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VIEWPOINT

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In this article, Richter and Weber propose eliminating the double taxation arising from the application of amount A by limiting the obligation to the ultimate parent company and entities that hold intangible assets used directly or indirectly in servicing market jurisdictions.

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Amount A is a new taxing right in the international taxation of profit. It is part of the OECD's two-pillar solution for the tax challenges of the digitalization of the economy. On July 11 the OECD published a progress report containing building blocks for the new taxing right.[1] One of the issues still to be resolved is eliminating the double taxation that arises from applying amount A to the profit allocation system. This article criticizes the proposed method to eliminate double taxation and presents an alternative for discussion.

The progress report focuses on group profitability, which must exceed a threshold for a portion (amount A) to be taxed by the market jurisdictions. Profitability also decides whether a country must eliminate the double taxation that arises when market jurisdictions exercise the new taxing right. However, the two definitions of profitability differ significantly. In the first case, the profitability index is the profit margin obtained by dividing the financial accounting profit of a group by its revenues. In the second case, the profitability index is a jurisdictional rate of return. That is to say, a jurisdiction must eliminate double taxation if the covered group's return on depreciation and payroll in that jurisdiction exceeds the returns in all other jurisdictions.

Using two different indices of profitability has several drawbacks. Not only is it more difficult politically to agree on common definitions, but two sets of calculations means higher compliance costs. Above all, reference to a jurisdictional rate of return represents a step backward from efforts to tax profit in line with value creation. In the international tax system, this goal is jeopardized by multinational enterprises' profit-shifting activities that separate entity accounting invites.[2]

[1] OECD, "Progress Report on Amount A of Pillar One, Two-Pillar Solution to the Tax Challenges of the Digitalisation of the Economy" (July 11, 2022).

[2] For a recent empirical study of profit-shifting activities using intangibles, see Katarzyna Bilicka, Michael P. Devereux, and Irem Guceri, "Tax Avoidance Networks and the Push for a 'Historic' Global Tax Reform," in *Tax Policy and the Economy*, Vol. 37 (forthcoming 2022).

The base erosion and profit-shifting project's inclusive framework therefore decided to refer to the group's consolidated profit to determine whether an MNE is in scope of amount A.[3]

Linking the obligation to eliminate double taxation to a jurisdictional rate of return effectively backslides to separate entity accounting and undermines efforts to bring profit taxation in line with value creation. This is because the obligation to eliminate double taxation — by applying the credit or exemption method — is costly in terms of tax revenue. Therefore, jurisdictions will seek ways to avoid it. If a specific level of return triggers the obligation to eliminate double taxation, jurisdictions will have an incentive to reduce their own returns. If the relevant return is based on depreciation and payroll, jurisdictions will provide accelerated depreciation and subsidize labor costs to encourage MNEs to invest in capital and increase employment, both of which have a lowering effect on depreciation and payroll return.

Further, it is not enough to require specific jurisdictions to eliminate double taxation. It must be clarified which group entity of a covered MNE is entitled to double taxation elimination if there is more than one in the jurisdiction. The progress report leaves this question unanswered.

In view of the drawbacks, one must ask whether there is a simpler way to allocate the requirement to eliminate double taxation. This article presents the allocation rule proposal for discussion:

> The obligation to eliminate double taxation should be limited to those entities of a covered group that hold intangible assets that are non-rival in use and employed directly or indirectly when servicing market jurisdictions. If the profits of the entities holding intangibles are not high enough to eliminate double taxation, the ultimate parent company is entitled to the elimination.

In this article, the proposed rule will be referred to as the "intangibles rule," and the progress report rule will be referred to as the "RoR rule."

Earning supernormal profits requires market power, which generally results from natural or legally created scarcity.[4] Natural scarcity is typical for natural resources, for example extractives. Legally created scarcity results from know-how when secrecy, patenting, licensing, and similar dispositions restrict third-party use. However, profit earned from extractive activities is excluded from the scope of amount A by political agreement. This suggests that supernormal profits that market jurisdictions are supposed to tax have to result from legally created scarcity in the use of know-how. The importance of such excludable know-how is underlined by John H. Dunning's eclectic paradigm of international business.[5] According to the paradigm, the wish to reuse expensively developed, excludable know-how is the key driver of production multinationalization. In the balance sheet, patented know-how should appear as an intangible asset.

Placing the requirement to eliminate double taxation on group entities directly holding intangibles links it to the source of supernormal profit. It curbs the incentive for jurisdictions to pursue beggar-your-neighbor policies. Tax regimes set up solely to attract the holding of intangibles simultaneously strengthen the requirement to eliminate double taxation. This implication helps to tax profit in line with value creation. If the profits of entities holding intangibles should not be sufficient to eliminate double taxation, the ultimate source of the supernormal profit must be know-how, which is kept secret. In that case, the ultimate parent company will hold the know-how, and it is perfectly appropriate to require the ultimate parent company to eliminate double taxation.

[3] The relevant measure of in-scope MNE profit or loss is financial accounting income with a small number of adjustments. OECD, "Statement on a Two-Pillar Solution to Address the Tax Challenges Arising From the Digitalisation of the Economy" (2021).

[4] Wolfram F. Richter, "Reforming International Taxation: A Critique of the OECD Plans and a Counterproposal," *Tax Notes Int'l*, June 28, 2021, p. 1823.

[5] Dunning, "Trade, Location of Economic Activity and the MNE: A Search for an Eclectic Approach," in *The International Allocation of Economic Activity* 395-418 (1977); and Dunning, "Toward an Eclectic Theory of International Production: Some Empirical Tests," 11 *J. Int'l Bus. Stud.* 9-31 (1979).

In practice, identifying which group entities hold intangibles could be difficult because of an information gap in MNEs' international financial reporting standards accounting information. IFRS accounting does not reflect intangible information reliably because the applicable rule[6] generally requires only acquired intangibles to be recognized, while limiting recognition of internally generated intangibles to specific circumstances, a requirement often not followed. In fact, there is an implicit option for the capitalization of internally generated intangibles under IFRS.

Intangibles are therefore not necessarily recognized as assets in IFRS financial statements even though they are possibly the entity's most significant assets.

Nevertheless, the intangibles rule remains a less costly option to administer than the RoR rule. IFRS accounting issues aside, it should not be difficult to determine which group entity is holding intangibles. As a rule, it should be just one entity. Only if intangibles are held by several entities is there a need for clarification, and various solutions are possible.

One idea allocates the obligation to eliminate double taxation to the relieving group entities in proportion to their adjusted profits. The counterargument is that in practice, profits are determined with a considerable time lag, making a simple rule that does not require elaborate and time-consuming calculations more advantageous. For example, profit that generates the obligation to eliminate double taxation could be split evenly among the relieving group entities. This is justified by the fact that it is impossible to differentiate between different intangibles in terms of valuation if they are all essential for business activity — that is, it makes little sense to differentiate among more or less valuable intangibles. If all intangibles are equally necessary for serving market jurisdictions, then all group entities holding those intangibles and the ultimate parent company should evenly share the obligation to eliminate double taxation.[7]

One could also tie the obligation to eliminate double taxation to the effective tax rate levied on intangibles. This would mitigate the incentive to attract intangibles with low tax rates.

Although several questions are still to be clarified, the intangibles rule remains easier to administer than the RoR rule. ■

[6] Financial reporting of intangibles is prescribed by IAS 38.

[7] The risk of incomplete elimination and remaining overhangs should be low in practice. The MNE has its own interest in ensuring that elimination always succeeds completely.