Tax Foundation Response to OECD Public Consultation Document: Secretariat Proposal for a "Unified Approach" under Pillar One

By Daniel Bunn

The Tax Foundation appreciates the opportunity to respond to the public consultation on the Secretariat Proposal for a "Unified Approach" under Pillar One. The proposal represents a significant shift in how large, highly profitable businesses will calculate their tax liability in the countries where they operate and have sales.

There is significant tax uncertainty in the current environment driven both by concerns about the potential policy outcome from the Inclusive Framework and unilateral measures taken by many countries, including some OECD members. It would be particularly harmful to the global business environment and business investment if the Inclusive Framework is unable to agree on a principle-based approach that minimizes the risk of double taxation and creates stability in the international system. Additionally, if there is also a risk to global tax stability if an agreement is reached, but contradictory unilateral measures remain in place.

The Inclusive Framework should take steps from this point to find a solution that both minimizes the burdens on multinational businesses and the impact on cross-border investment and the global economy.

General Comments

The Secretariat's proposal describes an administratively challenging plan to reallocate taxing rights to market jurisdictions. The proposal does not lay out a clear principle behind the approach. If it is the case that taxable presence and taxes paid in market jurisdictions are based on attributed value to those markets, then the proposal should show how that principle would be consistently applied. Instead, the proposal attributes taxing rights to markets based on the size of firms, high profit margins, sales in markets, users in markets, and marketing and distribution activities. Each feature could have different justifications, and the Inclusive Framework should agree on the principles from which those justifications arise.

Without the Inclusive Framework agreeing on clear principles for changing tax rules and allocating a new taxing right to markets, countries may apply the framework of any agreement in the way that best fits their own principles for taxing income of multinationals. This would result in more, rather than less, tax uncertainty.

The proposal describes multiple concepts that would be used to calculate whether, where, and how much a business will be subject to tax and how to reconcile new outcomes with old outcomes. Those concepts include:

1. Consumer-Facing Business
2. Deemed Non-Routine Profits
3. Sustained and Significant Involvement
4. Routine Marketing and Distribution Activities

Each concept will create challenges for administering the proposal and for creating tax certainty. Without clear, agreed-upon definitions and thresholds, businesses and countries are likely to react to the new system in ways that could impact the economy through trade and investment distortions and lead to double taxation.

Businesses that pay taxes based on Amounts A, B, or C will certainly face compliance costs associated with the new rules. However, the Inclusive Framework should be careful to consider impacts not only on existing businesses that may be within scope but also how incentives might change for future businesses that are not immediately within scope.

Out-of-scope firms could face significant uncertainty about the size of the compliance costs they might face when, through growth or rearranging of marketing and distribution functions, they end up having to comply with new rules. Each scoping issue in the Secretariat's proposal could create this type of uncertainty, adding to the risks and costs associated with growing a business. It is possible that firms that are out of scope due to size would be more attractive targets for acquisition from in-scope businesses, partially due to economies of scale in regulatory compliance.

The Secretariat's proposal also represents another regulatory burden faced by highly digitalized firms. Complex regulations and the associated high compliance costs can create barriers to entry that lead to smaller firms facing competitive disadvantages as they grow. Smaller digital firms could become less attractive targets for investment as independent entities and instead become targets for acquisition. Policymakers should take note of early evidence on the impact the General Data Protection Regulation (GDPR) has had on investment in new technology firms.[1]

The proposal hints at various carveouts and ways to tailor the formulas for various industries or activities. Carveouts and tailoring should follow directly from an agreed-upon taxing principle. A principle that informs why a particular sector should not be taxed using the new approach would also be valuable in minimizing the expansion of the new approach in the future. A formulaic approach that is adopted for the sake of political agreement could be expanded at any point in the future unless it is constrained by agreed-upon principles.

The proposal mentions that the arm's length principle (ALP) would be largely retained. If the Inclusive Framework believes that the ALP still works effectively in the vast majority of cases,[2] then that should be made clear. Otherwise, the proposal could breed uncertainty for taxpayers because the justifications the Secretariat suggests for departures from the ALP (simplification and addressing current tensions) could also be used to justify future departures from the ALP.

Impact Assessment

The Secretariat's proposal specifically mentions that the impact assessment will be used to inform policymakers on how much profits should be allocated with various definitions and quanta. The initial results from the impact assessment that have been publicly discussed seem to point to significant revenue effects but only modest impacts on business investment. This type of result is questionable because significant revenue effects likely translate into higher effective

[1] Jian Jia, Ginger Zhe Jin, and Liad Wagman, "The Short-Run Effects of GDPR on Technology Venture Investment," NBER Working Paper No. 25248, November 2018, https://www.nber.org/papers/w25248. They find that EU technology ventures were negatively impacted in their ability to secure funding relative to U.S. firms following the adoption of GDPR.
[2] OECD, "OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations 2017," July 10, 2017, https://www.oecd.org/tax/transfer-pricing/oecd-transfer-pricing-guidelines-for-multinational-enterprises-and-tax-administrations-20769717.htm.

tax rates for impacted businesses, and those higher rates can directly impact investment decisions through changes in the cost of capital and after-tax profitability.

The key factors for impacts under Pillar 1 will be the statutory rates of jurisdictions that gain new taxing rights and the share of sales into those jurisdictions. However, the economic story would become much more complex if countries do not uniformly implement policies agreed to by the Inclusive Framework.

The Pillar 1 negotiations should not only focus on the elements of the Secretariat's proposal but also on the elimination of Digital Services Taxes and other discriminatory unilateral measures (including cases of gross-based withholding taxes). An impact assessment should not assume these challenges would be resolved outside of Pillar 1 negotiations. If it is the case that the unilateral measures will be resolved outside of Pillar 1 negotiations, then the impact assessment should not be overly optimistic about the outcomes for tax certainty and the investment climate.

The Impact Assessment is a critical piece to understanding the way this proposal will interact with countries' revenues[3] and tax rates faced by investment. The Inclusive Framework should not proceed until the impact assessment of various options of the Secretariat's proposal have been completed and the results are published. Governments regularly perform and publish impact assessments before continuing debate on policies, and the same should be true for the Inclusive Framework.

The final impact assessment should include an appraisal of the economic impacts, impact on government revenues, and an assessment of the new compliance burdens the proposal would create.

Amount A

The new taxing right comes directly at the expense of current taxing rights. Because of this, relief from double taxation will be essential, but it will also create challenges. Therefore, the Inclusive Framework should agree on an administrative approach to Amount A that minimizes the chances for double taxation or multilateral negotiations over relief from double taxation.

The Secretariat's proposal lays out some examples to describe how Amount A would work to distribute some share of deemed non-routine profits to be taxed by market jurisdictions. Though the examples provide some logical flow to how the new taxing right is distributed, there is very little discussion to how jurisdictions with current taxing rights might reconcile Amount A with their current taxpayers.

[3] International Monetary Fund, "Corporate Taxation in the Global Economy," IMF Policy Paper, Mar. 10, 2019, https://www.imf.org/en/Publications/Policy-Papers/Issues/2019/03/08/Corporate-Taxation-in-the-Global-Economy-46650, finds that, using a 7.5 percent notional return to assets, worldwide residual profits are highly concentrated in the United States (34%), Japan (17%), and the United Kingdom (10%). See Appendix Table 3. These countries' tax bases are the most exposed under the Secretariat's proposal. Additionally, the U.S. runs a trade deficit in services for intellectual property (royalties) that amounted to $72 billion in 2018. This is according to data from Bureau of Economic Analysis, "International Data: International Transactions, International Services, and International Investment Position Tables," Table 3.1 U.S. International Trade in Services, https://apps.bea.gov/iTable/iTable.cfm?reqid=62&step=6&isuri=1&tablelist=51&product=1.

The Appendix describes a method for calculating Amount A with five separate variables:

Table 1. Pieces of the Amount A Puzzle

Profit Margin	**Z**
Deemed Routine Profits	X
Deemed Non-Routine Profits	Y=Z-X and Y=W+V
Deemed Non-Routine Profits Attributable to Markets	W
Deemed Non-Routine Profits Attributable to Other Factors	V

To achieve tax certainty and minimize negative economic consequences, it will be important for businesses to have clearly defined metrics that determine the "sustained and significant involvement" for a market jurisdiction to have taxing rights. Creating a definition with little room for negotiation or uncertainty either on the taxpayer or tax collector side would be a first step in minimizing confusion for Amount A.

Additionally, an approach where the home or headquartered jurisdiction has audit authority over the global amounts for each variable in Table 1 would allow taxpayers certainty on the starting point for each variable. In that exercise, the home jurisdiction would recognize that instead of taxing *z* as under previous policy, the country would be able to tax *x* and its share of *w* and *v*.

The business could then pair *w* with sales into jurisdictions where it meets the definition of "sustained and significant involvement" and pay tax according to the new taxing right under Amount A. The business would also pay tax on profits in both *x* and *v* where applicable, including in the home jurisdiction.

This top-down approach, where global numbers are divided and tax is paid based on that division, would be superior to a bottom-up approach where multiple jurisdictions could have audit authority and the total taxable profit could end up exceeding 100 percent of *z*. Other approaches that would require deductions or credits for foreign taxes paid under Amount A would likely create multiple administration challenges and potential for double taxation or the need for multilateral negotiations for relief from double taxation.

The top-down approach has the potential to create fewer compliance costs and uncertainty about a business's tax bill. Achieving certainty about taxes owed would allow businesses to know after-tax profitability and make investment decisions even in the context of the complexities of Amount A.

Among the potential drawbacks to Amount A are issues of defining income and allocating taxable profits to countries. The definition of income should appropriately account for losses, capital expenditures, and interest costs so as not to penalize growing firms or harm business investment. Additionally, the Inclusive Framework should seek to limit usage of gross-based withholding taxes as approximations for Amount A. The challenge of reconciling a withholding tax with the actual taxing right could lead to increased disputes or double taxation.

Amount B

The Secretariat's proposal to provide a fixed taxable return on routine marketing and distribution functions could help to address the number of disputes related to taxing those functions. However, the Inclusive Framework should be careful in designing market-specific rates of return for these functions. The purpose of the fixed taxable return should be to approximate the minimum taxable return that would address most disputes.

Inclusive Framework members should agree on a level that would satisfy most tax disputes in this area and avoid creating distortions by having multiple market-specific rates of return for marketing and distribution functions. Determining Amount B using a market-specific approach could cause businesses to strategically choose where to invest in marketing and distribution. However, a global minimum taxable return on marketing and distribution would make a business neutral to locating investment choices on marketing and distribution.

Additionally, setting Amount B as a minimum taxable return on marketing and distribution would be justified because countries could consider reasons to go beyond Amount B under Amount C.

Amount C

The Secretariat's proposal allows for countries to seek a higher taxable return than would be provided under Amount B. It seems from the proposal that a country would only be able to tax Amount C if it exceeds the combined Amounts A and B. However, any potential overlap of Amount C with Amount A would create the issue mentioned above, with a bottom-up approach to taxing Amount A where more than 100 percent of taxable profits could be taxed.

One approach to avoid overlap between Amounts A and C would be to not allow countries to tax Amount C for businesses that are in scope under Amount A.

The Secretariat's proposal to have binding and effective dispute resolution will be necessary to minimize the possibility of double taxation. The right to tax Amount C should be directly connected to a process to minimize conflicts between Amount C and the distribution of taxing rights under Amount A.

Conclusion

The complexities of current international tax rules create various distortions in business activities and the locations of profits. An approach that creates more distortions through new layers of complexity or without agreed-upon principles will likely lead to many of the same problems of the past. The approach laid out by the Secretariat would be a significant change to current rules and potentially introduce new layers of complexity and uncertainty. The Inclusive Framework should fully evaluate how both countries and businesses may react to the new approach.

It is paramount that the Inclusive Framework also comes to an agreement on ways to resolve disputes over current unilateral measures. Leaving disputes over Digital Services Taxes and related measures to another forum at another time would not be a celebrated response.

It is also imperative that the impact assessment be completed so that policy decisions are not made in an economic vacuum. The Secretariat's proposal has the potential to impact a variety of decisions by both businesses and governments, and an appraisal of the spectrum of outcomes will be necessary for policymakers to make informed decisions.

Unifying the proposal under sound principles in the context of clear economic analysis should allow the Inclusive Framework to minimize both the administrative and economic burdens that the Secretariat's proposal could create.

These comments have been provided with the possibility of success at the OECD in mind. To us, that means that countries would agree to a proposal that creates tax certainty through clear and consistent guidance, removes potential barriers to relief from double taxation, and eliminates contradictory unilateral measures.