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Taxing the Digital Economy – A Case Study on the Unified Approach (Forthcoming: Intertax, vol. 49, 2021, issue 1)

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In October 2020, the OECD Secretariat published the 'Report on Pillar One Blueprint' approved by the Inclusive Framework on BEPS as a result of the work on the tax challenges arising from digitisation. The Unified Approach (UA), which is the basis of the Blueprint, is intended to complement the existing system of corporate income taxation. The essence of the UA is to grant market countries the right to tax a portion of the profits of companies – regardless of whether they have a physical presence in the market country in the form of an affiliated company or a permanent establishment.

To develop a common understanding, what this blueprint is about, the case study explains the new system, discussing some issues arising from the ideas shared in the blueprint and reveals the complexity of the proposed new system. The case study focuses on the so-called Amount A which is part of the UA. Greil/Eisgruber then propose a substantial simplification, which would make Amount A an understandable, manageable and verifiable system. This will make it possible to levy taxes on Amount A in all legislations without double taxation.

Given the complexity of the proposed new system three issues are thought to be the most important:

1. Scope: What types of MNE groups should be within the scope of Amount A? Should it cover only MNE groups performing automated digital services (ADS), and/or should it focus on so-called consumer facing business (CFB), or should the scope be even wider to address the challenges of the digital economy in a comprehensive manner? Especially from the organizational perspective, the solution that is most effectively managed administratively should be pursued. Therefore, the final solution should only depend on facts that are easy to identify, that are transparent for all parties involved – MNE groups and all tax administrations. In a world where all businesses become digital almost daily, a formal description of which businesses are digital may not accord with these objectives.
2. Interaction between existing and new systems: mixing up the existing rules that are based on the arm's length principle (ALP) with a completely new multilateral approach of allocating deemed residual profits should be avoided. The integration of a bilateral but multilaterally coordinated approach in the form of the ALP with that of a multilateral procedure has considerable practical and procedural implications for both approaches. When all countries have finally agreed on an allocation of the deemed residual profit, it would be a complete disaster if an adjustment by any

one or two countries as a result of a transfer pricing audit, MAP, or arbitration would affect that multilateral agreement years later. It would be similar if the guidelines under Amount A and/or the agreement on the allocation of deemed residual profits make transfer pricing audits even more complicated or even impossible.

3. No double taxation: the new system should not result in double taxation of profits allocated by the new system. All profits that are part of that system are already taxed. If many countries receive additional profit, there must be a sincere way that all of these profits are released from the original taxation. This system must be transparent for all countries and independent from all different types of taxation by any legislation. Additionally it has to be a universal and exact system, how to determine the profit.

It must be made aware that the UA does not even fully address the challenges of digitalization. The UA only affects the transaction between the MNE group and the customer. This takes into account the fact that digitalization allows exploiting markets without being physically present in local markets. At the same time, the UA completely disregards the fact that digital and digitalizing business models are increasingly using intangibles or that economic success is based on them, that value creation processes are changing and becoming increasingly integrated and that people functions are fading into the background. However, it is precisely these factors that drive tax structuring opportunities and give rise to disputes between taxpayers and tax administrations as well as between tax administrations themselves. The ALP should continue to apply here, however, it will not be adapted to the challenges of digitalization. An increasing complexity with a burgeoning potential for disputes is inevitable, and the UA also contributes to this. The complexity is multiplied if there is an attempt to link the new system with the existing system and allow them to interact.

Therefore a simplification potential is to be pointed in the case study, in order to make the UA practicable. If the simplification measures were considered in order to be able to implement the new taxation system in practice, Amount A (as part of the UA) would be designed and implemented as a separate new income taxing right at the level of the MNE group as a whole including a new nexus and a profit allocation rule. It consists of a strictly formula-based system originating from accounting standards according to commercial law. Therefore, this system is completely detached from the current system and does not interfere with the existing tax system based on the ALP. The new system ensures that profits are allocated proportionately to market states and that the Amount A tax relief is not wholly imposed on a UPE country of residence. Rather, it is split up among those jurisdictions where the most profitable group entities or group PEs are located. It eliminates double taxation regarding Amount A, it is easy to administer by corporations and tax administrations due to a strictly formulaic approach, and should not lead to numerous dispute resolution procedures due to its simplicity.

Only a system that is simple, transparent, and administrable will prevent Pillar One from opening Pandora’s box where many countries are experimenting with new taxes that deviate from internationally established rules.

There is still the opportunity to make changes to the blueprint. This should be used now, since multilateral systems are difficult to change once they have been implemented.

You can read the full version of this article in the policy note section of Intertax, vol. 49, 2021, issue 1.

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