

O.E.C.D. TO USE HYBRID MODEL TO DEVELOP DIGITAL ECONOMY NEXUS AND PROFIT ATTRIBUTION RULES

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Tags

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Transfer Pricing

Unified Approach

INTRODUCTION

The O.E.C.D. announced on January 31, 2020, that its policy development efforts under [Pillar One](#), related to the taxation of the digital economy, will move forward using the non-consensus “Unified Approach” as a working model.¹ In the interest of averting the negative worldwide welfare effects of trade countermeasures to unilateral Digital Services Taxes, the O.E.C.D.’s deadline for obtaining a consensus outcome is highly ambitious. Consensus outcomes for Pillar One and its less controversial, but nonetheless complex, Pillar Two counterpart are expected by the end of 2020 – a relative blink of an eye when we recall that the groundbreaking B.E.P.S. Project began in 2012 and produced drafts in 2015.

POLICY CHALLENGES

The policy development and consensus-building effort will be led by the O.E.C.D. Center for Tax Policy and Administration. It will seek input and contend with criticism from a group of 137 tax administration representatives, known as the Inclusive Framework (“I.F.”).

The January 31 release and subsequent O.E.C.D. comments confirm that the target multinational corporate taxpayer will be determined using the same global sales test that applies to the Country-by-Country Reporting rules – that is approximately \$810 million at the current exchange rate. Preliminary estimates of the gain in tax revenue resulting from the proposed policies (currently 4% of global corporate income tax revenue) indicate that more than half of the reallocated profit will come from 100 multinational companies.

The I.F. members will have a difficult technical hill to climb while constantly evaluating the net benefit to their own treasuries, negotiating each step carefully.

The fundamental question is to identify those businesses that fall within the scope of the new rules. The answer poses a challenge. Initially touted as a regime for consumer-facing businesses, the anticipated list of businesses has been broadened to include automated digital services such as search engines, social media platforms, online marketplaces, and content streaming, gaming, cloud computing, and online advertising services. Consumer-facing businesses are tentatively defined to include (i) direct-sale operations, (ii) businesses that sell through resellers or intermediaries, and (iii) franchising and licensing businesses.

¹ See the O.E.C.D. statement on [“International Community Renews Commitment to Multilateral Efforts to Address Tax Challenges from Digitalisation of the Economy”](#) and [“O.E.C.D. Unified Approach Garner Less Unified Comments from Europe’s Tech Producers and Users”](#) from *Insights*.

Weighting factors are yet to be negotiated. These factors will be applied to identify and value (i) the residual profit of Amount A (*i.e.*, the new taxing right) to account for “digital differentiation” or different degrees of digitalization between in scope business activities, (ii) the all-important routine return that will serve as the threshold for the calculation of the residual profit under Amount A, and (iii) specific returns to market jurisdictions or regions.

In addition to anticipating and controlling for overlap and duplication resulting from the consensus formulae, the very fundamental question of a company’s ability to gather accurate sales data for the purpose of sourcing revenue to market jurisdictions and distinguishing between the jurisdiction of purchase and the jurisdiction of use or viewing is still to be resolved. It would appear at present that this problem will be handed to multinational companies to solve, much like Country-by-Country Reporting, which will result in much complaint followed by a consulting fee windfall.

Just as the peak of the hill becomes visible as the days get shorter in 2020, further challenges are anticipated in connection with the operation of the income tax treaty system, which usually relies on there being a transaction between controlled residents to effect resolution of double taxation. Under the Unified Approach, income can be allocated without satisfying the necessary condition of a controlled transaction. To achieve the intended policy outcome, significant changes to the mechanisms used by companies and tax authorities to adjust profit and resolve disputes will be required, including another series of multilateral-instrument-like treaty amendments. In principle, an essential policy feature will be the adoption of a mandatory and binding dispute resolution system to resolve disputes between tax administrations. While lip service to the adoption of a dispute resolution mechanism is popular, moving from concept to implementation has proved to be an ongoing point of disagreement between countries.

SAFE HARBOR PROPOSAL

Should the I.F. come to a consensus before the end of 2020 and agree to join hands and attempt to reach the summit of the technical hill, it will do so knowing it will meet the U.S. Secretary of the Treasury Steve Mnuchin on the way. Secretary Mnuchin has supported the type of multilateral solution the I.F. seeks and has proposed that Pillar One be implemented as an opt-in safe harbor. The O.E.C.D. has decided to address the safe harbor issue when all other matters have been resolved.

Given that the mood of large U.S. tech companies seems to be leaning in favor of abandoning the arm’s length standard in a selective way in exchange for tax certainty, the safe harbor proposal appears to be a potentially viable strategy to play if the objective of the I.R.S. and Treasury is the resolution of multisided tax controversy for its very largest tech firm taxpayers while maintaining the arm’s length standard and the ability to defend the corporate income tax base for the great majority.

A FINAL POSITIVE EXTERNALITY

It seems we must conclude on a positive note, as the prospect of an unavoidable hike through transfer pricing policy “Mordor” may be an unsettling idea. We are pleased to report that an unambiguously positive byproduct of the December 2020 O.E.C.D./G-20 deadline has been a renewed focus on the measurement of the

various aspects of the digital economy by national statistical agencies under the direction of the O.E.C.D.'s economics and statistics staff.² These efforts stalled in 2013 during the initial B.E.P.S. Project and have been resuscitated in the interest of measuring expected policy outcomes (*i.e.*, the increase in corporate tax revenue) at the firm level.

Despite what people may think about when this effort should have begun, it is crucially important that it has finally begun in an organized way. Data collection to date has focused on aggregate or national income statistics instead of firm-level data. Examples of useful data now getting serious consideration include (i) user counts or impressions by country, (ii) expenditure statistics of various types, (iii) sales by country in line with a common nexus standard, and (iv) employment and income by relevant occupation type. While they may not all become public statistics, these micro-level data are essential to the uniform and accurate application of the new Unified Approach.



² See "[Webcast: Update on Economic Analysis and Impact Assessment](#)" from the O.E.C.D.

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