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OECD's unified proposal on Pillar One poses challenges for dispute resolution

On October 9, the OECD Secretariat released a public consultation document proposing a unified approach under Pillar One of its work on taxing the digital economy. The proposal lays out a system for allocating profits and taxing rights among jurisdictions.

Last month, we wrote a column introducing the unified approach and describing its profit allocation mechanisms. These are an allocation to market jurisdictions regardless of physical presence, which is based on a modified residual profit split approach employing fractional apportionment (Amount A); an allocation based on a deemed arm's length return for any marketing or distribution activities performed in the jurisdiction (Amount B); and an allocation for any additional value provided by activities in the jurisdiction (Amount C). While the proposal aims to provide a high level outline for future agreement, it is not too early to consider some of the issues that the proposed unified approach raises, particularly in regard to dispute resolution.

Threat of double taxation

The proposal's use of simplified conventions and fractional apportionment is intended to promote simplicity and administrability. Yet the areas where the proposed non-arm's length rules dovetail with the current transfer pricing rules based on the arm's length standard – which would remain in place under the Secretariat's proposal – create the potential for double taxation. If an efficient system for eliminating double taxation, and for preventing and resolving disputes, is not forthcoming, what is intended to be simple and administrable may not work as intended, as lengthy disputes between tax administrations proliferate.

Some tax professionals have raised concerns about the ability of a foreign tax credit system to adequately protect against double taxation resulting from application of the proposed profit allocation rules. Moreover, before tax credits will be granted, a tax credit system may require that taxpayers act to reduce their foreign taxes in accordance with a reasonable interpretation of foreign law, and pursue administrative and treaty remedies to reduce or eliminate any proposed increase to foreign taxes. This the case with the U.S. voluntary tax rules in Treas. Reg. § 1.901-2(e)(5), for instance. Even if a tax credit system were implemented, therefore, it would likely not eliminate the need for robust dispute resolution mechanisms.

Transfer pricing is a zero sum game, and should remain so even with the overlay of the proposed non-arm's length allocations, since the OECD clearly does not intend the Pillar One solution to involve double taxation. One of the chief difficulties in the proposed approach is identifying which jurisdictions will surrender the profits covered by the new taxing right. Because residual profits may be allocated to multiple entities under current transfer pricing rules (e.g., because DEMPE functions are not centralised in a single entity), there will often be multiple jurisdictions that should surrender the right to tax profits, and figuring out the quantum of profits to be relinquished by each surrender jurisdiction presents unprecedented challenges.

Reducing and addressing disputes

The public consultation document on the unified approach mentions the International Compliance Assurance Programme (ICAP), advance pricing agreements (APAs), and mandatory arbitration as possible dispute resolution tools that may be needed to successfully implement the unified approach. ICAP, an OECD pilot programme built on multilateral risk assessment, may be a useful means of reducing the risk of disputes, and it will be important to make APAs available to cover Pillar One allocations as well as traditional transfer pricing issues. Moreover, mutual agreement procedure (MAP) cases under bilateral tax treaties will likely continue to bear much of the load of dispute resolution. However, current ICAP, APA and MAP procedures are ill-equipped to handle multilateral disputes involving a large number of jurisdictions, which will often be the case upon implementation of a Pillar One approach.

Moreover, current mandatory arbitration models are also ill-equipped to cope with such disputes. 'Baseball' arbitration, which involves the adoption of a resolution proposed by one of the parties, seems keyed to the incentives that exist in bilateral disputes, and may not be well adapted to matters involving three or more parties. On the other hand, reasoned decision arbitration, in which the arbitration panel independently arrives at an outcome after reasoning through the case, is time-consuming and may not be workable unless the OECD identifies an overarching principle to inform profit allocation under Pillar One. While a renewed commitment to existing dispute resolution tools such as ICAP, APAs, and arbitration is important, the OECD should also devote attention to how these mechanisms may be modified to best address the challenges raised by the unified proposal.

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