

Reproduced with permission from Tax Management International Journal, 48 TMIJ 133, 03/01/2019. Copyright © 2019 by The Bureau of National Affairs, Inc. (800-372-1033) <http://www.bna.com>

## If Metternich and Talleyrand Had Talked Tax

By Gary D. Sprague, Esq.  
Baker & McKenzie LLP  
Palo Alto, California

I'm sure that most readers of these Commentaries have had similar experiences. You're at a cocktail party with the local notables, and someone you just met asks you what you do for a living. You say that you are an international tax advisor. Your fellow guest can't hide that inadvertent frozen stare of dismay as they struggle to find something relevant to say in response. The conversation quickly turns to the high school football team.

The truth, however, is that now must be the greatest time ever to be in the international tax field. The OECD released on February 13th a Public Consultation Document, titled *Addressing the Tax Challenges of the Digitalisation of the Economy* which outlines the OECD's current thinking on possible changes to some of the most foundational principles of international taxation. Interested persons (which essentially is everyone in the world) were given until March 6 to consider carefully the propositions, debate them with other interested persons, and provide their considered comments to the OECD. Then the OECD will hold a Consultation in Paris one week after that, by which time the delegates will need to have studied what undoubtedly will be thousands of pages of comments, to allow the international community of businesses, academics, NGOs, advisors, and others to express their views as to how the international system of the future should be designed. To top it off, this process isn't being run by your parents' OECD; this time around it is the Inclusive Framework in charge, with 128 countries participating on an equal footing.

Seriously, this is great stuff! Sort of a Congress of Vienna for tax people. At the Congress of Vienna,

convened between November 1814 and June 1815, Metternich (representing Austria) and Talleyrand (representing France) — along with delegates from more than 200 states and princely houses — gathered to reshape the geographic boundaries of Europe, with the goal of producing a more stable political balance for the future. As the Inclusive Framework continues to add states as voting members, maybe even that number of state participants is within reach for the OECD. The Congress of Vienna even provides a precedent for participation at the OECD by “civil society” through NGOs, as the Congress included as delegates representatives of a variety of non-state organizations, including religious organizations and special interest groups. The purpose of the upcoming OECD Consultation essentially is the same as that of the Congress of Vienna: to debate whether redrawing of the boundaries of taxation rights over cross-border transactions could stabilize the political landscape of international tax for the next 100 years.

The historic boundaries of taxation rights in the OECD world have been defined by the permanent establishment (PE) standard in Article 5 of the OECD Model Tax Convention (MTC) for establishing nexus, and by the arm's-length principle of MTC Article 9 and the rules on profit attribution to a PE of MTC Article 7 to define the measure of income that can be taxed by a state. Those boundaries already were redrawn to some extent in the Base Erosion and Profit Shifting project; Article 5 was changed in material ways under BEPS Action 7 to allow a market state to impose income tax nexus upon a materially lower level of economic activity in the state by a nonresident enterprise than had been the case in the past, and various aspects of the rules for applying the arm's-length principle in the OECD Transfer Pricing Guidelines (TPG) were further elaborated under BEPS Actions 8–10 in ways that will result, in many cases, in an increased allocation of taxable profits to subsidiaries or branches operating in states into which multinational enterprises sell their goods or services. Even

though the ink is hardly dry on the Multilateral Instrument used to achieve multilateral adherence to the BEPS basic conditions, and the 2017 version of the TPG with all of the BEPS Actions 8–10 revisions is shooting up the best seller’s list at the OECD’s publishing arm,<sup>1</sup> various states large and small are insisting on a refreshed look at these boundaries, under the heading of further work on BEPS Action 1, addressing the tax challenges of the digitalized economy.

Perhaps the most notable aspect of the proposals on the table for discussion at the upcoming Consultation is that they are not small variations of a single theme. The proposals on their face represent a remarkable range of possibilities to change the international tax framework, and all to be accomplished with a package ready for implementation sometime in the next calendar year.<sup>2</sup>

Many experienced observers have argued that there is no need for material changes at this stage, when the effects of the BEPS Project haven’t even yet been reflected on tax returns and audited by tax administrations. These experienced observers have also pointed out that there could be further modifications to the existing framework which could achieve the same result of allocating more taxable income to market states without breaking existing principles, such as by a further constriction of the exceptions from PE treatment in the MTC, or further attention to features of the TPG which govern how and when multinational groups may allocate the residual profits from intangible properties to entities not subject to tax in the state into which the goods and services are sold. Those possible changes, however, aren’t on the table in the Consultation Document as options. The rules of engagement in the Consultation Document are to address two “pillars” of areas for change, and four main options under those pillars.

The first pillar contains three broad options for discussion. All of them expressly “would lead to solutions that go beyond the arm’s length principle.”<sup>3</sup> They differ in their mechanics of how to draw the new nexus lines and how to define the non-arm’s-length profit allocation, and the size of the profit allocation

gap they would leave between the ALP and proposed solution.

The first proposal under Pillar I focuses on the “value created by certain highly digitalized businesses through developing an active and engaged user base, and soliciting data and content contributions from them.”<sup>4</sup> This proposal quite clearly ring-fences certain (but only some) “highly digitalized” businesses, distinguishing among different highly digitalized businesses that would seem to have very similar economic profiles in the way they develop their product and go to market. The profit attribution element of the “user engagement” proposal would be to devise a profit-split intended to value the user contributions to the enterprise and applied to the residual profits of the entire enterprise, and attribute that portion of those enterprise residual profits to the state of the users. While the proponents of this proposal argue that this is a simple, targeted idea, the elements of ring-fencing only certain enterprises of a single industrial sector, proposed profit attribution based on the entire residual profits of an enterprise, the creation of nexus even in the absence of any actual physical connection with the market, and even the determination of nexus not by sources of revenue, but by consumers of free services, shows that this proposal lands pretty far outside the existing consensus on how source and residence state taxation claims should be balanced.

The third proposal of a “significant economic presence” is the least fully described in the Consultation Document, and apparently is something of a late entry into the list of candidates. This proposal would base nexus on a determination that an enterprise evidences “a purposeful and sustained interaction with the jurisdiction via digital technology and other automated means.”<sup>5</sup> While not the only factor to be used to establish nexus, revenue from the jurisdiction would be the “basic factor” to determine nexus. Once nexus has been established, then a fractional apportionment method would be applied to allocate profit to the market state. While there are no concrete details at this stage, the Consultation Document suggests that one approach under this proposal could be to base the apportionable profit on the consolidated profit margin of the entire global enterprise, and allocate based on factors which might include sales, assets, and employees. This approach looks a lot like formulary apportionment, which, of course, is about as far from the arm’s-length principle as one might imagine.

---

<sup>1</sup> Which one can buy through the OECD online store, to the extent that point is relevant to anyone’s thinking about taxation of remote sales in the digitalized economy.

<sup>2</sup> As Secretary-General Angel Gurría stated in his report to G-20 leaders regarding the June 28–29, 2019 summit in Osaka, Japan, “[m]y hope is at that summit, you will be able to celebrate an agreement on the what and how of a long-term solution to be delivered in 2020.” Stephanie Soong Johnson, *Time for an Update: The Digital Economy Tax Debate in 2019*, TaxNotes.com (Dec. 31, 2018).

<sup>3</sup> OECD Inclusive Framework on BEPS, *Addressing the Tax Challenges of the Digitalisation of the Economy — Policy Note* (Jan. 23, 2019), at 2.

---

<sup>4</sup> Consultation Document, ¶ 17.

<sup>5</sup> Consultation Document, ¶ 51.

The middle proposal is “based on the concept of marketing intangibles.”<sup>6</sup> In essence, this proposal would seek to identify those marketing intangibles exploited by the enterprise where there is “an intrinsic functional link between marketing intangibles and the market jurisdiction.”<sup>7</sup> This proposal is much more closely connected to the arm’s-length principle than the other two. The only profits to be considered for allocation to the market state are those arising from the specific marketing intangibles which actually have that intrinsic functional connection to the taxing jurisdiction, as opposed to putting into the apportionment base the residual profits of the entire enterprise.

The second pillar is advertised as less revolutionary, as it is described as simply continuing the work of the BEPS Project to address the continued risk of profit shifting to entities subject to no or very low taxation.<sup>8</sup> Pillar II contains two interrelated proposals, one an income inclusion rule which would require “significant shareholders” (not just majority shareholders) to take into taxable income a proportionate share of income of a corporation whose profits are not subject to tax at a minimum rate, and the second a tax on base erosion payments made to a related party that are not subject to a minimum rate of tax.<sup>9</sup>

Even though these proposals are described separately under their own pillar as simply a continuation

of the BEPS Project, they still would represent a dramatic evolutionary step for the international tax system. Both proposals seek to squeeze out of the international system the ability of multinationals to allocate residual profits to low-tax entities. Elements of the original BEPS Project broke new ground in seeking to conform domestic law across jurisdictions, as opposed to changing just treaty and transfer pricing rules. Examples include the anti-hybrid rules of Action 2, improving CFC rules in Action 3, and other areas. The income inclusion and base erosion payment proposals under this pillar would continue the expansion of OECD influence into areas once thought reserved for domestic legislation, and not incidentally also bring significant pressure on states to consider their domestic tax rate with reference to whatever minimum tax rate is set as the trigger for these rules. The Consultation Document is careful to note that setting domestic tax rates remains within the national sovereignty of states, but one might expect that some states would see these proposals, if enacted generally by the advanced economies, as constituting at least gentle persuasion about how the state should set its rates.

At the Congress of Vienna, the Great Powers and the other participants negotiated over how to draw the boundaries of national sovereignty on the geography of Europe. At the OECD this month, the Inclusive Framework will debate how to draw the boundaries of taxation of multinational enterprises making cross-border sales into states. Most historians regard the Congress of Vienna as a success, in that its results led to peace (or at least to no major wars) in Europe for 100 years.

Let’s hope the OECD and the Inclusive Framework are as successful.

---

<sup>6</sup> Consultation Document, ¶ 29.

<sup>7</sup> Consultation Document, ¶ 30.

<sup>8</sup> Consultation Document, ¶ 88.

<sup>9</sup> The U.S. GILTI (Global Intangible Low-taxed Income) rules are expressly noted as inspiration for the minimum tax proposal. The base erosion proposal differs from the U.S. BEAT (Base Erosion and Anti-Abuse Tax) rules in material ways, including in particular the test of whether the payment is subject to a low tax rate on the receiving side.