The **BEPS** Monitoring Group

COMMENTS ON THE OECD SECRETARIAT PROPOSAL FOR A 'UNIFIED APPROACH' UNDER PILLAR 1

This submission has been prepared by the BEPS Monitoring Group (BMG). The BMG is a network of experts on various aspects of international tax, set up by a number of civil society organizations which research and campaign for tax justice including the Global Alliance for Tax Justice, Red de Justicia Fiscal de America Latina y el Caribe, Tax Justice Network, Christian Aid, Action Aid, Oxfam, and Tax Research UK. This report has not been approved in advance by these organizations, which do not necessarily accept every detail or specific point made here, but they support the work of the BMG and endorse its general perspectives. It has been drafted by Sol Picciotto, with contributions and comments from Jeffery Kadet, Tatiana Falcao, Lakshmi Narayanan, Annet Oguttu, and Attiya Waris.

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SUMMARY

We welcome the attempt in these proposals to address the mandate of the G20 leaders for the BEPS project, to devise rules that can ensure that multinational enterprises (MNEs) pay tax in line with their activities in each country. We strongly support the proposal to begin from the global profits of each multinational enterprise (MNE), using a definition suitable for tax purposes. It is also commendable to aim to devise simple formulaic methods, and to ensure a more appropriate allocation of profits to source countries.

However, it should be made clearer that the justification for this is that MNEs now have increasingly close and continuing relationships with their customers and users, so that source countries are those where their activities in a significant sense take place, and are not merely markets. This has become much more evident with digitalisation of the economy, but is a longer-term trend that began with the shift to services and the post-industrial economy. Hence, in our view a comprehensive solution is needed, that applies to all MNEs without a size threshold, and not limited to consumer-facing businesses. Such distinctions would just add further complexity, by requiring segmentation of MNE accounts by business lines, and retaining current transfer pricing rules for large parts of the global economy.

The current proposals would also be undesirably and unnecessarily complex, because they are based on the residual profit split method. This would need a split of the supposed 'routine' from 'non-routine' profits, and a further division of the non-routine profits to decide the amount to be apportioned to 'market' countries, both determined by fixed percentage(s). Hence, the allocation not only of the routine profits but also the portion of the non-routine not apportioned by sales would continue to depend on the present unsuitable transfer pricing rules. The problems of supposedly 'stripped risk' structures being used for BEPS purposes is not confined to distribution, but is also used by MNEs to minimise tax payable by affiliates engaged in manufacturing, R&D and even some services activities.

A far simpler approach would be to develop the profit split method to apportion the global profits by factors reflecting the contributions made by affiliates of the MNE in each country. International agreement is needed on the general principles of allocation, which in our view should reflect the basic drivers of profit: labour, users, physical capital and sales, which are location-specific and can be quantified relatively easily. Further technical work could develop standardised allocation keys and weightings for common business models, to be applied presumptively and subject to open and transparent procedures for resolving divergences. This would finally establish international tax rules for the 21st century that would be simple to apply, predictable, sustainable and accepted as fair. (See Appendix 1.)

1 General Comments

This proposal is commendable in several respects. First, it begins to address the mandate of the G20 leaders for the BEPS project, to devise rules that can ensure that multinational enterprises (MNEs) pay tax in line with their activities in each country. Hence, it adopts a unitary approach to MNEs, starting from their global consolidated profits. Further, it accepts the need for a reallocation of taxing rights, towards source countries, although this is mischaracterised in the document. The reallocation should not be viewed as granting greater rights to 'market' jurisdictions. The true justification is that digitalisation has accelerated the longer-term shift to a post-industrial services economy, in which firms have closer and continuing relationships with their customers. Digitalisation is the latest of the enormous improvements in communications that have made it much easier for businesses to maintain these closer relationships across borders. In this increasingly dematerialised economy, producers and customers are more closely bound together and interactive, so that the old distinction in international tax between residence and source is much less salient. Finally, the document recognises the need for simplified methods for allocation of MNE income, which is particularly important for developing countries.

Although the proposal entails a significant reorientation, its design at present is faulty. It is understandable that the OECD Secretariat should seek to formulate a proposal that might gain political support by drawing from elements of the three main conceptual approaches put forward by governments. In our view, however, this is a mistaken approach. It is like trying to design a new car by combining parts of the blueprints prepared by different designers. The proposal is unnecessarily complex, and to make it coherent will further increase its complexity. This problem has been exacerbated by trying to satisfy even those who do not see any need for change, which will mean retaining the existing rules on transfer pricing for large parts of the system. The only consensus likely with this approach is that no-one will be satisfied.

1.1 The Structure of the Proposal.

The proposed 'new taxing right' would entail a multi-stage process:

(i) identify the MNEs within its scope: i.e. those above the size threshold, and which have some consumer-facing business;

(ii) identify the MNE group's global profits, starting from its consolidated financial statements prepared under the accounting standards of the headquarters jurisdiction in accordance with the Generally Accepted Accounting Principles (GAAP) or the International Financial Reporting Standards (IFRS) (paragraph 53);

(iii) segment these accounts on a business line and/or regional/ market basis, particularly to identify the profits from consumer-facing business lines that are within scope;

(iv) for these ‘consumer-facing’ business lines, separate non-routine from routine profits, perhaps by a simplified method using ‘a fixed percentage(s), possibly with variances by industry’ (paragraph 54);

(v) split the non-routine profits between the amount that should be attributable to market jurisdictions and that to other factors (paragraph 57), using an internationally agreed fixed percentage, possibly with variations between industries or business lines;

(vi) allocate the portion of non-routine profits attributable to the market jurisdiction by a formula based on sales - this is Amount A;

(vii) determine the allocation of Amount B, as a simplified method of attributing profit to the market jurisdiction for distribution functions (apparently from the routine profits);

(vii) determine the allocation of both the remaining routine profit and the portion of non-routine not allocated to the market under Amount A, using current transfer pricing rules, including Amount C;

(viii) ensure adequate coordination in the allocation of profits by Amounts A, B, and if relevant C, with the attribution of remaining profits under existing transfer pricing rules so that there is neither double taxation nor double non-taxation;

(ix) submit individual contentious cases to mandatory binding dispute resolution.

We agree with the starting point of defining the MNE’s global profits proposed in Step 1, and welcome the technical work to be carried out by the OECD to enable the determination of profit for tax purposes, perhaps starting from financial accounts. The remaining elements of the proposal are all in our view problematic, and introduce unnecessary and undesirable complications and limitations.

The structure is based on the ‘residual profit split’ method already accepted under the OECD Transfer Pricing Guidelines (TPGs). As we have pointed out in several of our previous submissions and reports, a better approach would be to build on the profit split method based directly on the contributions of the various entities, which is also accepted under the TPGs. This would provide a far superior method for deciding the key steps (iii) and (iv) in this proposed approach, which determine the proportion of the global profits that could be allocated to the ‘market’ under the new taxing right.

In the current proposal this key determination would be made by applying internationally agreed fixed percentages twice: first to split routine and non-routine profits, and then (using a different percentage) to divide the ‘non-routine’ profits between ‘market’ and other jurisdictions. This approach cannot provide the basis for a solution that could be effective, sustainable or accepted as fair. There are enormous differences between economic sectors, business models and even individual firms – and these might be further exacerbated by the geographic coverage of these firms, their target markets and main currency of operation. Hence, agreed fixed percentages could only provide a very crude approximation of both the ‘residual’ profit and the portion of it attributable to market jurisdictions. It is hard to see how a system applying percentages fixed in this way could provide the basis for a binding international agreement, let alone one that could be sustainable.

We again urge that the best approach for a lasting international solution is to build on the profit split method based on a contribution analysis. This would provide an approach that could be comprehensive, effective, and accepted as fair. Above all, it would be transparent and much easier to apply. The elements of this approach would be as follows:

(i) it would apply to all MNEs, i.e. firms with a taxable presence in more than one jurisdiction; for any firm having no physical presence outside its country of residence under current rules, appropriate thresholds would apply in the criteria for establishing non-physical nexus;

(ii) identify each MNE group's global profits, based on an internationally agreed methodology (as envisaged in the current proposal);

(iii) a political agreement on the general principles for apportioning the income based on objective factors that reflect real economic activities in each country: these should be **easily quantifiable** and **location-specific**; we suggest that these factors should be **labour**, tangible **capital** and **sales**;

(iv) detailed work to establish agreed standardised concrete allocation keys and weighting of these factors for common business models and economic sectors;

(v) application of the agreed methodology and splitting factors by MNEs and relevant tax administrations on a rebuttable presumption basis, coordinated where necessary through information exchange and mutual agreement procedures;

(vi) resolution of uncertainties and disagreements through a transparent procedure, resulting in published clarifications and determinations.

This approach would be in many ways similar to that of the current proposal. It would start from each MNE's global profits, and aim to apportion them by an internationally agreed methodology. The broad principles for apportionment would need to be agreed politically. However, under our approach the political decision would be based on clear principles that would provide a rationale for the allocation, not a number plucked from the air. Under the current proposal the political agreement would have no theoretical basis but would simply mean a flat percentage that would not in any way represent an allocation of taxing rights that is based on real activities. Further, it would entail a crude numerical allocation providing no flexibility for the specificities of the wide variety of MNEs and business models.

The application of the principles that we propose would depend on detailed methodologies to be developed by technical specialists, also by international agreement. There would be procedures for resolving conflicting interpretations and determinations to ensure no double taxation (or double non-taxation). But instead of arbitration or some other ad hoc individualised decision, the emphasis in our approach would be on agreeing a generally applicable methodology that would be published.

Overall, our proposed approach is significantly different in that it would establish a system that would be much simpler and easier to administer, as well as comprehensive, transparent and accepted as fair.

In the following sub-sections we discuss the main problems we see with the current proposal.

1.2 Scope Limitation: Size

The new provision is designed as a 'new taxing right', that would apply only to 'large consumer-facing businesses'. This first entails a size threshold. Large developed countries are advocating a high size threshold. Yet MNEs that at a global level may be considered medium or small can have a significant presence in the economies of developing countries and even some developed countries. Excluding them would mean that the current rules would remain unchanged for large parts of the world economy, and would be particularly detrimental to countries with smaller economies.

The new provision does not explore what it means to be a 'large MNE' from a developing country perspective. It seems clear from the assessment of the current state of affairs, that companies that are considered to be small and medium from the perspective of the global north can be actually considered to be large MNEs with substantial local impact from a developing or emerging economy perspective. Furthermore, since the size threshold currently being considered under the proposal does not take into account currency fluctuation or exchange rates, these companies could go under the radar and continue to operate without constituting a substantial market presence. Even a large MNE of global reach whose principle reporting obligation is in a developing or emerging economy could see itself under the unified approach one year, and out of the new proposed allocation rule the next, if faced with a large local currency devaluation. That would bring additional complexity both to the MNE, which would have to switch accounting standards, and to tax administrations, which might see a corresponding loss in revenue despite the continuous non-physical presence in the jurisdiction.

A size threshold of EUR 750 million was provided in BEPS Action 13 for the new obligation for MNEs to provide country-by-country reports (CbCRs), and this is mentioned as a possible threshold also for this proposal in the discussion draft (DD, para. 20). The reason for the threshold in Action 13 was to ensure 'an appropriate balancing of reporting burden and benefit to tax administrations', and the threshold was to be reviewed in 2020.[1] There was perhaps a case for such a threshold in relation to CbCRs not only because these were new reporting requirements for MNEs, but also because rather than simply requiring publication of CbCRs, a complex system was devised for home-country filing and exchange, which needed tax administrations to introduce new data handling systems.

It is hard to see a rationale for any size limitation for the new profit allocation methods. These proposals are intended to apply to MNEs that already have a taxable presence (permanent establishment, PE) under current rules, as well as to those to which the proposed new nexus would apply (DD para. 16). The size limitation would mean that MNEs could be taxed differently depending on their global size and their sales volume in relevant countries. It seems unnecessary, undesirable and unjustifiable to make this proposed new allocation method applicable only to the globally largest MNEs. The principles and the simplification will be a benefit for all MNEs and all tax authorities, regardless of an MNE's size and level of local sales.

1.3 Scope Limitation – Consumer-Facing

Secondly, the proposed new taxing right would apply only to businesses that are 'consumer-facing'. This would be a major limitation, for which there seems no valid justification. The reason suggested for this is that it has become increasingly possible, especially due to digitalisation, for some MNEs to 'project themselves into the daily lives of consumers (including users)'. We agree that there is a strong case for allocating rights to tax income from services to the country where those services are delivered, due to the close relationship between the customer and the service provider. However, this rationale is not limited to services provided to individual consumers.

The provision of services generally entails much closer ties between supplier and customer than for sales of physical goods. Services generally involve a continuous relationship, often on a subscription or retainer basis, rather than discrete sales transactions. They usually necessitate close interaction between the parties, involving reciprocal flows of information,

[1] BEPS Action 13 Final Report: *Transfer Pricing Documentation and Country-by-Country Reporting* 2015, paras. 53-54.

and requiring trust and confidence. These features are if anything more salient for business-to-business services than for consumer services. The G20 called for tax to be paid 'where activities take place', and in the case of services it is clear that key elements of the activities take place where the services are delivered, not just where the service provider is resident. Hence, there is a strong case for reconsidering the allocation of taxing rights for all services, indeed it is in some ways stronger for business than for consumer services.

This is particularly important for developing countries, since the provision of services by non-residents is often material to their domestic economies. This results in a double disadvantage. Not only are they often restricted from taxing the income earned, but also the payments by local residents to non-resident service providers erode the local tax base, since they are generally deductible from business profits. Also, the legal person providing the service can often be located in a convenient jurisdiction, where the payment is subject to low or no taxation. The BEPS project recommendations so far have done little to end such practices.

Many countries attempt to combat this by applying a withholding tax on the gross amount paid by the service recipient. Although such taxes are relatively easy to administer and hence can be effective, they are not profit-related and are easily passed on directly to the consumer. Furthermore, the restrictions on source taxation in tax treaties may also prevent such taxes, depending on the categorisation of the payment, and on the wording of the 'Other Income' article in the treaty.

A more appropriate and effective solution is for the income itself to be taxable in the country where the services are furnished. Many developing countries in principle apply tax to all income or profits derived from or arising in the country, including income from services delivered in the country. Some countries aim to apply this principle also to digitalised services, for example Kenya[2] and Saudi Arabia.[3] However, their rights to levy such tax are limited by tax treaties, which allow taxation of the income of a non-resident only if there is a taxable presence. Many developing country tax treaties include a provision for a 'services PE' based on article 5.3.b of the UN model convention if services are delivered by personnel on behalf of the non-resident for a minimum period (usually 6 months).[4] Even if there is a taxable presence, there is still the issue of attribution of profits. Many treaties also include a provision based on article 7(4) of the UN model, which allows the use of fractional apportionment if that has been traditionally used in the country. It seems that few if any countries have applied this approach systematically, although they may perhaps begin to do so now. Indeed, India's Central Board of Direct Taxes has already put forward a proposal to introduce fractional apportionment in attributing profits to non-residents with a 'business connection in India'.[5]

[2] Finance Bill 2019 clause 3, amending the Income Tax Act s.3: 'income chargeable to tax includes income accruing through a digital marketplace'.

[3] It has been reported that the Department of Zakat and Tax has issued new guidelines according to which a non-resident will be deemed to have a PE if services are furnished to a person in connection with that person's activities in the country for the relevant threshold period (usually 183 days), regardless of whether the persons furnishing the services are physically present in the country (see EY Global Tax Alert 30 July 2015, available here). This is not limited to digitalised services, and is based on the strong source taxation principle in Saudi tax law (Gidirim, V. (2016), 'Taxation of Foreign Multinational Enterprises Conducting Business in and with Saudi Arabia.' *Bulletin for International Taxation* **70**(4).

[4] This is usually interpreted to require physical presence, though some countries do not accept this view: see UN Model Convention 2017, Commentary to article 5, para. 10.

[5] Our comments on the Indian proposal are available here.

The proposed limitation of the new taxing right to consumer-facing business would raise difficult categorisation problems for a large proportion of services, including those delivered by digitalised means. For example, digitalised advertising is a business-to-business service, as it is not paid for by consumers. Similarly, digital marketplaces often provide a platform for third-party businesses, rather than direct sales by the platform provider to consumers. For such business models, and many others, clarification would be needed on how 'consumer-facing' would be defined, as suggested in paragraph 20.

The concept of 'consumer facing' seems intended to exclude many types of services from the current proposal, ranging from engineering and construction to professional, advisory and consultancy services. All such activities entail close contacts between service providers and their customers and others in the country where the services are provided. The failure to include these activities is a serious limitation on the proposals, for which it is hard to see any rational justification. Rather than assessing the group's presence based on a tiered approach, the question should be whether the group as a whole has a presence in a country due to its close interaction with customers, and then to determine the extent of its presence.

The document suggests that other exclusions are under consideration. It states that 'extractive industries are assumed to be out of the scope' (paragraph 15). It would clearly be inappropriate for actual extraction activities to be included in this proposals, since the rents from extraction of raw materials should be taxed by the source country. However, many companies provide engineering and other services in the extractive sector, often through non-resident offshore entities. There is clearly a strong justification for the income derived from such activities to be taxed in the country where the services are delivered, so they should not be excluded. Any exclusion should be limited to the export of commodities or raw materials, and not to the extractives sector as a whole.

1.4 Increased complexity

The biggest disadvantage of the proposals is that they would significantly increase the complexity of international tax rules. This contradicts the aim, expressed in paragraph 17, that 'an "administrable" solution is essential, especially for emerging and developing countries'.

An effort is being made to ensure that the new measures proposed would themselves use simplified methods. However, the new taxing right proposed as Amount A is designed as an overlay on the existing rules for allocation of MNE income. This means that the current rules would continue to apply:

(i) to MNEs not within the scope of the new provision; and

(ii) to the allocation of the 'non-routine' profits.

Adding a new allocation method in this way will inevitably increase the complexity of the system, even if the new method itself is designed to be relatively easy to apply. This can be seen from our outline in section 1.1 above of the structure of the proposal. The complexity results from both the multi-stage procedure, as well as from the need to continue to apply current transfer pricing rules, and to coordinate that application with the allocations of Amounts A, B and C under the new taxing right.

The proposal seems to overlook the likelihood that the portion of the deemed non-routine profits not allocated to market jurisdictions as Amount A could be attributable to several countries, especially due to the joint creation and exploitation of intangibles within an MNE group. The illustration provided in section 3.1 of the document provides only a highly simplified case where intangibles are owned by a single entity. However, even under the

existing transfer pricing rules mere ownership does not justify attribution of income. The revised TPGs now emphasise the need for a more extended analysis, focusing on the so-called DEMPE functions (development, enhancement, maintenance, protection, and exploitation). Under the current rules this remains subjective. We have explained our approach to this issue in more detail in our previous submission in March 2019.[6]

1.5 Continued Reliance on Current Transfer Pricing Rules

Throughout the document, there is an ongoing theme about the current transfer pricing rules working well in most cases. Paragraph 28 on page 8 is typical and reads, in part:

> … At the same time, while a number of criticisms of the arm's length principle have been voiced, there is a recognition that the current rules work reasonably well for most routine transactions.

We take issue with this fundamental point.

This point is belied by what is said in the Paragraph 30 explanation of Amount B:

> … However, given the large number of tax disputes related to distribution functions, the possibility of using fixed remunerations would be explored, reflecting an assumed baseline activity. …

Paragraph 52 on page 13 comments:

> … This is important because, by introducing a threshold based on profitability and targeting deemed non-routine profit, the proposed method is designed to materially limit the disruption of the conventional transfer pricing that is applied to routine activities. …

There are several issues with this fundamental point that the current rules work reasonably well and should be continued.

A first issue of course is that application of these rules to imaginative tax structures has been an important contributor to BEPS. A second issue is that these rules are in practice highly complex and difficult to apply, especially for developing countries. In Africa for example the introduction of transfer pricing rules is recent and partial. Only 18 out of 55 countries now have detailed regulations, and many even of these have not yet formulated policies for enforcement. This approach is not useful for the large majority of developing and often post conflict countries, which face much more basic problems of tax administration.

A third issue is that the unified approach is based on methods that separate routine from non-routine profits (referred to as residual profits). This is conceptually flawed, since the super-profits or rents of MNEs derive from the synergy of their combined activities in many countries. The proposal makes an assumption that routine activities do not contribute to an MNE's overall profitability beyond some normally very limited amount. Rather, in many of today's business models, these 'routine' activities and functions are integral and important

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[6] Available at https://www.bepsmonitoringgroup.org/news/2019/3/10/addressing-the-tax-challenges-of-digitalisation-of-the-economy. Since that submission, our argument about the DEMPE functions has been echoed by other commentators, notably Ara Stepanyan and Steven D. Felgran ('People Functions Redux: A New Approach to Profit-Splitting Factors', *Tax Notes International*, 2019, 95: 1237-1246). They also cite Plotkin and Axelsen, 'The Three-Factor Formula vs. the Sources of Income in the New and Weightless Economy', *Tax Management. International Journal* 4: 3-20. These arguments, from tax professionals, demonstrate that there is growing support for developing formulaic apportionment methodologies, based on the existing profit-split method and concepts such as the DEMPE functions in the current Transfer Pricing Guidelines. For a brief outline of our proposal, see the Appendix, which also refers to previous submissions that provide more detail.

parts of the company's overall business model. For example, think of the warehousing and physical delivery systems of online retailers and marketplaces such as Amazon that provide the rapid delivery that is such an important aspect of the group's appeal to customers. This fast delivery is a critical part of their business model, representing significant value, and results from the integration of the entire supply chain. Simply assigning routine profits to such functions does not encompass this value. The proposed sales-based allocation for Amount A will of course include a portion of these profits, but really no more than a token amount.

As a fourth issue, affiliates within an MNE group often also carry out other activities that contribute to the synergy of its integrated operations, such as procurement, research and development, design, communications, manufacturing, etc. As mentioned in the previous sub-section, the proposal glosses over the issue of the allocation of the portion of the non-routine profit not attributed formulaically to the market. It seems that the intention is to continue to apply current transfer pricing rules to determine the allocation of income for such activities. It is hard to claim that these rules generally work well for such activities.

As a final issue, the ad hoc and fact-intensive analyses required by current transfer pricing rules require armies of specialists within both MNEs and tax authorities. While what these many specialists do is very important to establishing an MNE's tax obligations to multiple countries, it is an enormous drain of resources that could be better invested in other societal uses. There are other ways to establish an MNE's tax obligations to multiple countries that would provide equally fair results to all parties and that would require much less effort.

1.6 Double Non-Taxation/Double-Taxation

Paragraph 56 on page 14 reads:

> The completion of this step [splitting group-wide profits into their routine and non-routine components] would not be intended to disturb the actual allocation of the remuneration derived from actual routine activities under the current transfer pricing framework. Instead, the purpose of the simplifying conventions would be merely to simplify the calculation of the deemed non-routine profit subject to the new taxing right.

We understand and recognise that this divorcing of the calculations of Amount A and Amount B is practical; one Amount should not be dependent on the other Amount. If these two Amounts were interdependent, then the practical issues of having to resolve all Amount B profits before finalizing the Amount A would be paralyzing to the system. This however does create the potential for some amount of double non-taxation or double-taxation. This is another reason for the alternative approach that we recommend. There should be just one allocation with weightings as necessary that takes into account all profit and all activities, assets, and sales. This would in a simple and direct way ensure no double non-taxation or double-taxation.

1.7 Political Determination of Profit Splitting

Paragraph 58 on page 15 reads:

> Given the practical difficulties of using conventional transfer pricing rules for this step, the proposed approach assumes that a share of the deemed non-routine profit attributable to the market jurisdiction would be determined in accordance with a simplifying convention, such as non-routine profit multiplied by an internationally-agreed fixed percentage, though it is possible that different percentages might be applied to different industries or business lines.

This approach means that Amount A will be the product of a political agreement that identifies one or more fixed percentages to be applied to all MNE situations. This sort of agreement means that taxing rights are based on an *artificial standard* and not on *real* activities, assets, and sales. It will be recalled that one of the most fundamental objectives of the BEPS project was to align value creation and profits. An Amount A determined using politically agreed fixed percentages means that this objective has been jettisoned.

We believe that the aim to align value creation and profits must be retained. Our recommended approach would ensure this and would do so in a much simpler manner. Our approach entails just one allocation based on the key factors - labour, users, capital and sales - that reflect the *real* activities of the MNE in each country. In contrast, the application of fixed percentages as suggested would be arbitrary, as well as creating complexities. The political determination of the percentages for Amount A seems intended to make it hard for countries to make any further claims based on Amount C.

A criticism that has commonly been made of formula apportionment is that it would require political agreement on the apportionment factors. We agree that this is necessary. In our view, however, it should be easier for countries to agree these principles that would provide a balanced allocation between supply and demand factors, than to decide a flat percentage to be applied to all firms regardless of their actual business model and activities. As we have argued, by developing standardized allocation keys and weightings for standard business models and economic sectors, there will be results that are fair to both tax administrations and taxpayers…and that achieve true simplification.

1.8 Guidance for Required Taxpayer Disclosures

As noted above, there are many activities, whether related to marketing and distribution or not, that go beyond the 'baseline' or routine activities that are contemplated for the established fixed returns. In theory, a local country can pursue additional taxable revenue as an Amount C. However, it is inevitable that there will be a lower level of audit activity due to the defined fixed returns for these 'baseline' or routine activities. As such, local audits will seldom conduct the work necessary to identify Amount C situations.

With this being the case, mandatory taxpayer disclosure requirements that will highlight activities that go beyond the defined 'baseline' or routine activities must be a part of any new approach. Only in this way will tax authorities be alerted to situations that legitimately warrant an Amount C. Future detailed work must provide guidance on such disclosure requirements.

2. SPECIFIC QUESTIONS

2.1. Scope.

Under the proposed "Unified Approach", Amount A would focus on, broadly, large consumer (including user) facing businesses. What challenges and opportunities do you see in defining and identifying the businesses in scope, in particular with respect to:

a. their interaction with consumers/users;

b. defining the MNE group;

c. covering different business models (including multi-sided business models) and sales to intermediaries;

d. the size of the MNE group, taking account of fairness, administration and compliance cost; and

e. carve outs that might be formulated (e.g., for commodities)?

We do not regard this limitation as either desirable or necessary. The only opportunity it would provide would be for tax advisers to exploit the inevitable uncertainties in the definition of 'consumer-facing' to ensure that a low level of income would be attributed to the country of sales.

As discussed in section 1.3 above, there is in our view if anything a stronger justification for allocating taxing rights over business services to the country where those services are performed. The limitation to consumer-facing will inevitably create difficult problems of classification. Many business models derive value from systematic collection of data or content from customers or users, but this value may be realised in business-to-business sales, notably for advertising. If these are to be considered consumer-facing, how would the line be drawn?

Similarly, as we also discussed in section 1.3, a carve-out for the entire extractive sector would exclude the many services activities in this sector, which are often carried out by non-resident companies. A more targeted exclusion only for exports of commodities might be more appropriate. However, neither of these exclusions would seem necessary if, as currently proposed, the new taxing right is anyway limited to consumer-facing business.

2.2. New nexus.

Under the proposed "Unified Approach", a new nexus would be developed not dependent on physical presence but largely based on sales. What challenges and opportunities do you see in defining and applying a new nexus, in particular with respect to:

a. defining and applying country specific sales thresholds; and

b. calibration to ensure that jurisdictions with smaller economies can also benefit?

As stated in section 1.3. above, the scope of any 'Unified Approach' should be expanded, not limited by adopting a new nexus based on sales and other factors. In our view, the nexus should be based on factors reflecting a significant and sustained contact with customers, clients and users, proportionate to the size of the country's economy. While sales may provide a useful rule of thumb, they should not be the primary or a necessary criterion.

A clear principled approach and objectively measurable criteria for evaluating the place of sales needs to be developed. The OECD work on VAT with regard to "place of supply" can provide some guidance in this regard. This needs to be complemented by a new reporting requirement for MNEs to publish country-specific sales figures across all jurisdictions, preferably as part of public CbCR.

2.3. Calculation of group profits for Amount A.

The starting point for the determination of Amount A would be the identification of the MNE group's profits. The relevant measure could be derived from the consolidated financial statements. In your view, what challenges and opportunities arise from this approach? Please consider in particular:

a. what would be an appropriate metric for group profit;

b. what, if any, standardised adjustments would need to be made to adjust for different accounting standards; and

c. how can an approach to calculating group profits on the basis of operating segments based on business line best be designed? Should regional profitability also be considered?

We agree that consolidated financial statements are the best available starting point. However, this is not enough. As part of this process, there must be integration with CbCRs.

In our submission of 22 February 2014,[7] we stated:

> … A master file must include a reconciliation of all business line reports to individual jurisdiction reports as required by CBC (see below) and to the overall multinational corporation's consolidated financial statements of which they must, inevitably, form a part.
>
> This will mean that, by default, such business line reports will need to:
>
> a. Reconcile turnover by line with turnover by jurisdiction and for the group, inevitably requiring disclosure of turnover by source and destination and the identification of all intra-group transactions;
> b. Reconcile employee head count and costs by business line report with jurisdiction reports;
> c. Reconcile capital employed and tangible assets used with jurisdiction reports;
> d. Reconcile royalties paid and received, interest paid and received and services fees paid and received on an intra-group basis with jurisdiction reports;
> e. Reconcile profit before tax with jurisdiction reports;
> f. Explain any residual profits or losses incapable of reconciliation with jurisdiction reports on a country-by-country reporting basis as shown in or excluded by business line reports;
> g. Reconcile jurisdiction reports on a country-by-country reporting basis to group consolidated profits without in this case any residual elements being allowed since all profit must be located;
> h. Reconcile group consolidated profits with net profits before tax as reported to tax authorities by jurisdiction as opposed to net profit before tax as reported on a country-by-country reporting basis to therefore reveal profit not reported for tax purposes.
>
> This reconciliation process will produce most of the data needed to reveal any base erosion and profit shifting which may be taking place.

This integration with CbCR and reconciliation of all information will provide more integrity to MNEs' calculations and submissions as well as tremendously ease the work of applicable tax authorities.

As regards question (c), in our view, there should be no built-in segmentation by business line, or by region. The presumption should be that every MNE derives its super-profits or rents from the synergy of the combination of its activities. Certainly, the profitability of different lines of business will vary in different time periods. However, if such divergence is maintained, and synergies are not apparent, firms will come under pressure from their investors to divest or demerge business lines.

Nevertheless, the proposal that we have put forward would entail the formulation of allocation keys and weightings that are appropriate for various standard business models and

[7] Available at https://www.bepsmonitoringgroup.org/news/2018/5/8/bmg-submission-on-country-by-country-reporting?rq=report

sectors. For a firm that combines several business models, these could be blended when applied to the individual firm. Allowances could also be made for country or regional differences, to take into account for example if a business is in a start-up phase. This would be far preferable to attempting to unscramble accounts by business lines, or regionally.

2.4. Determination of Amount A.

In determining Amount A, the second step would exclude deemed routine profits to identify deemed residual profits. The final step would allocate a portion of the deemed residual profits (Amount A) to market jurisdictions based on an agreed allocation key (such as sales). In your view, what challenges and opportunities arise from this approach?

As explained in section 1.1 above, we regard these steps as unnecessary and undesirable, particularly as they introduce considerable complexity. In our view, the most suitable approach is not the residual profit split, but a profit split based on the actual contributions made by affiliates in each country where the MNE has activities.

2.5. Elimination of double taxation in relation to Amount A.

What possible approaches do you see for eliminating double taxation in relation to Amount A, considering that the existing domestic and treaty provisions relieving double taxation apply to multinational enterprises on an individual-entity and individual country basis? In particular, which challenges and opportunities do you see in:

> *a. identifying relevant taxpayer(s) entitled to relief;*
>
> *b. building on existing mechanisms of double tax relief, such as tax base corrections, tax exemptions or tax credits; and*
>
> *c. ensuring that existing mechanisms for eliminating double taxation continue to operate effectively and as intended.*

In our view, there needs to be a group-wide approach to ensuring there is no double taxation. This would be an integral part of our suggested comprehensive approach to allocation of profits. It would be essentially a territorial system, that would use the appropriate allocation factors to determine the income attributable to the entities in each jurisdiction. Under this approach, there would be no need for a foreign tax credit. The OECD secretariat proposals have adopted a hybrid approach, that would allocate by formula a part of the global consolidated profits but retain the existing rules on transfer pricing to attribute the remainder to individual entities. Consequently, it would need a hybrid procedure for relieving double taxation, that would first consider how the global tax base has been allocated, and then decide on the appropriate relief. In our view, this greatly increases the complexity of the proposals.

We recognise that Pillar 2 would involve some recognition of income in home countries for which there should be a foreign tax credit mechanism. That should be considered in connection with Pillar 2. We also recognise that some countries through their taxation of foreign subsidiary dividends (e.g. China) or their controlled foreign corporation rules (including the U.S. GILTI rules) will already have a foreign tax credit mechanism. Perhaps in connection with Pillar 2 considerations, there will be useful guidance that could be provided to such countries to coordinate with Pillar 2 results.

2.6. Amount B.

Given the large number of tax disputes related to distribution functions, Amount B of the "Unified Approach" seeks to explore the possibility of using fixed remunerations, reflecting an assumed baseline activity. What challenges and opportunities does this approach offer in terms of simplification and prevention of dispute resolution? In particular, please consider

any design aspects and existing country practices that could inform the design of Amount B, including:

> *a. the need for a clear definition of the activities that qualify for the fixed return; and*
>
> *b. a determination of the quantum of the return (e.g., single fixed percentage; a fixed percentage that varied by industry and/or region; or some other agreed method).*

As we have repeatedly pointed out, the 'stripped-risk' problem is not confined to distribution. MNEs also operate manufacturing, R&D, services and other affiliates that they claim work on a stripped risk basis.

In section 1.5 above, we stated that:

> [I]n many of today's business models, these 'routine' activities and functions are integral and important parts of the company's overall business model.

Hence, in our view, the proposal for Amount B is doubly inappropriate. First, it singles out distribution, and ignores other functions that are inadequately remunerated under current principles due to the erroneous 'stripped risk' concept. Secondly, it would allocate only a small 'routine' profit to distribution, albeit using a formulaic method.

As recommended above, we believe that the complexity and detail of these proposals should be eliminated and replaced by a better approach that would build on the profit split method using the contributions of the various entities within concrete standardised allocation keys and weightings that have been specifically determined for common business models and economic sectors.

2.7. Amount C/dispute prevention and resolution.

In the context of Amount C of the "Unified Approach", what opportunities do existing and possible new approaches to dispute prevention offer to reduce disputes and resolve double taxation? In particular, what are your experiences with existing prevention and resolution mechanisms such as:

> *a. (unilateral or multilateral) APAs;*
>
> *b. ICAP; and*
>
> *c. mandatory binding MAP arbitration?*

The document is unclear about the scope and application of the proposed strengthening of dispute resolution. These questions suggest that it is being considered only for Amount C, although in paragraph 50 the document says: 'A strong emphasis on dispute prevention and resolution is integral to each of the three types of profit that make up the proposed new profit allocation rules.'

In our view it is totally inappropriate to rely on compulsory dispute resolution, especially arbitration, when the rules to be applied are subjective. The aim should be the prevention of disputes. The adoption of clear and simple methods on the lines we suggest would cause far fewer conflicts. However, as we have explained, the process of development of standardised allocation keys and weightings, as well as their application, should be done cooperatively. Any issues or conflicts of interpretation should be resolved transparently, with published decisions. Regarding the use of unilateral or multilateral APAs, although they have been found useful for complex transfer pricing situations where data on comparables is not available, APAs do not solve all transfer-pricing problems and they are not suitable for all types of transactions. APAs work best for transactions undertaken by generally compliant

taxpayers,[8] and they are most useful for relatively straight-forward issues involving tangible property, services and routine intangibles, but not so helpful in resolving difficult issues like those involving high value intangibles.[9] APAs have been mainly introduced by developed countries and have not been adopted that much by developing countries because APA negotiations can be quite complex and contentious. Often developing countries have to employ costly specialised personnel to deal with APAs. For developing countries to benefit from APA, they would need to build up their experience, the challenge though is that APAs are often developed in private negotiations, which can create increased BEPS risk. The development of standardised allocation keys and weightings that we recommend could certainly build on the experience of APAs, although in our view these should be sectoral, and should be published for full transparency.

This would be very different from the present highly secretive procedures, dominated by tax practitioners from rich countries, that are rightly viewed with suspicion by developing countries. Mandatory binding arbitration would be particularly inappropriate. The current proposals would retain the current transfer pricing rules to a great extent. Far from 'working reasonably well' as the document suggests they are, as we outlined above, highly subjective and an inevitable cause of conflicts. The type of arbitration currently preferred, 'last-best-offer', reduces the process to an unprincipled haggling over amounts and favour those with the most experience in presenting a compelling argument over those with better underlying arguments that may not be well presented. This cannot provide a basis for a system that could be sustainable or accepted as fair. An arbitration system where arbitrators simply pick one of the two options without any fully written explanation justifying the result, but only 'short reasons' explaining the choice which are not made public, is untenable. The lack of jurisprudence on precedents to follow can lead to legal uncertainty. A system geared towards getting quick resolution to disputes, without consideration to fairness and transparency, is not viable. Instead of mandatory binding arbitration, reference could be had to the UN's recommendations to use other dispute resolution mechanisms such as mediation and conciliation.[10]

[8] The Platform for Collaboration on Tax (IMF, OECD, UN and WBG) *A Toolkit for Addressing Difficulties in Accessing Comparable Data for Transfer Pricing Analysis* (2018) at 62.

[9] Federal Tax Conference Discussion Paper *The Real World of Transfer Pricing Today* 77 Taxes 175 (1999) at 175.

[10] UN Committee of Experts on International Cooperation in Tax Matters "Secretariat Paper on Alternative Dispute Resolution in Taxation" (8 October 2015) at 14.

APPENDIX 1

PROPOSED APPROACH

A new approach is needed for a long-term solution fit for the 21st century.

We propose a combination of principles and pragmatism that will provide (i) results that are fair to both taxpayers and tax authorities, and (ii) true simplicity of application.

- First, a **single enterprise principle** should be adopted, to replace the inappropriate fiction that affiliates of a multinational corporate group are independent of each other.
- Secondly, the aim should be to allocate income and taxes according to the fundamental factors that generate profits: **labour, capital and sales**. This would provide a balance between operational factors (employees, physical assets and users where appropriate) and sales to third-parties (without which profits cannot be realised).
- Thirdly, based on closer analysis of different industries/sectors and their commonly-used business models, the Inclusive Framework, along with other relevant organisations, would develop detailed definitions of these broad factors and their quantification and appropriate weightings. This work would pragmatically develop standardised allocation keys and weightings that would mandatorily apply to taxpayers using these industry/sector common business models. A rebuttable presumption would apply for appropriate flexibility.
- Lastly and importantly, the quantification (i.e. the allocation keys) must be **objectively measurable and location-specific**, using only physical factors reflecting the actual assets, activities, and sales in the countries concerned.

The use of standardised keys and weightings eliminates any need for the resource-consuming functional analyses and other extensive work required for a taxpayer to support its transfer pricing, or for the tax authorities to evaluate and, as necessary, adjust that transfer pricing. This would create greatly simplified international tax rules that would reduce the administrative burdens especially for poor countries, reduce compliance costs and provide greater certainty for business, and improve competitive equality between multinationals and domestic firms. They should be underpinned by an institutional framework to resolve issues and conflicts as well as to formulate appropriate changes to the detailed methodologies as technology and business practices evolve.

This approach is in our view compatible with existing tax treaty rules but would be a sharp departure from the present OECD guidelines on transfer pricing. These have become impossibly complex and difficult to apply, generating continuing conflicts and disputes.

In a more general system, revised OECD guidelines would reflect the proposals outlined in the discussion draft, which have some commonalities, indicating the possibility of convergence. None of these proposals would be adequate or appropriate alone, but they could all be subsumed into the approach we outline. The 'user contributions' and 'marketing intangibles' proposals entail some allocation of tax to market jurisdictions but not a completely sales-based formula, and the 'significant economic presence' proposal explicitly suggests a balanced formula.

See our submission to the public consultation in March 2019 for a fuller explanation.