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The OECD Pillar 1 “Amount A” Tax Under Scrutiny Through the Ability to Pay Prism

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The magnitude of the so-called Pillar 1 of the OECD Unified Approach to address the tax challenges of the digitalization of the economy should not be underestimated, especially after the endorsement by the Inclusive Framework that took place last week. Specifically, under the name of “Amount A”, the proposal entails the creation of a new tax on the profits of MNEs meeting certain requirements that apportions deemed residual profits -a percentage of the overall profits of the MNE, yet to be determined- to market jurisdictions in accordance with a proxy based on sales. Albeit the project always refers to a new “taxing right”, I consider appropriate to address the issue as indeed entailing -additionally- necessarily new domestic levies replicating the resulting structure and elements of the proposal will have to be adopted, if not directly agreed in an international instrument.

This new tax is currently being tailored by a supranational body, the OECD, and requires a broad consensus for its effective implementation, entailing significant regulation changes both at a treaty and at a domestic level -replicating the proposal by the OECD- that, if implemented successfully, will imply an unprecedented shifting in taxing powers among jurisdictions worldwide. This undertaking has no parallel in history, hence the need to further scrutinize the features of the new tax, to adequately assess its pertinence and feasibility. As with any other tax, its alleged aim, its structure and its effects must be contrasted with overarching tax law principles and guidelines, such as neutrality, inter-nation equity, efficiency or practicability, among others. In this blog entry, focus will be on the impact of the ability to pay principle in the specifics of Amount A.

Ability to pay is without any doubt one of the most relevant principles to be followed when distributing the overall tax burden in a given jurisdiction. It is widely used as a proxy of equality in tax law and is thus linked to fairness considerations. Notwithstanding, its contours are difficult to define, due to a differing scope depending on its insertion in each specific legal system -even entailing constitutional issues in certain jurisdictions-, and differing views of scholarly literature that has approached the subject matter. That said, generally, a common understanding of this concept within corporate income taxation would entail that (1) no taxes should be imposed unless actual taxpaying capacity related to any manifestation of wealth exists, (2) those displaying the same ability to pay should be taxed equally and (3) taxation should ideally be based on comprehensive rules for determining taxes due under each specific wealth manifestation[1].

As the Amount A proposal is based on broadening taxing rights of market jurisdictions, it could seem at first sight that the ability to pay principle does play a limited role in the proposal, due to

the fact that this proxy does not serve to define the distribution of taxing rights among states, as "ability to pay helps to define the cake, but it does not help to slice it"[2]. This proxy mainly concerns jurisdictions taxing the worldwide income of their residents, yet the relevance of the ability to pay notion within Amount A should not be miscalculated. Truth is that the specifics of Amount A are still to be defined and agreed, but with the available information one can envisage the challenges that the drafters are currently facing. Here, I would like to briefly focus on two issues that are related to the many facets of ability to pay in this context, namely the calculation of the profits of MNEs under the scope of Pillar 1 and the relief of double taxation.

The first issue I would like to bring into discussion concerns the adoption of a specific set of accounting standards as a departure point to determine the residual profits that Amount A would tax -i.e. the definition of the cake to be sliced-. The draft report on Pillar 1 issued in October 2019 states that "The relevant measure of profits could be derived from the consolidated financial statements" (par.53) under GAAP or IFRS, although "further consideration will need to be given to the appropriate measure of profits and also to potential standardized adjustments to the reported profit" (ibid). Leaving aside the discussion on which set of rules -either US GAAP, IFRS or prudence-based local GAAP – better reflect the ability to pay of an enterprise, what is clear is that the aim of accounting rules and standards -mainly to provide relevant financial information to stakeholders, among other goals- differ from that of taxes, as does the subsequent design of the said sets of rules. The main concern refers to timing matters, the potential recognition of unrealized profits -in the case of US GAAP or IFRS- or the generation of hidden reserves through prudence-based rules in local GAAP and their conformity with ability to pay from a tax perspective. Henceforth, the drafters of Pillar 1 should be aware of this fact when proposing a specific set of accounting rules to determine the aggregated profit of MNEs. It is also important to note that the adoption of adjustments may enhance an alignment of the resulting profits with the ability to pay notion -which, I insist, differs in each jurisdiction-, but could run contrary to simplicity and consensus may be then more difficult to achieve. What it is clear is that a uniform solution will have to be provided, as the determination of the taxable base must avoid disparities in its determination that could derive in multiple taxation and thus run contrary to the ability to pay of the MNE.

That said, disparities may be triggered not only at the level of the calculation of the profits of an MNE, but also on what concerns the interaction of Amount A with current international tax rules. It must be noted that the stand-alone character of Amount A entails significant issues derived from a scenario in which a different -worse- treatment of an MNE affected by Amount A, when investing in a given jurisdiction, would have vis-à-vis an MNE not impacted by this new taxing rights. As both the traditional rules and the newborn ones -namely Amount A- aim at taxation of corporate profits, the difference in treatment under comparable circumstances may be at odds with the ability to pay principle and may entail further incoherence issues derived from the fact that the very computation of the said profits would lead to different results.

Another concern regarding the calculation of the profits of the MNE refers to the proposal of segmenting it in accordance with business lines. This may potentially lead to an infringement to the ability to pay notion in the case of an MNE with profitable business lines but suffering losses on an aggregated level, as it could end up being liable to pay taxes on inexistent income in those market jurisdictions in which part of the said segmented profits would be allocated. In addition, the risk of contravention of the ability to pay principle also concerns the identification of the taxpaying entity. It is clear that a mechanism to identify which entity or entities within the MNE will be liable for the taxes imposed by market jurisdictions must be put in place. Notwithstanding, as the Pillar 1

project stated that sales through unrelated distributors will also be covered, market jurisdictions in which no physical presence of an MNE exist may try to claim this new tax to the said distributors, even when their ability to pay clearly is beyond the scope of Amount A. This issue may be addressed through the centralization of the collection of the tax through a “one stop-shop” system to avoid burdens on unrelated parties, perhaps accompanied by tax-free transfers between the units of the MNE present in the market jurisdictions to the ultimate parent that would thus act as a collection agent.

Still with the ability to pay rationale in mind, the second issue I would like to briefly comment concerns double taxation. Although subject to discussion, several authors have linked the ability to pay principle to the need of providing double tax relief, being this aspect one of the biggest challenges that the Pillar 1 project has to solve to achieve a successful implementation.

Indeed, the interaction of amount A with amounts B and C, combined with their interaction with the current international tax set of rules, could give rise to manifold taxation due to counting the same profits multiple times. For instance, returns generated by high value marketing functions that should be rewarded through amounts B and C, could also be included as amount A’s non-routine profits, exceeding the actual aggregated profit of the MNE. Also, several residence jurisdictions could tax the same income that was allocated to market jurisdictions without granting relief. This is because in the context of Pillar 1, the OECD moves away from a transactional view -in which the identification of the source State and the residence State as the one obliged to eliminate existing double taxation was clear in the majority of cases- to adopt an overall profit approach that makes extremely difficult to ascertain which country should grant double tax relief, i.e. which jurisdiction should surrender its taxing rights in favor of the market country. If functions generating residual returns -i.e. returns beyond routine ones, which are precisely the ones Amount A would tax- are spread among the components of an MNE, as happens in most MNE business structures, the issue of which jurisdiction must grant relief becomes evident. If the entities attracting residual profits under existing rules are tax resident in jurisdictions different from that of the ultimate parent, it would be senseless and without any justification to require its residence jurisdiction to grant double tax relief for amount A. An alternative would be to define which entities are indeed obtaining the said residual profits -in line with a FAR (functions, assets and risks) analysis- to determine the jurisdictions that should grant relief, yet this solution is somehow at odds with the formulaic nature of Amount A.

Anyhow, a mechanism should be put in place to grant double taxation relief between market and surrender states. Again, consensus is paramount in the matter of double tax relief. Probably this is one of the most delicate problems the promoters of Amount A have to face, because what is far from doubt is that this new tax entails an unpredicted shift in the allocation of taxing rights that may lead certain jurisdictions to reject the implementation of the project. For instance, if the United States -whose representatives have already expressed their reluctance to the agreement- refuses to agree on the implementation of Pillar 1, its feasibility would be completely hindered, as traditional treaty limitations on the taxation of business profits only if physical presence exist will still apply and thus, US MNEs would not be affected by Amount A at all.

Such a threat is one of the biggest challenges the OECD will have to face. Soon enough the outcome of the negotiating process will be unveiled and then it will be ascertained whether this titanic enterprise succeeds or fails. If the latter, then the discussion on whether more realistic, easier to implement options that are more in line with the current status of international tax rules than Amount A may be adopted instead. Proposals such as withholding taxes on services or

predetermined margins and methods on transfer pricing were, despite the said motto of the OECD of working "without prejudice basis", inexplicably discarded in the course of the discussion on the taxation of the digitalized economy. Perhaps the time to seriously reconsider their feasibility will come in the near future.

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[1] See J. Englisch, *Ability to Pay, in Principles of Law: Function, Status and Impact in EU Tax Law* (online books IBFD 2014), sec.19.1.

[2] See W. Schön, *International Tax Coordination for a Second Best World (Part I)*, 1 World Tax Journal 67, 73 (2009).

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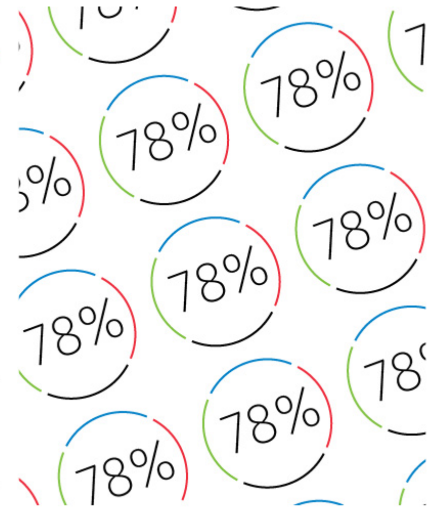

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