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The Faulty Assumptions Underlying Pillar One

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The OECD's ambitious "Pillar One" project was undertaken, in its words, to address the tax challenges arising from the digitalization of the economy. Billed as the follow-up to Action Item 1 in the BEPS project addressing base erosion and profit shifting, this new project (together with Pillar Two, a minimum tax) is sometimes referred to as "BEPS 2." On January 31, 2020, the OECD issued a statement (the "Statement") describing its progress to date and setting out a timeline to arrive at a consensus. This short note will not attempt to describe Pillar One in detail, and assumes that the reader is generally familiar with the proposal. The focus of this note is on the unstated assumptions embedded in Pillar One, which, it will be argued, are seriously faulty, at least as applied in the context of the U.S. tax system.

The heart of the Statement is the creation of a new taxing right to be accorded "market jurisdictions." There would be three quanta of taxable profit allocated to market jurisdictions, denominated as Amounts A, B, and C. Amount A would be a share of "residual profit" allocated using a formulaic approach. Amount B would be a fixed payment for distribution and marketing functions. Finally, Amount C is meant to encompass any additional profits allocable to distribution and marketing where the taxpayer has traditional nexus in the market jurisdiction.

The Statement repeatedly asserts that Pillar One would be a tax on profits, not on revenues. It speaks in terms of profits being ***reallocated*** to market jurisdictions, although it is a bit hazy on exactly the jurisdictions from which such profits would be reallocated.[1] The goal of taxing profits sets Pillar One apart, at least superficially, from the types of digital services taxes (DSTs) being adopted and proposed in several countries, notably France, Italy, Spain, and Mexico. A DST typically is a low rate of tax on turnover or revenues. It functions like an excise tax or, as in Mexico, a value-added tax. The new Pillar One regime is not a tax at all, but rather a type of worldwide allocation of profits or income. One of the goals of Pillar One is to bind countries to give up their DSTs and sign up instead for Pillar One's reallocation of profits approach.

The new tax is clearly intended to qualify as an income tax. Recognizing that different countries use different measures of income, the Statement would calculate taxable profits by reference to a taxpayer's consolidated financial accounts. Rather than attempting the probably impossible exercise of determining which profits are residual and relate to market jurisdictions, Pillar One as currently proposed would use formulas by industry and type. There are several weaknesses to this approach.

First, this approach to the determination of residual profit will likely draw objections on the ground that an international panel should not have the authority to reallocate income and taxing power. It is worth noting that when the United States enacted GILTI, a tax

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[1] It appears that the formulae mentioned below would reallocate based on percentages of sales and profits on a country-by-country basis. The goal would be to reallocated profits from tax havens in which little or no sales are made to market jurisdictions.

aimed at residual profit roughly aimed at income from intangibles, it was done by subtracting from income a percentage of the controlled foreign corporation's adjusted basis in tangible property.

Second, profits are calculated annually; this topic is addressed, in part, further below. Third, profit would be determined on a consolidated basis, divorcing the tax base from accepted international norms of respecting separate companies. The consolidated approach raises numerous difficult issues that have already been the subject of comments by others.[2]

Beyond these problems is the fact that U.S. tax rules do not give any effect whatsoever to profits calculated for financial accounting purposes. One reason for this is that the goal of financial accounting rules is to prevent businesses from overstating profits, whereas the goal of the tax system is the opposite: to prevent taxpayers from ***under***stating profits. Moreover, when a U.S. company calculates taxable income, including foreign-source income, it is required to allocated items of deduction between U.S.- and foreign-source income following detailed and somewhat arbitrary tax rules that make no attempt to ''trace'' items of deduction to a particular income stream. The results can differ very significantly from accounting income. Although the Statement makes passing reference to the difference between GAAP and IFRS, the real problem is not which accounting standards are used, but that the U.S. tax base has nothing to do with any accounting system.[3]

The Statement notes that double taxation would be avoided through either a credit or an exemption system. However, most of the discussion in the Statement is based on the assumption that active income would avoid double taxation under an exemption, or ''territorial'' system. This is the assumption underlying the ''reallocation'' language that appears throughout the Statement. Put simply, the assumption is that if tax rights are ''reallocated'' to a market jurisdiction, the jurisdiction that would otherwise have taxed the profits so reallocated will yield that portion of its taxing power through exemption of those same profits.

U.S. persons are taxable on their worldwide income. The United States does not employ a territorial system. (The sliver of CFC income excludible under new Section 245A is like a piece of plankton on a whale.) The United States does not relieve double taxation, in the cross-border case, by the use of an exemption system for active income earned outside the United States. Instead, the United States uses only a foreign tax credit.

The U.S. foreign tax credit rules are entirely about source. The credit is limited to the foreign tax on the proportion of worldwide income that U.S. tax rules consider to be from foreign sources. This limitation is applied separately to what are nominally four, but actually five, separate ''baskets'' of income. Not only is source for this purpose determined using U.S. source rules (which often differ from those of other countries), famously complex U.S. rules apply to determine the amount of expenses, such as interest and R&D, properly allocated to gross income from foreign sources to arrive at net foreign source income. Obviously, this method of determining what tax is creditable does not harmonize with a formulaic approach to calculating profits. If another country taxes an item of income belonging to a U.S. person, that does not make the item foreign source or fix the amount of the item: only U.S. rules matter. This is why U.S. tax treaties contain a ''resourcing'' rule that, where the treaty partner is given the right to tax an item of income that the United States believes is U.S.-source income, the United States will yield and provide a foreign tax credit as if that item had a foreign source. But this is a rule found only in treaties, and has traditionally been applied sparingly.

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[2] *See, e.g.*, Osler firm comments March 6, 2019, ¶10:

> The proposals suggest that taxing rights may be allocated on an MNE group basis, rather than on the basis of separate legal entities. Detailed rules will be required to (i) define the scope of the MNE group — including across multiple jurisdictions and taking into account multiple forms of entities and joint ventures, (ii) address the tax consequences arising where the MNE group changes — including through acquisitions, divestitures and spin-offs, or arising from sales or dispositions of assets (iii) address differences in taxation periods between MNE group members (including across multiple jurisdictions), (iv) address intra-group compensation payments for the use of losses or taxes paid by one member of an MNE group that are economically attributable to another, (v) address the impact of currency fluctuations, (vi) address the manner in which revenues are to be calculated across jurisdictions (including with respect to both timing and quantum), (vii) eliminate the double counting that could otherwise arise through intra-group revenue or resales, and (viii) address the circumstances and consequences that may arise if the manner in which revenue is computed is revised (such as may occur when relevant accounting rules change) — and ensure that countries accept a common method of computing revenue without ceding their rights to compute tax liabilities to an accounting body or other third party.

While some of these issues are more easily resolved than others — for example, most consolidated financial statements will already have eliminated double counting from transactions between group members — depending on the system in place in a given country, some of these issues may prove to be intractable.

[3] A good case can be made that the primary problem with Pillar One is that it was developed by economists, who know nothing about tax rules and who may have simply assumed that tax and accounting systems are roughly the same. This is not true in the United States.

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The Statement frames the changes it is proposing in terms of the traditional system of taxing business income. That traditional system, according to the Statement, relies on nexus through physical presence and on arm's-length pricing. The Statement never mentions the other key components of the traditional system, namely source and residence. The omission is evidently due to a belief on the part of the Statement authors that source and residence principles are relevant only to the taxation of what we call ''FDAP,'' that is, income other than business profits. Since Pillar One is all about taxing business profits, the authors appear to have assumed that source and residence do not matter. But the U.S. rules for taxing worldwide income turn exclusively on source. They are based on the notion that the country of residence has the right to tax worldwide income, and will cede that taxing right only to income that the United States sees as having a foreign source.

The Statement's uncritical assumption that the state of residence would cede taxing power thus does not work in the U.S. tax system. Even if the United States were amenable to the approach of Pillar One, its tax rules would not accommodate that approach. While a tax on profits should be a creditable tax (the typical DST would not be), the credit cannot work properly together with Pillar One's approach of merely reallocating income between countries. Pillar One can avoid double taxation only if all countries agree to calculate income in the same way, and further agree to allocate that income using something like formulary apportionment. This is something that might be tried in a harmonized system such as the one developing in the European Union, and would be similar to the UDITPA system in place among the 50 U.S. states.[4] But to get U.S. agreement to such a radical change, much less the agreement of all countries, seems quixotic.

Even if one assumes that the U.S. tax rules could be changed in some manner that would accommodate Pillar One, there is a critical policy issue, not addressed in the Statement, relevant to why the United States (as well as other countries), would not be likely to agree to yield to a market jurisdiction the right to tax Amount A. The issue is how to compensate the United States for the taxes lost when it gave a U.S. taxpayer a deduction for the costs to produce the profits being taxed.

To take a simplified and stylized example, suppose USP, a U.S. corporation, incurred 100x of expenses to produce a valuable digital platform. Suppose that all of those expenses were deducted (including by way of amortization) against USP's other U.S. taxable income. USP then exploits the platform in Country B, incurring no marginal cost to do so, since the up-front costs have already been incurred. Because Amount A is based on annual financial statements, it would not necessarily reflect those previously deducted costs. In that event, Country B would be permitted to tax a portion of USP's revenues that do not represent true profit. It is hard to imagine why the United States would grant a foreign tax credit or exemption for the full amount of the Country B tax. If it did, it would be subsidizing Country B. If it did not, then USP would be subject to unrelieved double taxation. For reasons analogous to the foregoing simple example, countries that grant a participation exemption do not do so if they would bear a loss or deduction. It is also why many countries limit the exemption to less than 100% of the dividend received.

The Statement assumes that capital put at the risk of a venture does not require an extraordinary return, which is an obvious economic fallacy. It does not seem possible to adjust Amount A for risk capital through the use of formulae. The failure of the Pillar One approach to address risk capital, up-front costs, and losses borne by the taxpayer's home country means that in practice, the approach of Pillar One more closely resembles a tax on gross revenues than a tax on profits. The short shrift given to the many difficult issues surrounding how to measure profits and allocate them among groups only reinforces the suspicion that the tax is a disguised excise tax on the revenues of certain large multinationals. The Statement is not just about tweaking nexus and transfer pricing rules. To make the approach it outlines viable, all countries would need to buy into a radical new worldwide formulary approach and a reasonably common tax base.

[4] A possibly reasonable approach would be to implement Pillar One only in the EU as part of the proposed common consolidated income tax base proposal. But given that Pillar One is clearly aimed at U.S. multinationals, this approach is unlikely to be entertained.

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