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Cos. May Face Headaches Whatever Global Tax Plan's Fate

By **Natalie Olivo**

Law360 (August 10, 2022, 6:00 PM EDT) -- Multinational corporations awaiting the outcome of a massive global tax rewrite can likely expect either new profit allocation rules or a patchwork of unilateral measures designed to increase the tax take for market countries — and compliance headaches under each alternative.

An international agreement on new profit allocation rules would theoretically provide a uniform and administrable tax system, but the reality may involve complications that arise from layering a new regime on top of long-standing norms for dividing cross-border earnings, tax practitioners told Law360. Meanwhile, political hurdles may prevent countries from translating their deal into domestic legislation, prompting jurisdictions to return to the unilateral digital services taxes that spurred global negotiations in the first place.

As some tax observers see it, countries may revive their DSTs and enact new ones if they see a dead end for the profit allocation rules, which form the first pillar of the international corporate tax rewrite. Multinational corporations may ultimately treat DSTs as the cost of doing business — a scenario that could be more predictable than Pillar One rules — but complying with a potentially patchwork system could bring its own complications.

In an environment where multinational corporations want tax certainty, each scenario probably has more downsides than upsides, according to Jenny Austin, a partner at Mayer Brown LLP. Pillar One has unknowns, while DSTs wouldn't be uniform — and both situations involve complexity, she said.

"I think to some degree, we're in a no-win situation," Austin said.

The Path to Pillar One

The Pillar One rules form half of a two-pronged international corporate tax overhaul that was designed to create new taxing rights and a global 15% minimum effective tax rate. Nearly 140 jurisdictions agreed to the overhaul in principle in October after years of negotiations led by the Paris-based Organization for Economic Cooperation and Development.

The Pillar One regime would reallocate a portion of large multinational corporations' profits to market jurisdictions where businesses have customers but not a physical presence. The regime's scope is designed to cover only about 100 large multinational corporations — specifically, those with global sales above €20 billion ($20.6 billion) and profitability above a 10% margin — that earn significant profits remotely. For those companies, 25% of profit above the 10% threshold would be reallocated to market jurisdictions.

Prior to the October agreement, some countries had moved forward with their own DSTs, which generally involve a levy on revenue from digital services, such as online advertising, provided remotely by large companies. The U.S. government contended that the measures unfairly targeted U.S. tech companies and accordingly threatened tariffs against several countries — France, Italy, Spain, Turkey, the U.K., India and Austria — before ultimately suspending them as discussions continued at the OECD.

As part of the Pillar One deal, countries agreed to eliminate their DSTs in exchange for new taxing rights that wouldn't be based on physical presence — a departure from the current international tax system that was created in the 1920s.

Pillar One represents an agreement by major countries — most significantly, the U.S. — to give up some of their tax revenue to market countries that, under normal international tax principles, have no basis to collect that tax, according to Mayer Brown partner Michael Lebovitz. That is a significant agreement among governments, and multinationals have agreed to come to grips with that, he said.

"That's a big step that has gotten lost in all of the complexity around this," Lebovitz said.

The Uncertainties of a New System

The Pillar One agreement has safe harbors and other elements that could lead to a simplified compliance system that companies may prefer to DSTs — in theory, at least.

An official with the U.S. Treasury Department said during a conference in July that the OECD is working "to get as much simplicity as possible" in the Pillar One regime. As some see it, an administrable profit allocation system may be more appealing to businesses than DSTs, including for nontech companies — such as large pharmaceutical corporations — that would likely be affected by Pillar One but not digital measures.

If the goal is a system that's simple and administrable for corporate taxpayers and tax authorities, companies may be able to control the outcome under Pillar One in a way they couldn't with unilateral DSTs, according to Austin at Mayer Brown. Companies may also see their compliance burdens eased under Pillar One's safe harbor for marketing and distribution activities, she said, in addition to Pillar One's Amount B, which covers routine operations.

If it works out that the safe harbor and Amount B give companies tax certainty and reduce their compliance burdens, "that may be a point where Pillar One may be even better than unilateral DSTs," she said.

Whether these aims of simplicity and administrability are reached is another matter. Complications could emerge due to the structure of Pillar One's profit allocation system, which is layered on top of traditional arm's-length transfer pricing rules that divide intercompany profits based on how unrelated businesses would behave.

The Treasury official, Christopher Bello, senior counsel in the department's Office of International Tax Counsel, noted that transfer pricing disputes may not be resolved for years. There will be cases where related adjustments would have changed the results under Pillar One's profit allocation rules, he said at the July conference.

In the meantime, the OECD has outlined procedures to resolve transfer pricing disputes and other cross-border conflicts that could affect the measurement of earnings that are subject to Pillar One's Amount A, which covers the profit reallocation rules. It's unclear how these proposals would operate in reality.

As Lebovitz saw it, it will likely take years before there's experience with resolving disputes under Pillar One, raising questions about what that means for transfer pricing issues in the interim. In addition, he noted that companies involved in large, long-term transfer pricing disputes are skeptical about the dispute resolution mechanics and other procedures that were designed to provide certainty under Amount A.

"Their skepticism that all of that is going to work seamlessly, I think is reasonable," he said.

Ratification Questions

The Pillar One agreement involves a multicountry treaty that needs to be ratified in each jurisdiction that signed the deal, potentially leading to a hampered implementation process due to political hurdles at the country level.

Existing bilateral tax treaties base income taxing rights on physical presence. With this century-old concept now off the table, a multilateral accord would need to include a profit allocation formula and a means for multiple countries to resolve disputes at once. The OECD initially aimed to have a multilateral convention, or MLC, ready this summer, but the organization's secretary-general said in May that signing will be delayed until at least November.

Practitioners expect that negotiators at the OECD will ultimately agree on a multilateral treaty and other technical details required to implement the rules. The sticking points, they say, center on adoption at the country level, including ratification of the MLC.

The OECD work is only the first step, said Elizabeth Stevens, a member of Caplin & Drysdale. Complicated politics in the U.S. and other countries mean it could be a while before there's a critical mass of countries applying the new rules, she said.

"There's still a lot to be done, and that contributes to my skepticism of Pillar One being implemented," she said.

In a similar vein, Marc André Gaudreau Duval, a partner at Davies Ward Phillips & Vineberg, said negotiators will likely reach a consensus on how to apply the Pillar One rules. But complications will arise when the MLC needs to be ratified in each country, he said.

As Gaudreau Duval saw it, it's unlikely the MLC will be ratified in the U.S., where tax treaties need approval from two-thirds of the Senate.

"I just don't see two-thirds of the Senate accepting Pillar One," he said. "And if the U.S. is not on board, the whole Pillar One dies."

A DST World, for Better or Worse

If the Pillar One agreement fails to see widespread adoption, multinational corporations may ultimately face old and new unilateral measures. The compliance process could involve fewer unknowns than Pillar One, but it's likely to bring its own complications, particularly if DSTs are viewed as income taxes rather than measures more akin to sales taxes.

If there's no Pillar One agreement, countries seeking to tax large corporations that use remote markets will likely enact DSTs along with similar measures for nontech corporations, such as pharmaceutical companies, according to Gaudreau Duval.

The practitioner, who is based in Montreal, noted that pharmaceutical companies likely wouldn't be caught by Canada's proposed DST, which would take effect only if Pillar One isn't implemented by 2024 and would apply to tax years beginning in 2022. However, "nothing prevents Canada from implementing new rules to say, 'pharmaceuticals are now subject to that new special tax,'" he said.

Countries may be unwilling to give up the taxing rights assumed by those enacting DSTs and could very well deny foreign tax credits in those cases, resulting in double taxation, Gaudreau Duval said.

"There's only one pie and everybody's fighting for more slices," he said.

Compared to the unknowns and complexities of Pillar One, DSTs are at least based on familiar concepts, and multinationals may consider them "the devil you know," according to Lebovitz at Mayer Brown.

The OECD has outlined a theory about how profits will get allocated, but it's unclear how those rules are going to operate in practice, he said. On the other hand, companies essentially know how a sales tax works, and that's what a DST really is, Lebovitz said.

In a similar vein, Stevens at Caplin & Drysdale said that instead of income taxes, DSTs could be viewed as something akin to value-added taxes or goods and services taxes. These measures aren't creditable because they're not income taxes, but they're business costs that companies can deduct, she said.

Companies would have the same choices about what to do with DSTs as they would with other costs, such as passing it through to their customers or taking a hit to profits, Stevens said.

The measures may seem less worrying, she said, if companies "stop thinking about it as an income tax, and just start thinking about it as something equivalent to a charge for the privilege of doing business in a jurisdiction."

--Additional reporting by David van den Berg and Dylan Moroses. Editing by Aaron Pelc and Roy LeBlanc.
