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Tax Pros Leery Of Digital Tax Untethered From 'Arm's Length'

By **Molly Moses**

Law360 (July 15, 2019, 3:04 PM EDT) -- As the Organization for Economic Cooperation and Development works to solve the problem of taxing companies in the digital economy, practitioners are uneasy about proposals that stray from the arm's-length standard — the principle underpinning essentially all international tax policy.

In its documents describing possible new taxing approaches for the current economy, the OECD has been upfront about its decision to seek a solution outside the arm's-length principle. The three main proposals for attributing value from digital transactions rely on proxies rather than an analysis of an individual company's data, and the organization is also pushing for a minimum tax.

Outside the Organization for Economic Cooperation and Development's Paris headquarters. (AP)

In pursuing these approaches, the OECD is effectively turning its back on a system that has been in place for nearly a century.

“It's a big deal,” said Thomas Linguanti of Morgan Lewis & Bockius LLP. “The arm's-length standard has been the lingua franca of multinational taxation since the League of Nations.”

As outlined in its February draft, the OECD is considering proxies for the value of digital transactions based on user participation, marketing intangibles or a company's significant economic presence. The “program of work” released in May expanded on the common elements in those proposals and described other possible approaches, including a modified residual profit split method.

The May document separately recommended a global anti-base erosion or GloBE proposal, which would allow countries to tax companies headquartered in their jurisdictions if they earn income in other countries that tax at lower rates. The GloBE, essentially a minimum tax, arose under the second “pillar” of the OECD's digital economy taxation work, the pillar devoted to fighting tax avoidance.

The rationale for the minimum tax and the other, more formulaic approaches is that the companies selling into countries with a market for digital services often have no taxable entity in the market jurisdiction. There is intense political pressure to design a tax acceptable to these market countries,

which could otherwise go the way of France, the U.K. and others and implement a digital tax unilaterally.

The notion that local affiliates should get some form of extra compensation based on the market goes against a traditional economic analysis, according to John Warner, a shareholder at Buchanan Ingersoll & Rooney PC.

“The market countries are trying to say the local affiliate, because it serves the market, ought to have a supervalue ascribed to what it does because it's tapped into that market,” he said.

But that view doesn't account for competition in the market, Warner added.

“A traditional microeconomist would say the affiliate has to fight with others in the market,” Warner said. “They can't charge extra just because they're in a certain market — they'll be limited because it's competitive.”

That means unless the affiliate has developed a valuable intangible, it would get a regular return and nothing more, he said.

Others worried that moving away from the arm's-length standard and the long-standing economic concepts on which it is based would create instability and uncertainty in the tax system.

“As soon as you unmoor yourself from the arm's-length principle, you're left open to arbitrary and theoretical approaches that have no basis in the commercial reality in which we live,” Linguanti said.

The contemplated minimum tax struck many practitioners as such an approach.

“It's not even formulary anymore; it's completely arbitrary,” economist Elena Khripounova of Mayer Brown LLP said of the minimum tax. “The allocation of profit becomes not arm's-length. It becomes just what everybody wants.”

Elizabeth Stevens, an associate with Caplin & Drysdale Chtd., agreed. “There's no principle” underlying a minimum tax, she said. While the tax would be more likely to stick if it were implemented through a treaty, Stevens added, “still, market countries could come back and ask to renegotiate the number.”

Departing from the Arm's-Length ‘Fiction’

Others, however, said that as business structures have evolved, the arm's-length principle has become less relevant.

“The arm's-length standard is based on a fiction, which is this idea that you can take a related-party transaction and you can find an equivalent outside the related-party context,” said Lilian Faulhaber, a professor of tax at Georgetown University Law Center.

For decades, the pricing of intangible assets transferred between companies has highlighted the fictional nature of the arm's-length standard “because there's no situation where you'd have these intangibles being sold to an unrelated party,” Faulhaber said.

U.S. companies with valuable intangibles have often achieved significant tax savings by transferring those assets to affiliates in low-tax jurisdictions. The need to use an arm's-length benchmark when no similar unrelated-party transactions exist has been a problem for the Internal Revenue Service in cases such as that of Amazon.com. Faced with no arm's-length comparable for the company's transfer of technology and other assets to a Luxembourg subsidiary, the agency calculated their value based on an estimate of future cash flows — and lost in the U.S. Tax Court.

Transactions in the digital economy are “even further afield from the concept that underlies arm's-length” than intangibles transactions, Faulhaber noted.

The discounted cash flow method the IRS used in Amazon was at least by some definitions an arm's-length approach, as it was designed to come up with the amount an unrelated party would have paid for the assets. But, Faulhaber said, in the case of digital transactions, “it's not even always clear what intellectual property underlies the transaction, what entity is using it to provide what level of service to what customer.”

Alex Cobham, chief executive of the Tax Justice Network, a U.K.-based group campaigning for tax fairness, said the arm's-length standard had failed to curb the widespread tax avoidance from companies' intangibles transfers and was likely to be even less effective in combating profit-shifting from digital transactions.

“The digital sector should not be seen as an exception, but simply a slightly more extreme case” of the tax avoidance carried out through using intangibles and other mechanisms, he said.

Those techniques have made “a joke of the arm's-length principle” and given rise to an explosion in profit shifting since the 1990s, Cobham asserted.

“Back then, only 5-10% of U.S. multinationals' global profits were declared for tax purposes outside the jurisdictions of real economic activity,” he said. “By the 2010s, this rose to 25-30% and perhaps above.”

A report from the International Monetary Fund said in March that countries outside the 36-member OECD lose about $200 billion in revenue each year, or about 1.3% of gross domestic product, because multinational companies shift profits to low-tax jurisdictions.

The Question of Fairness

Discussions of tax policy in the digital economy aren't concerned with correct pricing so much as they are with the question of fairness, Faulhaber said.

“They're bigger conversations about what's the fair amount to tax, what's the right party to tax,” she said — and about “who's been kept out of the international tax system until now and wants to have a voice and a right to tax.”

According to Cobham, the solution to digital taxation is one the OECD and businesses have long resisted: global formulary apportionment. The existing tax system, he said, should be replaced with a formula that would apportion profit according to the location of factors such as employment and sales, which “would apply equally to the digital sector as to others.”

What seems likely to emerge, however, is a hybrid tax system, where the arm's-length standard continues to apply to some transactions and others are taxed according to a percentage or threshold. That already exists in countries including the U.S., where the 2017 tax overhaul added provisions such as global intangible low-taxed income and the base erosion and anti-abuse tax, layering them over the existing transfer pricing rules.

Using Existing Tools

Some practitioners saw the solution to taxing the digital economy as within the arm's-length standard, arguing companies are well equipped to track the revenue from such things as user interaction with a website.

“There are tools that track eyeballs, visitors to the website,” Khripounova said. “Amazon obviously knows; Google probably should be able to do that because they have an analytic tool.”

Linguanti agreed that digital companies had the data. A company with a web-based service that sells news from around the world has a way to measure how many people click on its website at any given time, and that's information it provides to advertisers.

“They know who's clicking on it, and how many times they're clicking on it,” Linguanti said. “These companies won't exist if they don't have the ability to capture that information and tell their advertisers or funders why they're profitable,'”

In a digital economy, internet clicks and views are business transactions, he said. Where those occur, “you're always going to have arm's-length tools to look at and commercial reality to look to.”

--Additional reporting by Joseph Boris, Todd Buell, Natalie Olivo and Alex M. Parker. Editing by Robert Rudinger and Tim Ruel.

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