HOW SOON IS NOW? O.E.C.D. STARTS WORK ON A SUBSTITUTE FOR UNILATERAL DIGITAL ECONOMY FIXES

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Tags
Arm's Length Standard
Digital Economy
Nexus
P.E.
Transfer Pricing

> When you say it's gonna happen 'now'
> When exactly do you mean?
> See I've already waited too long
> And all my hope is gone
>
> – The Smiths, "How Soon Is Now?"

This month finds the arm's length principle continuing to operate among O.E.C.D. Member States and the broader inclusive framework working toward international tax reform of the digitized economy. In a little more than a year, this may be different. The O.E.C.D.'s work plan[1] for urgent policy development will investigate a new nexus standard and departures from the arm's length principle in certain circumstances where the approach underlying decades of global entente may no longer be suited. The O.E.C.D. aims to release final guidance late in 2020.[2]

Meanwhile, the stakes in transfer pricing controversy and G-20 public finance policy are high. O.E.C.D. Member States and the broader "inclusive framework" nations have not reached international consensus but, nonetheless, demand urgent delivery of a policy solution from the O.E.C.D. At the same time as the O.E.C.D. is doing its work, its members and other inclusive framework nations are proposing and enacting new income taxes on digital services and advertising revenue.

In its role as a consensus-building organization, the O.E.C.D. has synthesized three competing proposals concerning permanent establishment ("P.E.") and attribution of profit to P.E.'s for digital economy companies. This synthesis is called the "Unified Approach." The current debate between tax administrations concerning the attribution of profit to digital or non-physical P.E.'s features three popular approaches:

- A modified residual profit split method that introduces a new simplified convention for dividing non-routine profit deemed to be subject to tax within a newly defined digital P.E.
- A fractional apportionment method that departs from the residual profit split approach in favor of developing a formula used to allocate total group profit to identified market jurisdictions
- A series of distribution-based approaches that modify existing marketing and distribution pricing mechanisms to identify baseline profit attributable to

[1] O.E.C.D. (2019), Programme of Work to Develop a Consensus Solution to the Tax Challenges Arising from the Digitalisation of the Economy, O.E.C.D./G-20 Inclusive Framework on B.E.P.S., O.E.C.D. Publishing, Paris.

[2] O.E.C.D. Centre for Tax Policy and Administration, Public Consultation Document: Secretariat Proposal for a "Unified Approach" Under Pillar One, October 9–November 12, 2019.

marketing, distribution, and user-related activities and then identify and allocate non-routine profits to certain market jurisdictions[3]

For the proposed unified profit attribution approach to apply, (i) a company's activity in a foreign market jurisdiction must meet the new nexus standard, (ii) the company must exceed a consolidated global sales threshold, and (iii) the business sector of a company must fall outside proposed industry carveouts for the financial, extractive, and commodities sectors. The €750 million country-by-country reporting threshold has been suggested as a reference point. This threshold has become widely popular in proposals attempting to regulate global businesses without adversely affecting larger local businesses.

Notable in the public consultation document is an indication of the intent of the working group to examine an expanded application of the new digital nexus and profit-attribution rules to all companies that are "consumer-facing businesses." The term "consumer" is defined in such a way as to refer to individuals who acquire or use goods and services for personal purposes and is synonymous with the term "user" in the public consultation document. Almost certainly, these terms will have broad implications, which may prove difficult to foresee, for companies with multi-sided business models.

The proposed operation of the new nexus rule would depend on a specified revenue threshold in a particular market, with some consideration made for the size of a country's market. The sources of revenue that contribute toward the threshold amount include online advertising services directed at nonpaying users, remote sales to customers located in the market jurisdiction, and sales made to related or unrelated distributors located in the market jurisdiction. In designing the nexus standard, the O.E.C.D. has been careful to note that the objective is business model neutrality and the ability for the nexus standard to be used in allocating taxing rights under new, yet-to-be-developed business models.

A possible effect of the proposed rules is a move toward local incorporation of customer-facing businesses and a greater reliance by multinationals on intercompany licensing and other business-to-business transactions that are judged under more traditional arm's length transfer pricing rules.

THE ABC'S OF TAXING THE DIGITAL ECONOMY

At the heart of the profit allocation method proposed under the Unified Approach is a three-tiered mechanism.

The following example of a global streaming services company with both physical and digital presence in a market jurisdiction illustrates the approach to calculating the three amounts or sources of market jurisdiction profit:

- Amount A is a percentage of global residual profit. Under this alternative, a resident company that has a non-physical or digital nexus that meets the revenue threshold is deemed to earn W%, the residual profit of the global group or business line. Group or business line consolidated global profit is Z%. Routine profit of the same global business line is X%. The proportion

[3] *Programme of Work, op. cit.*, Chapter II.

W% of the residual Z% - X% is taxable in the jurisdiction. W% is to be either fixed by formula or fixed by formula with some variation by industry and will itself be a residual after consideration of profit attributable to other factors such as trade intangibles.

- Amount B is a fixed baseline or routine marketing and distribution return for activities taking place in the market jurisdiction. The baseline will be determined as a function of either a single fixed percentage, a percentage that varies by industry or region, or some other agreed method.
- Amount C is an arm's length return for marketing and distribution activities in excess of the functionality reflected in the fixed return under the baseline approach in Amount B but not overlapping the result of the residual profit approach in Amount A.

"A particular area of oversimplification and concern is the blurring of the comparable profit split method (the transactional profit split in O.E.C.D. terms) with global formulary apportionment."

The public consultation document indicates that most dispute resolution will be required under a Mutual Agreement Procedure ("M.A.P.") and mandatory binding arbitration articles of applicable income tax treaties in respect of the arm's length return in Amount C. Other multilateral policy changes would be implemented across Articles 7 and 9 of applicable income tax treaties in a manner broadly consistent with the Multilateral Instrument used to implement the various B.E.P.S. recommendations. Public commentary has been requested on definition, measurement, administration, and dispute resolution aspects of the proposed Unified Approach.

In the U.S., the arm's length standard looks at its O.E.C.D. cousin with no immediate plans for a new hairstyle, exploration of a different musical genre, or additions to its spring wardrobe. In general, the I.R.S. position has been that a better understanding and quantification of the profit effects of marketing intangible development and use can mitigate double taxation and that other analytical tools are preferable to resorting to the blunt instrument of profit apportionment. The time to choose will come again for the I.R.S. and Treasury.

In the meantime, there are double tax cases to be resolved with tax authorities that find some transactional and traditional transfer pricing methods too cumbersome to apply. These tax authorities appreciate the apparent simplicity of the profit split method and the brilliance (and magnitude) of the result. See our article "A New Way to Do the Splits" for a discussion of technical developments that contribute to the O.E.C.D. digitalization work plan. Like it or not, the profit split method is now in fashion.

HOW SOON IS NOW FOR A NEW APPROACH?

A particular area of oversimplification and concern is the blurring of the comparable profit split method (the transactional profit split in O.E.C.D. terms) with global formulary apportionment. Eager for simplification and perhaps foreseeing some fraying of the consensus around the arm's length principle, certain tax authorities in North America – meaning C.R.A. in Canada – and further afield are seeking to pass off global formulary apportionment results for transactional profit split method outcomes.

Despite the rejection of formulary apportionment by the O.E.C.D. Member States in 2017, this tax administration practice is being employed with respect to tax years that predate 2017 multilateral guidance from the O.E.C.D. and in rule regimes where relevant guidance from case law is nonexistent. This should not come as a surprise, as many O.E.C.D. Member States apply retroactive effect to income tax treaties when and as the O.E.C.D. model is revised.

In a sense, treaties should be viewed as a dynamic agreement that changes with the time and philosophy of the O.E.C.D. Member States and other tax administrations participating in the inclusive framework.

Ongoing controversies may find their way in two or three years' time to the Competent Authorities of O.E.C.D. Member States that reference the forthcoming 2020 O.E.C.D. guidance when resolving a double tax issue through a M.A.P. Then again, not all treaty partners may apply the forthcoming guidance in the same way. Companies involved in certain types of transfer pricing controversy, whether with the I.R.S. or with foreign tax administrations, should tread carefully during this period of policy transition.

The most recent definition of global formulary apportionment is found in the 2017 O.E.C.D. Guidelines[4] and can be defined by the three steps taken to obtain its result:

- Determining the unit to be taxed, *i.e.* which of the subsidiaries and branches of an MNE group should comprise the global taxable entity;
- accurately determining the global profits; and
- establishing the formula to be used to allocate the global profits of the unit. The formula would most likely be based on some combination of costs, assets, payroll, and sales.

Global formulary apportionment is also defined by what it is not; that is an application of the profit split method under the arm's length principle:

> Global formulary apportionment should not be confused with the transactional profit methods discussed in Part III of Chapter II. Global formulary apportionment would use a formula that is predetermined for all taxpayers to allocate profits whereas t**ransactional profit methods compare, on a case-by-case basis, the profits of one or more associated enterprises with the profit experience that comparable independent enterprises would have sought to achieve in comparable circumstances** [emphasis added].

Global formulary apportionment is the transactional profit split method without the comparability analysis or demonstration by some other means of the division of profit that would result from a transaction or other dealings between independent enterprises.

While it is not necessarily the case that any analysis that does not reference comparable circumstances is an application of formulary apportionment, it remains true that such an analysis is not consistent with an O.E.C.D. transfer pricing method or the arm's length principle. Rather, it is consistent with unitary taxation in California, absent a water's edge election.

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[4] O.E.C.D. (2017), O.E.C.D. Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations 2017, O.E.C.D. Publishing, Paris.

This approach is distinct from the digitalizing economy profit attribution proposal under the Unified Approach that seeks to build consensus and retain a principled approach to minimize future double tax disputes in an environment of significant political pressure.

CONCLUSION

No matter how packaged, the mood in the O.E.C.D. when it comes to tax jurisdiction is that market matters and global taxing rights should be allocated based on market activity and attributes. Brainpower and manufacturing prowess are less important in this approach.