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INSIGHT: Tax and Digitalization—Policy Should Not Be Based on Myths

BY JEFFERSON VANDERWOLK

The OECD-led Inclusive Framework on BEPS is continuing to pursue its program of work on the tax challenges of digitalization, which aims to reallocate non-routine multinational business profits in favor of market countries (Pillar 1) while also creating a global minimum tax regime (Pillar 2). The current status of the project is that the OECD Secretariat has prepared draft reports on ''blueprints'' of the proposed Pillar 1 and Pillar 2 regimes, and has sent those draft reports to the member countries of the Inclusive Framework for comments which will be considered by the Framework's steering group in early September.

The reports will then be finalized and submitted to the full Framework in early October. Assuming the reports are approved (perhaps subject to reservations by certain member countries, or more generally subject to being ''without prejudice'' to the views of all member countries), the reports will then be delivered to the G20 finance ministers in time for their mid-October meeting. It is widely expected that the report on the Pillar 1 blueprint will leave unfinished a number of crucial elements of the proposed regime, such as the formula to determine how profits of a multinational group would be reallocated to market countries. The draft blueprint says that some of these elements will require political decisions by the Inclusive Framework. The report on the Pillar 2 blueprint will probably have fewer unfinished items, although it is not likely to specify the component on which the entire pillar hinges, namely, the minimum tax rate.

Alongside the work of the OECD and the Inclusive Framework, the UN Committee of Experts on International Cooperation in Tax Matters has been discussing issues related to digitalization as well. Although the UN Committee has not yet published any proposals, it is reportedly considering a proposal to use global formulary apportionment (also known as fractional apportionment) to allocate both routine and non-routine profits (i.e., total profits) of multinationals to the market jurisdictions where customers or users of their services reside. This idea was suggested in late 2018 to the Inclusive Framework by India and some other developing countries, but was not incorporated into the Pillar 1 proposal that emerged in 2019.

Given that tax officials of India and other developing nations are participating in both the Inclusive Framework and the UN Committee, it would appear that the global formulary apportionment concept might re-emerge in the deliberations of the Inclusive Framework. India has pioneered other tax ideas that are gaining traction with other countries, with its equalization levy on payments to nonresident businesses for online advertising (imitated by digital services taxes elsewhere), and its significant economic presence standard for tax nexus (which has been considered by the Inclusive Framework but not adopted in the draft Pillar 1 blueprint).

It is worth considering the policy arguments that are being made for the proposed reallocation of profits under Pillar 1 (and for digital services taxes), and for the global formulary apportionment concept.

The European Commission argued, in its DST proposal in March 2018, that multinationals providing digital services were paying far less in income taxes than multinationals in other industries. In doing so, it cited specific effective tax rate calculations that have never been fully explained, and were publicly disputed by the economists whose work was cited as the basis for the calculations. Nevertheless, the idea that large internet-based businesses are not paying their ''fair share'' has been repeatedly asserted by European politicians, whose words are then reported in the press without qualification. The Covid-19 pandemic has prompted those same politicians and others to assert in addition that digital services providers need to be taxed more heavily because their services have been in great demand during the economic shutdowns caused by the pandemic. Inevitably, heavier tax costs would be passed on to consumers, but the politicians prefer to remain silent on that inconvenient fact.

It needs to be recognized that, regardless of exactly how the European Commission computed the effective tax rates that it cited in early 2018, it had to have been using data from earlier years, before many (if not all) of the digital services companies in question had restructured their global operations in light of the likely implementation by many countries of the BEPS Project recommendations made in late 2015. In truth, these companies now pay income taxes along with all of the other taxes payable by resident businesses in the markets in which they have established reseller entities. Their local profit margins are determined for tax purposes using the updated transfer pricing guidance resulting from Actions 8-10 of the BEPS Project. Anecdotal evidence suggests that, in many market jurisdictions, including some OECD member countries, tax auditors are unreasonably demanding that these businesses report taxable profits significantly in excess of an arm's-length return.

Thus, the narrative that digital multinationals are not currently paying their fair share in market countries is a myth. The fair share of tax owed by any nonresident business, as a policy matter, is the local country tax on the amount of profit that would be expected from arm's-length dealings with respect to the taxpayer's activities in the taxing jurisdiction. To the extent that the digital services providers are using resident entities in market jurisdictions and doing their transfer pricing according to the updated rules, they are undeniably paying their fair share of tax in those jurisdictions.

In effect, some market countries are attempting to tax the digital services sector as though the law provided for global formulary apportionment (which it does not), allocating global profits, both routine and non-routine, among countries on the basis of sales to local residents or the number of local users of the taxpayer's services. The thinking appears to be, ''They are making profits because our residents are buying, or using, their services, so we should be able to tax the part of their total profit that is proportional to our market.''

This also is a myth, as it overlooks the important fact that another reason for the profits is massive spending on research and development, and network infrastructure, outside of those market countries. That spending is deducted in computing the companies' income tax liability in the places where the R&D is conducted and the network infrastructure is located. Why should the countries that have made that investment in the success of those businesses be denied the ability to collect income tax based on the full measure of profits that are attributable to the R&D efforts and capital investments?

The Inclusive Framework process is clearly a politically driven one. If politics is the art of compromise, perhaps the member countries will eventually settle on a deal that gives everyone a bit of what they want. But it is important to make policy based on reality, not myth.

The international business community, understandably, wants tax rules that are reasonably clear, consistent, administrable by taxpayers and governments alike, and not punitive. The Inclusive Framework could probably achieve that, with regard to profit allocation to markets at least, by tweaking the current rules to introduce a formula that reallocates a modest amount of a multinational's non-routine profit to its markets. We won't know the outcome until a future year, but there is still hope that the outcome will be reasonable.

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