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# INSIGHT: Slicing the Shadow: OECD Consultation Highlights Profit Allocation Difficulties

BY JEFFERSON VANDERWOLK

"Allocating income among various taxing jurisdictions bears some resemblance . . . to slicing a shadow. In the absence of a central coordinating authority, absolute consistency, even among taxing authorities whose basic approach to the task is quite similar, may just be too much to ask."

Although this would have been an appropriate observation during the Organization for Economic Cooperation and Development's (OECD's) recent public consultation meeting in Paris on proposals regarding the tax challenges of digitalization, it was actually said in 1983 by the Supreme Court majority in *Container Corp. v. Franchise Tax Board*. The justices were talking about the constitutionality of a state law (California's franchise tax, which was based on formulary apportionment of the worldwide income of a corporate group), but the comment is equally applicable in the context of national income tax laws that apply to the various members of a multinational group.

The OECD-led Inclusive Framework of 129 countries is aiming to reach consensus on a profit allocation method for the taxation of cross-border business income. On Feb. 13, 2019, the OECD issued a public consultation document on "Addressing the Tax Challenges of the Digitalisation of the Economy" containing three policy proposals on "Revised profit allocation and nexus rules." Voluminous submissions were made within a three-week comment period, and international tax policy specialists then gathered in Paris in mid-March to discuss the issues.

One important point to note at the outset is that there is already an agreed standard for allocating profits to a business entity for income tax purposes: the arm's-length standard, as articulated in Article 9 of the Model Tax Conventions of both the OECD and the UN and in the transfer pricing guidelines of those organizations. Some of the countries in the Inclusive Framework seem to be of the view that digitalization is causing problems with the operation of the arm's-length standard in practice. The recent proliferation of new taxes on revenue from the sale of online advertising space and other digitalized services is cited as evidence of a need to change the prevailing international tax standards in a way that would allocate more profits to taxpayers in countries where customers are located.

Among the many comments on the OECD's consultation document, perhaps the most fundamental was the question of what, exactly, is the problem that the proposals are intended to solve? Is it that the current nexus standard for the exercise of taxing rights—the definition of permanent establishment in Article 5 of the Model Tax Conventions—allows non-resident companies to earn sales profits through the internet that are not taxable in the country where the purchasers are located? Or is the problem that the transfer pricing rules allocate too little profit to the sales and marketing end of the value chain—or fail to allocate any profits to contributions made by agencies outside the business itself, such as data provided by users or public goods and services provided by the government where customers reside?

No answer has yet emerged from the OECD-led process. If the problem is with the nexus standard, then it seems unnecessary to seek a new way of "slicing the shadow" using new profit allocation rules. Yet, remarkably, the discussion of the nexus and profit allocation proposals at the consultation meeting was mainly focused on profit allocation. Many speakers took it as given that the Inclusive Framework had already decided to change the rules so as to allocate more profits

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to countries where customers are located, even though the OECD's consultation document made it clear that all of the proposals were ''without prejudice'' to existing policy standards, and one of the proposals (the so-called user-participation proposal) would allocate profits not on the basis of paying customers but on the basis of users contributing data (no matter how minimal) or editorial content.

Indeed, some business representatives at the public consultation meeting appeared resigned to accepting whatever changes might ultimately be agreed on by the Inclusive Framework, provided that multinationals would not be subjected to double taxation and would have the benefit of simpler and clearer income tax rules. Perhaps this reflects concern about unprincipled tax audits as well as continued unilateral tax measures against multinationals if the Inclusive Framework fails to agree on any of the proposals. But if the new agreement is going to be about profit allocation, the Supreme Court's warning about the difficulty of slicing the shadow needs to be kept in mind.

Absolute consistency of profit allocation for tax purposes, among a large group of sovereign taxing states, is probably too much to hope for. Therefore the multinational business community might be better off advocating for a more realistic approach to achieving a more clearly defined goal (including, for example, adoption of mandatory binding arbitration).

*Jeff VanderWolk is a partner at Squire Patton Boggs in Washington.*