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TAX CONTROVERSY IN EXAM & APPEALS

TIME TO TRY A MORE COLLABORATIVE APPROACH?

PROPOSED SECTION 382 REGULATIONS IN CURRENT M&A TRANSACTIONS

INTERSECTION OF NATIONAL SECURITY WITH M&A: CFIUS

EMERGING LEADER: SOONTHREE COCHRANE

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Digital Tax

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Question: Why should a "*non*-digital-born" company be concerned about digital tax?

It's a valid question. Many taxpayers that operate in traditional, supply-chain-based business models rightfully tuned out of the Organisation for Economic Co-operation and Development's (OECD's) earliest discussions of digital tax, thinking it was exclusively for "digital-born" taxpayers. However, the scope defining the net of digital tax captured by the "new nexus" has broadened beyond highly digitalized companies to potentially include what we would consider "non-digital-born" organizations that are consumer facing. Simply stated, if your company sells into jurisdictions remotely, either directly or indirectly through a third party, you may trigger what is considered the new nexus.

The OECD, the World Economic Forum, and the World Bank have collectively and independently validated the idea that global economic growth hinges on the integration of digitalization. With limited exception, the essence of digitalization is arguably embedded in a multinational corporation's global value chain. From a macroeconomic perspective, it is easy to align with the famous notion, often attributed to the influential cyberpunk novelist William Gibson, that "the future is already here—it's just not very evenly distributed."[1] There is no debate about the expansive reach of digitalization within the global economy; the challenge ahead for the OECD Secretariat (hereinafter the Secretariat) and the 135 countries that have joined the OECD/G20 Inclusive Framework on Base Erosion and Profit Shifting (hereinafter the Members) lies within the calibration of the new digital tax framework with the microeconomic reality in which the taxpayer operates as well as the nature of the relevant business model, while preserving the time-tested foundation of transfer pricing: the arm's-length principle.

Under this mandate, the Secretariat released a proposal in October 2019 introducing what is known as the Unified Approach, which blends three distinct options under "Pillar One"[2] in the hope of finding common ground and thus agreement across the Members.

Given the velocity of this project and of economic change, we respect the urgency inherent in finding a balanced, collaborative solution for the Members that would preempt the disruption potentially caused by unilateral measures, as we have seen increasingly in recent weeks. With an aggressive timeline commitment made to the G20, the OECD is expected to expand the depth and guidance around the transfer pricing and treaty implications of digital tax by late 2020.

In this article, we anticipate some of the implications for multisided-platform, digital-born (versus non-digital-born) companies posed by the Unified Approach of Pillar One comprising five "building blocks," namely scope, nexus, profit allocation, elimination of double tax, and dispute prevention and resolution. The following discussion, which is based on Aptis Global's response to the OECD's request for public comments,[3] focuses on three of these elements—scope, nexus, and profit allocation—and addresses certain hurdles to practical implementation as well as theoretical challenges.[4]

The Interpretation and Interaction of Scope and Nexus

Scope

Given that the Secretariat has broadened the scope of digital tax under Pillar One to include all "consumer-facing businesses," effectively expanding scope beyond highly digitalized businesses,[5] there are potential issues and questions that may arise for this widened breadth of companies within this new scope, comprising brick-and-mortar, B2B, and B2C companies that bear some element of digital capability within the supply chain.

Based on the premise that the scope for the new taxing rights is defined by a business flow (e.g., tangible, intangible, or service) that is *ultimately* consumer facing (e.g., directly or indirectly) in the absence of traditional nexus (e.g., physical presence), the implementation challenges for taxpayers lie in defining the subtle nuances found when interpreting this scope, the threshold parameters, and the potential industry and market adjustments needed to account for such differences as well as the potentially burdensome systems modifications to obtain the segmented financial data that may be required for compliance.

As a litmus test, a scope assessment first determines the presence of sales, confirming or negating the digital nature of the sale of either a good or a service, including the sale of data embedded within a good or service as well as data by itself, collectively representing "digital differentiation." The integration of digital assets within the supply chain, such as the deployment of data, yields another area that the Secretariat is expected to address in more detail.

Taxpayers that fall within the qualitative parameters of the Unified Approach scope, and thus are deemed "consumer facing," will then apply the quantitative threshold to consolidated revenue to determine whether they have triggered the new taxing right. Threshold is likely to align with that of the Country-by-Country Reporting under the Base Erosion and Profit Shifting (BEPS) Action 13.[6]

In those fact patterns where only certain business units or divisions may be in scope for the new taxing right, segmented financial reporting will be required. The inherent complexity for some organizations will be daunting to derive segmented data by division, or even down to the customer level, whereby a business may have both B2B and B2C business flows for the same product. Moreover, the level of detail for total system profit must be reliably, consistently, and repeatedly available for ultimate compliance.

In the case of divisional losses, the Secretariat may consider a matching rule whereby only losses relevant to the in-scope division or business unit would be considered. As a result, there would be no cross-divisional offsetting of losses from out-of-scope business units. With companies that are suffering total system losses, yet do not have sufficiently reliable financial reporting systems to create divisional financial data, the Secretariat should consider a broader rule for such total system losses. For companies suffering from complex loss scenarios, we suggest that the Secretariat create some form of electability for a safe harbor payment that would allow companies that cannot produce sufficient financial data to satisfy the new taxing right through a safe harbor minimum threshold payment or a specified time period during which the taxpayer can opt out of the new taxing right obligation.

Nexus

The next step in this analysis contemplates whether identified revenue streams are sufficiently connected to a local market, confirming whether the new nexus exists by jurisdiction. To validate the presence of the new nexus, it must be determined if an enterprise has "sustained and significant involvement" in a local economy in the absence of a physical presence.[7]

Given the multiple levels of distribution that may exist within an organization's supply chain, the task of identifying the jurisdictions in which revenue arises is not straightforward. Serving as trigger points in the new nexus analysis, the identification of primary points of distribution within a supply chain should be a manageable exercise, in that they theoretically represent the same points that determine scope. However, the secondary points of distribution, which may be activities conducted entirely by a third party, become increasingly complex to identify and particularly to capture in a company's financial records for tax reporting purposes.

To measure the sustained and significant involvement requirement under the new nexus, a secondary level of threshold test would be appropriate at the local market level, subject to refinements. This could be coupled with the taxpayer's election for a safe harbor yet would nonetheless be necessary to validate whether each jurisdiction would merit pursuing the calculation of the new taxing right under the Unified Approach. For example, an entity may fall within scope under a threshold applied to group or consolidated revenue, yet the nexus tests could yield an insignificant presence in a specific local market that would require neither a minimum safe harbor nor a Unified Approach calculation at the local level.

Further guidance is needed around measures of sustainability in affecting a local market nexus, considering both the pragmatic financial data challenges in implementing the scope and threshold nexus tests as well as the interpretation of how conventional income-sourcing principles might be adapted to this new nexus test.

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Profit Allocation

Although the Secretariat has arguably maintained the foundational aspects of the arm's-length principle, the Pillar One Unified Approach nonetheless embodies a departure from the arm's-length principle with respect to the new taxing right itself. The intricacies defined in the final version of the Unified Approach will determine whether the arm's-length principle has indeed been sustained as the cornerstone of transfer pricing. Under this framework, three types of taxable profit are potentially available for allocation: A, B, and C, whereby A represents the new taxing right, which is derived from factors outside of traditional transfer pricing conventions, otherwise covered under B and C. In our analysis, we have interpreted the Secretariat's October 2019 report to include the following mechanics for determining profit allocation under the Unified Approach, applied once a taxpayer has met the tests for scope and nexus.

Step 1

First, determine the (presumably industry-/market-adjusted) minimum percentage of total system profit to be allocated to the new taxing right, indicative of a minimum profit allocation for the market intangibles collectively present in the local jurisdictions (noting that distinct market contributions would be addressed later).

Although this is termed "Amount A," we have interpreted this to potentially be the first of two possible components of A, depending on the residual profit remaining after the following steps, and thus consider this first component to represent a placeholder for allocated profit to ensure a minimum return to local market intangibles is preserved.

Step 2

Next, determine the minimum operating margin appropriate (presumably industry-/market-adjusted) for the Amount B indicative of an arm's-length return for the distributor.

If the intent under B is to establish a simple, realistic, and modest minimum level of operating margin for a distributor, it is necessary to distinguish a limited risk distributor (LRD) from the additional functions expected of a full risk distributor (FRD) with returns that would fall under C. It is suggested that the B profit allocation be limited to that of a routine return of an LRD and all other functions, risks, and assets borne by the entity in question for B that would be borne by an FRD, which would then fall under C. Moreover, this quantitative framework should be adapted to each industry and local market.

Clearly, it is appropriate to capture losses for FRDs under the Unified Approach; this is an economic reality that cannot be ignored. In transfer pricing theory, an LRD merits a routine return and should not bear losses, with limited exceptions for startup operations and extraordinary operational and business circumstances. In the case of an FRD, the profit/loss attribution would thus fall into C, and any losses could offset any remaining residual that would otherwise be shifted to A.

As the most commonly contested transfer pricing transactions in the world, distribution returns should be given depth and detail in the Unified Approach guidance. Absent sufficient guidance, unilateral approaches may surface that create unnecessary disputes.

Step 3

Next, determine the routine return appropriate to the remaining intercompany transactions under traditional transfer pricing methodologies, which would include a routine return for functions outside of distribution, such as manufacturing, R&D services, and management services as well as residual return allocated to the principal operating companies (POCs)—and IP owners. One area of clarity expected from the Secretariat in the final version will be the treatment of shares services and management costs across A, B, and C as well as a cap on the remuneration to the POCs and IP owners, addressed in the next step.

Step 4

Assuming a cap is placed on the maximum residual return allowable for POCs and IP owners, it is possible to have residual profit after calculating the first component of A, B, and C. Should the Secretariat include this limitation, we would then assume that this secondary residual profit would revert to A as additional profit subject to the new taxing right.

By definition, allocating a minimum threshold of profit to A for local market intangibles already represents an implicit constraint on the profit level potential ultimately allocable to the POCs and IP owners. However, taking it a step further with a potentially capped level of return for an entrepreneur would change the fundamental characteristic of POCs and IP owners as the risk-takers and reward-reapers. Moreover, the risk of some degree of overlap within the interactions among A, B, and C also highlights the exposure to double taxation. Given the trade-offs under consideration to avoid unilateral measures, the best mitigation strategy is to align the markets through both industry and local market adjustments for A, while ensuring that a balanced framework for B and C is established as the transfer pricing foundation, sustaining the character of the entrepreneurs as the risk-bearing and reward-reaping entities as prescribed under the arm's-length principle. To this end, we would suggest the Secretariat avoid a cap on entrepreneurial return.

Achieving a holistic, well-constructed analysis of this kind is no small task. Creating this analysis reliably and consistently for consecutive tax years will be a major endeavor, perhaps a herculean one for taxpayers with challenging financial reporting systems. The narrative in support of this exercise in both master files and local files must go beyond the common early BEPS implementation strategies of "less is more" to ensure that a balanced, cohesive story has been memorialized and that the elements of DEMPE—development, enhancement, maintenance, protection, and exploitation, both digital and traditional—have been well grounded in the economics of a solid transfer pricing strategy.

Refinements

As the Secretariat delves into the details of its research in developing the Pillar One Unified Approach, a total system profit approach similar to what has been proposed by taxpayers in the November public comments will likely solidify into the path forward. The Pillar One team is focused on a new report scheduled for release during their January 29–30, 2020, meetings and is concurrently managing the transfer pricing economics as well as the treaty and other public policy considerations. While certain voices of dissent remained around the essence of digital tax during the public hearings in November in Paris, most of the dais discussions, as well as the hallway conversations we had, were more focused on how to preserve the arm's-length principle while modernizing the 100-year-old international tax system to accommodate the digitalization of the global economy.

While we wait for the late 2020 final guidance, tax executives are best advised to conduct a "new taxing right readiness review." In anticipation of an accelerated digital tax implementation as soon as FYE 2021/2022, the time to act is now. For Q1 2020, we encourage tax departments to discuss the potential scope of the new taxing right as it applies to their business flows and the inherent need that will follow for detailed segmented financial data with their CFO and CTOs, respectively. Telling a holistic, globally consistent value-chain story has never been more critical; a review of the current master file and local file reports is recommended to ensure that the portrayal of local markets aligns with the digital reality. Furthermore, in the case of consolidated or divisional losses, conducting a cost attribution analysis of the existing transfer pricing framework is essential. With limited exceptions, Pillar One is a tax channel to watch closely in 2020.

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Endnotes

1 Nicholas Davis, "What Is the Fourth Industrial Revolution?" *World Economic Forum*, January 19, 2016, *www.weforum.org/agenda/2016/01/what-is-the-fourth-industrial-revolution/*.

2 OECD Secretary General Tax Report to G20 Finance Ministers and Central Bank Governors, *OECD*, October 2019, *www.oecd.org/tax/oecd-secretary-general-tax-report-g20-finance-ministers-october-2019.pdf*.

3 Aptis Global comments on public consultation document, "OECD Secretary-General Tax Report to G20 Finance Ministers and Central Bank Governors," dated October 2019, submitted November 12, 2019, published November 15, 2019, *www.aptisglobal.com/resources*.

4 Although our comments focus on the first three building blocks, naturally any changes to nexus and profit allocation would require modifications to the dispute resolution mechanisms, APA framework, and mutual agreement procedures. These changes would not be in isolation from the fundamental changes required in Articles 5, 7, 9, and 10–13, accordingly.

5 The current industry exceptions under consideration include extractives, commodities, and wholesale financial services. As the details are being refined, it remains to be seen whether the local marketing hubs that represent extractives in the local markets will be ultimately exempted. It is likely that intermediate goods will be exempted in the spirit of distinguishing the B2B from the B2C aspects of what is classified as consumer facing.

6 Following BEPS Action 13, the Secretariat will likely set the threshold at, or perhaps above, €750 million in consolidated group revenue.

7 OECD Secretary General Tax Report to G20 Finance Ministers and Central Bank Governors, *OECD*, October 2019, *www.oecd.org/tax/oecd-secretary-general-tax-report-g20-finance-ministers-october-2019.pdf*, p. 17.