideas and providing rationale and cover for particular designs, the blueprints offer much practical guidance for would-be builders of less-grandiose buildings.

The pillar 1 blueprint provides detailed revenue-sourcing rules for automated digital services and consumer-facing businesses, along with guidance on how to apply the rules. The profit allocation method in chapter 6 may have been designed with those services and businesses in mind, but enterprising jurisdictions might not feel bound to limit themselves to only those businesses — or even to the quantum of amount A — and might apply the formulary approach more broadly. Even jurisdictions that stay in the suggested scope of amount A might follow some version of steps 1 (profitability threshold) and 2 (reallocation percentage) to justify their tax bases and either skip step 3 (allocation key) or adopt aggressive positions for the amounts they have a right to tax. Those jurisdictions aren't likely to worry about the double-counting problem described in the blueprint.

For jurisdictions that remain in building mode, either individually or in regional (or otherwise like-minded) groups, the income inclusion and switchover rules in the pillar 2 blueprint provide a fairly well-fleshed-out model for a minimum tax. At the very least, the pillar 2 blueprint gives jurisdictions something beyond the global intangible low-taxed income rules as a starting point. Similarly, the undertaxed payments rule gives source jurisdictions a conceptual method and specific suggestions for protecting or enhancing their tax bases, particularly in contrast to the base erosion and antiabuse tax. Jurisdictions seeking to expand source taxation more generally have the pillar 2 blueprint's inclusion of a subject to tax rule.

Jurisdictions that use effective tax rates in their controlled foreign corporation or other tax rules have ideas to consider and can benefit from other countries' lessons, as described in the blueprints. Jurisdictions seeking to simplify some of their rules will find ideas in the blueprints, especially if they are willing to accept rough justice in the interests of decreased complexity and increased certainty.

Both blueprints give a jurisdiction interested in requiring a company to calculate tax liability using financial reporting, especially consolidated financial reporting, a lot to work with. For a tax base that looks to consolidated financial accounts, not just the income of the specific entity, chapter 5 of the pillar 2 blueprint is a pretty good instruction manual.

Jurisdictions seeking to encourage tax certainty have approaches, albeit mostly hortatory. The pillar 1 blueprint includes processes to improve tax certainty through effective dispute prevention and resolution mechanisms. My fear, however, is that if this turns into a do-it-yourself project for inclusive framework members, rather than part of a broader compromise, the provisions on eliminating double taxation and on tax certainty specific to amount A will be ignored, with the ensuing problems addressed only through regular double taxation relief. Even so, one hopes the ideas regarding dispute prevention and resolution other than for amount A could be used by a more select group of jurisdictions — perhaps the early adopters of mandatory binding arbitration. Those include steps 1 (improvements to dispute prevention processes), 2 (improvements to the mutual agreement process), and 3 (a binding dispute resolution mechanism beyond amount A).

The pillar 1 blueprint also suggests a multilateral instrument for dispute resolution. Regardless of what happens on digital taxation generally, those ideas deserve further consideration. Even without a full-fledged tax treaty, taxpayers could benefit from an arrangement in which jurisdictions can exchange information and agree to resolve domestic taxation in a coordinated way. Even if there were no changes to substantive law, clear procedures for taxpayers seeking resolution would be great.

III. Conclusion

Sometimes, goals are appealing — even tantalizing — but remain elusive because there is no clear pathway to implementation. Despite the topicality of the blueprints, many of the concerns they seek to solve are long-standing ones. The problems have not gotten any easier to solve, and bulldozing through them pushes them out of the line of sight rather than solving them. One can be frustrated by the lack of progress and put off by the complexity associated with making the various trade-offs necessary to effect a fair and lasting solution.

But simple solutions, such as the proposed article 12B of the U.N. model treaty and digital services taxes, create their own problems even if they avoid the daunting complexity of pillar 1. Any new rules require careful consideration of trade-offs. Excessive complexity is to be avoided, but solutions that ignore problems caused by their simplicity are going to have consequences that should be foreseeable. Tunnel vision may be good for focus, but it means ignoring what is happening around you, and that never leads to a stable, long-term outcome.

Selective use of aspects of the blueprints poses dangers. First, just because a provision was included in the blueprint does not make it internationally accepted. Whether a provision deserves implementation should depend on its merits, not simply its inclusion in a compromise-driven document. Similarly, just because a problem has no good answer doesn't mean that any answer is as good as another. If jurisdictions' line-drawing becomes too arbitrary, ideas that are too complicated to be implemented might enter into force anyway thanks to rationalizations. For example, figuring out whether payments are undertaxed is hard, as shown in the discussion of the undertaxed payments rule. Short-circuiting that analysis by determining whether a payment is undertaxed based simply on whether it goes to a country on a good or bad list is sidestepping the obstacle, not solving it.

The blueprints were written by a committee, and a large one at that. They reflect compromises, and it will be concerning if jurisdictions choose preferred parts while conveniently ignoring others. Samson reputedly used a donkey's jawbone to slay a thousand men. More dangerous weapons could lie in the rubble if pillars 1 and 2 collapse. ■