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Technical Questions Remain In Simplified Global Tax Proposal

By **Natalie Olivo**

Law360 (July 20, 2021, 6:06 PM EDT) -- Countries are finalizing new tax rules for corporations that earn significant profits in jurisdictions without needing a physical presence — and while this conceptual threshold appears simpler than previous proposals, underlying technical questions remain about identifying consumers and tracking revenue.

The agreement of more than 130 countries on **a** comprehensive rewrite of the international tax rules announced by the Organization for Economic Cooperation and Development this month includes a reallocation of large multinational corporations' residual profits to jurisdictions where they have customers but no physical presence. Specifically, the measure would apply to companies with a global turnover above €20 billion ($23.6 billion) and profitability above a 10% margin, according to the OECD, which said final rules will be released in October.

This latest proposed scope for the rules no longer includes taxation categories for automated digital services and consumer-facing businesses. These terms had prompted criticism in the past from the U.S. government and major streaming platforms, including Netflix and Spotify, which argued the categories were "arbitrary and highly complex."

Specialists say this new mechanical approach gets to the heart of the matter — companies earning a lot of profits remotely — but how to source revenue to market jurisdictions in different remote transactions is far from clear. Even without terms like "consumer-facing businesses," there are still questions about how to identify consumers when companies have, for example, eyeballs looking at advertisements, according to Lilian Faulhaber, a tax law professor at Georgetown University Law Center.

"I think these are just inherent questions that are built into trying to tax the type of transactions that we have now, that were not previously being caught by our international system," she said.

From "Digital Business Models" to Profitability

The Paris-based OECD began mulling what it called "tax challenges of the digital economy" as part of its project on base erosion and profit shifting. Concluding that it would probably be impossible to "ring-fence" digital transactions, the organization held off on issuing related proposals along with other BEPS recommendations in 2015.

As the OECD continued to lead discussions on the issue, some countries moved forward with their own digital services taxes. The U.S. government responded by threatening retaliatory tariffs against the measures, which officials claimed unfairly targeted the U.S. technology sector.

In October 2019, the OECD aimed to discourage more unilateral measures with the introduction of a two-pronged approach — Pillar One and Pillar Two — that would **create new taxing rights** while also seeking agreement on a global minimum tax. The organization said Pillar One's profit reallocation rules, which fall under a new taxing right called Amount A, would cover "highly digital business models" in addition to consumer-facing businesses, including those that sell products through intermediaries.

As the OECD continued to fine-tune the proposal, the U.S. in April pushed for a simplified Pillar One scope, contending that the measure should cover only the most profitable companies. According to the U.S. government's presentation to the OECD, the plan could focus only on those "that benefit most from global markets, are most intangibles-driven and are equipped to handle the compliance burden that Pillar One entails."

The latest version of Pillar One was released by the OECD on July 1 and has since received support from more than 130 jurisdictions. The €20 billion turnover threshold for profit allocation under Amount A could be reduced to €10 billion, "contingent on successful implementation, including of tax certainty," according to the OECD, which said it would review the agreement seven years after it's implemented.

This mechanical set of tests for the scope of Pillar One certainly moves the focus of this project away from digitalization, but that's not a new shift, according to Barbara Angus, EY's global tax policy leader.

She cited a recent endorsement of the proposal by finance ministers from the Group of Seven wealthy countries, who said the new rules would address "the tax challenges arising from globalization and the digitalization of the economy."

As Angus saw it, "that's really a better way to look at this project, particularly when you factor in Pillar Two as well."

Earlier versions of the Pillar One proposal had included the concept of intangibles, such as valuable brand trademarks or data collected from users.

According to Faulhaber at Georgetown, the previous focus on intangibles was trying to get at what allowed companies to be really profitable. The new scope is just trying to say, "'what we care about is profitability,'" she said.

The new scope essentially asks two questions, Faulhaber said: Are companies earning a lot of money in the big picture, and "where do you have lots of consumers, but you don't actually have to be physically present?"

Lingering Technical Uncertainties

While the new scope for Pillar One appears to involve a more straightforward approach than previous iterations, several technical details have yet to be worked out, including revenue sourcing rules.

According to the OECD, sourcing rules determine the revenue that would be treated as deriving from a particular market jurisdiction. In a brief description of the latest proposal from July 1, the organization said revenue will be sourced to market jurisdictions "where goods or services are used or consumed."

In this context, "goods or services" could include items that a company sells to a distributor and otherwise have no connection to the market, according to Michael Lebovitz, a partner at Mayer Brown LLP. The company could meet the revenue and profitability threshold, but it might not know where its product ends up, he said.

"That was both the breakthrough and the challenge arising from changing this formulation from a focus on digital to just a focus on high profitability," Lebovitz said.

This approach makes sense because high profitability is driven by intangibles, and companies generally don't need a physical presence in a country to use their intellectual property, he said.

"That's the theoretical underpinning of the proposal, but it's going to create challenges from a sourcing standpoint," Lebovitz said.

Companies would also need to identify their consumers or users, including where they're located — a requirement that may not currently be on some corporations' radar.

Compliance efforts for Pillar One aren't the type that can be done at the end of the year, after companies recognize they fall within the regime, according to Jenny Austin, a partner at Mayer Brown. For internet-based or services-based companies, it takes a lot of work on the front end to make sure their information technology systems are tracking where users are, she said.

Laurie Dicker, a transfer pricing technical tax leader at BDO, similarly said that measuring a company's non-physical presence in a jurisdiction is an enormous challenge that is yet to be worked out.

She gave the example of a multisided digital platform that brings together buyers and sellers from different locations, raising the question of where a transaction takes place.

"There are absolutely a lot of implementation questions around that," Dicker said. "That's just one layer of them."

In the latest version of Pillar One, the OECD noted that "a detailed implementation plan together with remaining issues" will be finalized by October.

Austin said details of the Pillar One proposal will be critical. She also noted that the negotiations among countries aren't over.

"I think we're at the beginning stages of a new way of taxing companies," she said. "But I think there's a very long road to go before we actually get to a final agreement that could be implemented or agreed to by all the countries involved."

The Question of Scope Itself

As countries hash out the final details on how Pillar One would operate, the exact parameters of the new scope aren't quite clear yet.

The OECD has said these new tax rules would apply to about 100 of the largest and most profitable multinational corporations. Meanwhile, a slightly lower estimate of 78 affected companies was provided in a recent report published by the European Network for Economic and Fiscal Policy Research, or

EconPol Europe. The reports' authors reached their estimate based on the profitability threshold of 10% and the current carveouts for financial services and extractive companies.

For profit above this 10% threshold, the OECD's current agreement calls for 20% to 30% of this amount to be reallocated to market countries. According to the EconPol report, if this figure lands at 20%, then the total amount of reallocated profits would be $87 billion.

As for the types of companies that would be included under Pillar One, the report said this element is strongly affected by the definition of profitability: pre-tax profits as a proportion of revenue, rather than pre-tax profits as a proportion of equity invested. Among European companies with revenues above $20 billion, almost twice as many have a return on equity above 10% compared to those with a return on revenue above 10%, according to the report.

Pharmaceutical and tech companies are more likely to be included than companies in other sectors, but it's not easy to pin down the reason, according to Martin Simmler, a research fellow at the Oxford University Center for Business Taxation and one of the report's authors. He told Law360 that it could be the business model — where margins from sales are just larger compared to other industries — or it could be related to intangible assets.

Simmler noted that equity is not as easily observed as revenue. Meanwhile, he added, the pharmaceutical and tech companies that would be subject to Pillar One also have a return on equity above 10%, meaning they'd be included if the scope looked at equity instead of revenue.

"They would also be captured by the alternative measure," Simmler said. "But if the alternative measure is used, the industry distribution of firms subject to Pillar One would be closer to the actual industry distribution of large firms."

--Editing by Tim Ruel and Neil Cohen.
