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INSIGHT: The OECD's Tax Policy Process on Digitalization—Minimizing the Risk of Unintended Damage

BY JEFFERSON VANDERWOLK

''Primum non nocere'' (''first, do no harm'') is an ancient tenet of medical practitioners. It should also be borne in mind by policymakers—especially those making tax policy.

As everyone in the multinational tax world knows by now, the OECD-led Inclusive Framework of 129 countries is committed to delivering a report to the G20 leadership next year on how to address the tax challenges of the digitalization of the economy. There is a strong political push to find a consensus-based ''solution'' that will be seen as closing loopholes believed to be currently available to multinationals, while at the same time acting as a broad-spectrum antibiotic against unilateral digital services taxes that have been spreading throughout the world.

The Inclusive Framework is expected to finalize a detailed program of work in late May 2019. The work plan will most likely be structured along the lines of the proposals in the public consultation document issued in mid-February, with two ''pillars.'' Pillar One contains proposals that would, according to the consultation document, ''expand the taxing rights of the user or market jurisdiction'' with respect to cross-border business income. Pillar Two has a global minimum tax proposal, put forward by France and Germany.

The author has previously commented on some of the many questions about these proposals and will not rehash those comments now. Rather, this short article will consider the outlook going forward—what is likely to emerge from this process, and how can the risk of bad results be minimized?

A threshold question is whether the process will actually produce an agreement. It's a fairly safe bet that 129 sovereign nations will not all sign up to implement the same tax policy on multinational corporate profits. However, that doesn't mean that the process will be considered a failure. Agreement among a critical mass of countries, representing a majority of the Inclusive Framework and a majority of the global economy, will probably be sufficient to support a recommendation to the G20. And that recommendation could be worded in a manner allowing each country to interpret it in a way acceptable to them, allowing broad acceptance of the recommendation but creating more uncertainty for taxpayers.

Therefore, it is likely, given the political climate, that some sort of solution will be devised. What will it look like? And what damage might it do?

That question is easiest to answer with regard to Pillar Two, the global minimum tax. There are no competing proposals here, only design challenges. There will be an inclusion rule for low-taxed income of controlled foreign companies and branches, in residence countries, and an anti-base erosion rule for payments to low-taxed foreign affiliates, in source countries. The big issues include the minimum tax rate and the mechanism for avoiding double taxation. If (and it is a big ''if'') the rules can be designed to achieve single taxation at a global level, at a reasonable minimum rate and in a predictable manner, little or no harm should result.

The greater risk of harm appears to lie in Pillar One, where the proposals involve fundamental concepts of source-based taxation of cross-border income: nexus (i.e., jurisdiction to tax) and allocation of income among countries. The proposal perceived as most likely to succeed is the so-called ''marketing intangibles proposal'' championed by the U.S., which as its name suggests would modify current profit allocation and nexus rules to ensure that some part of the non-routine income of a multinational business attributable to marketing intangibles would be allocated to the market jurisdiction, regardless of whether the business has a physical presence there. The proposal is not explicitly limited to any particular type of business or industry. According to the consultation document, it would apply ''in all situations in which businesses have significant marketing intangibles that can be attributed to customers of a jurisdiction.''

It is possible that the marketing-intangibles approach will be combined in the work plan with a proposal advanced by the U.K., the ''user contributions proposal.'' This would attribute some non-routine profits to a country based on the data or other content contributed by residents of that country to the business, and would be limited to internet-based businesses such as search engines, social media, and marketplaces connecting suppliers and customers. Additionally, it is possible that a third proposal, the ''significant economic presence'' approach put forward by India, will form part of an attempted synthesis of the three proposals aimed at the goal of finding consensus.

The risk associated with the Pillar One proposals (or potential combinations of them) is that the consensus requirement might lead to a compromise that abandons established principles of taxation (regarding both jurisdiction and income allocation) in favor of a perceived quick fix, leaving multinationals vulnerable to revenue grabs wherever consumers of their products or services are located. The desire for simplicity and certainty, which is shared by taxpayers and governments alike, could result in an agreement on a ''solution'' that is little more than a fixed formula for divvying up a multinational group's profits between the countries where customers or users are located, without regard to whether the group actually has significant marketing intangibles, or net profits, attributable to a particular country.

To minimize potential damage, the Inclusive Framework should concentrate on finding an approach that is limited in terms of both scope of coverage and degree of reallocation of profits. The scope should be restricted to large multinationals (such as groups subject to country-by-country reporting) and to non-routine profits from sales into markets where the group's sales revenue is disproportionate to its local functions, assets and risks. Where the new rule does apply, the amount of profit reallocated should be a limited, modest amount. To minimize compliance burdens, the tax administration of the group parent company's country of residence should be solely responsible for auditing the group's compliance with the new rule. That tax authority could then share information with relevant countries as appropriate (similar to the sharing of country-by-country reports) to enable those countries to assess and collect the taxes due.

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Jeff VanderWolk is a partner at Squire Patton Boggs (US) LLP in Washington.