The **BEPS**

Monitoring

Group

COMMENTS ON PILLAR 1
DRAFT MODEL RULES FOR NEXUS AND REVENUE SOURCING

These comments by the BEPS Monitoring Group (BMG) analyse the draft model rules on nexus and revenue sourcing, released by the OECD Secretariat on 4 February 2022 for public consultation, in the continuing work to address the tax challenges of the digitalised economy by the Task Force on the Digital Economy (TFDE) set up by the G20/OECD Inclusive Framework on BEPS. 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 is based on our previous reports, and has been drafted by Sol Picciotto and Jeffery Kadet, with comments and contributions by Abdul Muheet Chowdhary, Sakshi Rai, Sudarshan Rangan, Attiya Waris and Yansheng Zhu.

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A. General Comments

1. Context

We welcome the release of this draft for public comments. It is nevertheless regrettable that it concerns only a part of the detailed technical rules, and that so little time was allowed, only two weeks. This makes informed comment difficult, especially as there is little explanation of the overall structure, even though there have been some significant changes since the Pillar One blueprint was published in October 2020. As many commentators have noted, the OECD secretariat has been working at unprecedented speed on these proposals, and it is unfortunate that this is taking place with little or no public consultation.

This is perhaps understandable, since the proposals are being developed with the involvement of representatives of many governments. Furthermore, consultations are generally dominated by businesses and their paid advisers, predominantly from the global North, who inevitably tend to criticise proposals that would challenge their existing business models, and complain about the compliance costs of new requirements. Such criticisms from vested interests could substantially slow down or even sabotage the process. Allowing two weeks for comments may be regarded as better than nothing, but on the other hand it privileges industry insiders who are likely to have more familiarity with the issues involved, and certainly have significantly more resources than civil society organisations.

It should be recognised that public consultations have a wider purpose than simply consulting on the technical feasibility of specific technical measures, since the broad policy approach adopted is closely linked to the design of detailed technical implementation methodologies.

A wider public debate is also particularly important for proposals such as these at a global level, which it is hoped or expected would be implemented by countries with little or no further opportunity for modification. We urge the Inclusive Framework to ensure that there is adequate public consultation on the whole of the Pillar One proposals before they are finalised. Without this, we fear there would be significant difficulties, both in ensuring adoption at national level and in the subsequent practical implementation.

2. Background

It should be recalled that the work on addressing the tax challenges of digitalisation of the economy was Action One in the Action Plan on BEPS approved by the G20 in 2013. No agreement was reached on measures under Action One, but much analysis of the issue was carried out and published, particularly in long reports by the TFDE in 2015 and 2018. These made it clear that digitalisation had only exacerbated the flaws in international tax rules, and a new approach was needed to (i) the definition of taxable nexus, and (ii) the allocation of the global profits of multinational enterprises (MNEs) among the countries where they have real economic activities. In the absence of any agreed way forward, a variety of alternative measures were adopted. Many of these aimed at ensuring taxation of revenues from digitalised services, while others imposed anti-base-erosion taxes, such as the UK's Diverted Profits Tax, and the GILTI and BEAT in the US tax reforms of 2017. These measures have provided the impetus for renewed attempts to reach a consensus on a multilateral approach.

Following the TFDE's report of 2018, three proposals were made for dealing with both these issues: one focusing on 'user participation' as the key factor, a second stressing 'marketing intangibles'. The third, which was put forward by the G24 developing countries, proposed a taxable presence nexus based on the concept of a 'significant economic presence', combined with a method for apportioning each MNE's global profits. It resulted in the agreement in July 2021 by the Inclusive Framework on BEPS accepting the need for a formulaic approach for allocating at least a portion of the global profits of MNEs, based on revenue from sales by destination. However, since 2019 the ambition and scope of the work have been severely restricted. The current proposals would apply to only about one hundred of the largest and most profitable MNEs, those with global sales over €20 billion and a profit rate over 10%. Furthermore, the bulk of MNE profits would continue to be allocated under the existing defective rules on 'transfer pricing'.

The statement of July 2021 nevertheless constituted a historic breakthrough, as we said in our comments at the time. It showed that there was global support for a new approach that could ensure that MNEs were taxed on their global profits in each country according to where they have real activities. It was based on the blueprints for Pillars One and Two published in October 2020, which provided all the building blocks for a formulary approach towards allocating a proportion of the global profits of MNEs. The Pillar One proposals provide (i) a nexus test based on sales in a jurisdiction, and (ii) an allocation based on sales by destination. The Pillar Two proposals provide (i) a methodology for adjusting financial accounts for tax purposes that could be applied to the global consolidated accounts already produced by MNEs, and (ii) methodologies for identifying and specifying the location of (a) physical assets, and (b) payroll costs of employees.

In December 2021 model rules were published for the proposed global anti-base erosion tax (GloBE) under Pillar Two. Although no public consultation has been suggested on the rules

themselves, we have published our own comments,[1] and look forward to participating in the consultations planned for the proposed Implementation Framework, and on the Subject to Tax Rule which also forms part of Pillar Two. We warmly applaud and congratulate the staff of the OECD, and other officials from countries around the world participating in the Inclusive Framework, who have been working so hard on this arduous and highly complex technical work. We hope that our comments may be helpful, particularly for those from low- and middle-income countries, for whom effective participation has been particularly difficult, especially with the relentless pace of the work.

3. Nature and Status of the Model Rules

The present discussion draft provides detailed technical rules for identifying the source of sales. They would be used in determining which countries would be eligible for an allocation of taxing rights, in respect of MNEs within the scope of Pillar One, over so-called Amount A, which is 25% of the 'residual' profits, defined as profit in excess of 10% of revenue. We assume, although this is not stated in the discussion draft, that this methodology will also be used in determining the actual allocations of Amount A among eligible countries.

These model rules are very detailed, and the discussion draft is unclear about their intended status. The draft describes them as a 'template that jurisdictions could use as the basis to give effect to the new taxing rights over Amount A in their domestic legislation', but also states that they would be 'translated into' the Multilateral Convention and its Explanatory Statement. International conventions are difficult to negotiate and to revise, and obtaining approval for ratification is difficult in many countries. This is particularly the case for the USA, which is obviously a key participant. Hence, a multilateral convention is appropriate only for creating arrangements that are intended to be long-standing.

It would clearly be impractical and undesirable for the complete model rules to be embodied in such a convention. Given the novelty of the methodology, it is inevitable that many issues will arise in practice on implementation, so there should be flexibility to enable their adaptation and continuous improvement. Furthermore, the scope of Pillar One is at present very limited, as it is restricted to around one hundred of the largest and most profitable MNEs. However, this can also be seen as an advantage, if Pillar One can be designed as a test-bed for the new approach that it entails, with a view to its future refinement and expansion. The design may fail, or more likely it will require significant modification. For all these reasons, in our view the model rules should take the form of a 'soft law' template. The key to successful implementation will be the structural and administrative elements, which are more appropriate for a binding international agreement.

B. Specific Comments

1. Revenue Threshold for Nexus

In order to determine which countries meets the threshold of revenue required for an allocation of Amount A, a Covered Group must apply the revenue sourcing rules group-wide to 100% of its revenues on an annual basis. Since revenue must be determined for each and every jurisdiction to determine whether the threshold level is reached or not, the lower threshold level of €250,000 instead of €1m that is provided for countries with a GDP less than €40 billion will have no effect on compliance costs. This is because once the revenue

[1] Available at https://www.bepsmonitoringgroup.org/news/2022/2/9/comments-on-the-model-rules-for-the-globe.

level by country is determined, the calculation of Amount A for any particular country is purely formulaic.

There is a serious and significant need to more completely recognise the interests and needs of many countries with very small economies. Given also that a lower threshold would not result in any greater administration or compliance burden, there seems no reason not to lower the general threshold level. We suggest that there should be one uniform level of €50,000.

Assume an in-scope MNE, which has €249,000 of revenue allocated to a jurisdiction and a profit margin on revenue of 30%. Under the formulaic agreement as set out in the 8 October 2021 Inclusive Framework Statement, that jurisdiction's allocated revenue is €12,450 (25% agreed market jurisdiction share x [€74,700 (30% actual profit margin on revenue) – €24,900 (10% deemed routine return)]).

From the perspective of a developed country, this allocated revenue of €12,450 will seem immaterial. However, it must be realized that this 'small' amount of allocated revenue gets multiplied by the number of in-scope MNEs that earn revenues from this jurisdiction. Even today with only about one hundred in-scope MNEs, it is not unreasonable to postulate that 50 MNEs will have €50,000 or more of revenue sourced in any one small-economy country. Assuming an average allocated revenue per MNE of €10,000, there would be €500,000 of aggregate taxable profits. Already today this is material for many small countries. This would also make it possible to test the feasibility of the methodology for a possible scaling-up in the future, by expanding the scope of this new approach.

Hence, we recommend that the presently agreed €1 million/250,000 threshold levels should be lowered to one uniform level of €50,000.

2. Deletion of the Knock-out Rule

The sourcing rules depend on the use of a Reliable Method, defined as one that identifies where revenues arise using either a Reliable Indicator or a specified Allocation Key. The Allocations Keys are of their nature less accurate than a Reliable Indicator, since they use a country's share of a general measure, such as final consumption expenditure (used for the 'Global Allocation Key'). Hence, it is important that a Reliable Indicator should be used whenever reasonably possible.

Schedule A provides the Detailed Revenue Sourcing Rules, and the use of an Allocation Key is governed by paragraph 6 in Part 2. Three conditions are specified: (i) the Allocation Key is permitted in the relevant revenue sourcing rules, (ii) the Covered Group demonstrates that it has taken reasonable steps to identify a Reliable Indicator and has concluded none is available, and (iii) the prior application of the Knock-out Rule. This Rule is defined in Part 10 paragraph 10 as:

> 'in the context of applying an Allocation Key, a requirement that the Covered Group must identify a Jurisdiction or a group of Jurisdictions where it can be reasonably assumed that Revenues did not arise.' (Footnote omitted.)

In our view, key goals in the design of these rules should be administrative simplicity, achieving results that are fair to tax authorities and taxpayers alike, and careful attention to the needs of developing countries and small countries. With these goals in mind, we are concerned about the requirement that application of the Knock-out Rule is a pre-condition for the use of any Allocation Key.

There is a danger that MNEs in their efforts to reduce their compliance burden will inappropriately use this highly subjective Knock-out Rule, which is impossible to audit, to

significantly reduce the number of jurisdictions to which revenue will be allocated when the chosen Allocation Key is applied. An adequate ability to audit is crucial to ensure the effectiveness of the rules.

Many in-scope MNEs have numerous operational divisions that each conducts its activities somewhat independently of other divisions. In such cases, where the MNE wishes to apply an Allocation Key since it has identified no Reliable Indicator, it is very likely that each applicable division will apply the Knock-out Rule separately. With inappropriately liberal application of this rule by one or more divisions, it is without doubt that revenues properly sourced to many developing countries will be artificially reallocated to developed countries. Not only will this understate the revenues of many developing countries, hampering their much-needed recovery from the pandemic, but it will also cause many such countries to fall below the applicable €1 million/250,000 nexus thresholds.

We appreciate that the intent of the Knock-out Rule is simplification. However, this is simplification that is meaningless. If there are additional jurisdictions included in the allocation to which an Allocation Key is applied, there is zero administrative benefit. Despite this meaningless simplification, the inevitable and inappropriate liberal application of this Knock-out Rule, especially by numerous divisions within each MNE, will cause meaningful reductions of allocated revenue for many developing countries. The results of this will in many cases mean not only less Amount A, but zero Amount A since the lower amounts of revenue sourced in a country may fall beneath the nexus threshold.

For the above reasons, we strongly recommend that this highly subjective and totally-impossible-to-audit Knock-out Rule be eliminated. It is highly prejudicial to developing countries and results in zero simplification.

If it is decided to retain the Knock-out Rule, then it must not be a pre-condition for application of an Allocation Key. Rather, it should be optional, but with the caveat that it should be used only in the circumstances, which are expected to be rare, where there is actual documented knowledge that the good or service is not provided in one or more specific jurisdictions. We appreciate that footnote 39 states that any application of the Knock-out Rule should be justified by “actual knowledge”. Given the likely liberal interpretation that too many MNEs will make, actual documented knowledge must be the standard.

3. B2B Services

Part 5 of Schedule A deals with sourcing rules for Services. These are particularly important because the close relationships of services providers with customers are a strong justification for allocating taxing rights to the country where the customer is located. This is especially the case for services to business customers, since payments for such services are usually deductible, so when such payments are made to a non-resident services provider they reduce the source country tax base.

Section H of Part 5 deals with Revenues from Business to Business (B2B) Services, and paragraph 1 establishes the general principle that such revenues are deemed to arise in the country where the ‘place of use’ is located. Paragraph 2 specifies the Indicators that can be used, provided that they meet the requirements for a Reliable Indicator. If there is no Reliable Indicator available under this general rule, and the Business Customer is not a Large Business Customer, then the place of incorporation of the Ultimate Parent Entity (UPE) of the Business Customer is deemed to be a Reliable Indicator. A ‘Large Business Customer’ is defined (in Part 10, definition 36) as a one that is a member of a corporate Group that is required to file a Country-by-Country Report, although if the MNE service provider has been

unable to ascertain this for a specific customer after taking 'reasonable steps' it may assume the customer is not a Large Business Customer.

This is not appropriate, in our view, because it will mean an effective allocation of revenue mainly to developed countries from developing countries. In the many cases that such a Business Customer is below the threshold for country-by-country reporting, there is a greater chance that such a group will outsource services to support its operations in countries where it has relatively few of its own personnel. This will often be in developing countries.

Given this situation, instead of applying the place of incorporation of the Business Customer's UPE, either the Low Income Jurisdiction Allocation Key or the Regional Allocation Key should be used. Note that this treatment using an Allocation Key would be consistent with the treatment of Business to Business Services sold through Resellers as set out in Part 5 paragraph H(10), which in that case mandates the use of the Global Allocation Key and not the location of the UPE.

4. Definition of Location

The Part 10 General definition for Location appears internally contradictory. Within the definition itself, a business is located where it has physical premises from which it operates. For an individual, the location is where the individual is habitually located.

Despite this clear focus on an actual business location where there are premises and activities or an individual's habitual location, footnote 40 states:

> Commentary will provide additional guidance on the meaning of this term and will confirm that the tax residence of the business or individual (where that is known to the Covered Group) can be taken as its location.

Aside from this contradiction, it is clear that many MNEs have initiated structures so that a group member may be tax resident in one jurisdiction, but may operate not through its own employees and agents, but rather through branches (often hybrids) or de facto agents (i.e. other group members that are operating on its behalf, ostensibly as independent contractors) that conduct crucial business functions which would seldom if ever be assigned to an unrelated person. Further, there many wealthy individuals that have sought resident status for tax purposes in certain jurisdictions that are selling themselves as tax havens for individuals. Such individuals may of course spend some portion of each year within these jurisdictions, but it is likely that many have continued to be habitually located elsewhere.

We are not suggesting that the tax residence of a business or an individual should not be one possible indicator of the Location of a business or individual. However, it is not, and should not be designated as, the primary indicator. Rather, the actual business location where there are premises and activities or an individual's habitual location should be the primary indicator, where such information is available.

5. Retention of Data

Footnote 3 states:

> 'While the allocation of the revenue is at an itemised level, which necessitates access to the initial transaction record to answer the sourcing rule, the Covered Group is not required to retain that data on every item. Instead, as noted in the introduction, the approach to compliance would be at a system level, and not at an individual transaction level.'

Given that such data is a necessary basis to precisely evaluate the compliance of a Covered Group, even at a system level, and retaining such data may not increase additional costs of business operations, such data should be retained by the Covered Group for a fixed period of time. This could extend to the end of the evaluation of the compliance of the Covered Group by the relevant evaluating body through the dispute prevention and resolution mechanisms.

6. **Access to and Use of Computer Programmes**

The definitions under Intangible Property of copyright, copyrighted work and intangible property on page 34 exclude computer programmes. However, the definition of Digital Good as 'the provision of content by digital means' includes computer programmes. This issue needs closer scrutiny. Considerable confusion has been created by the exclusion of computer programs and software from the definition of copyright by the Commentary to article 12 of the OECD model tax convention, which is out of line with their treatment in international intellectual property conventions.

If computer programmes are treated in the context of these model rules as Digital Goods, it should be made clear that 'the provision of content by digital means' refers to the provision of access to and the rights to use and operate computer programmes, i.e. that they are not the 'digital means' by which content is provided. Furthermore, it should be made clear that 'Revenues from a transaction in digital goods' includes any grant of rights in respect of computer programmes, including the right to simply run or operate the programme.

A clarification should also be made that the exclusion of computer programmes from the definition of copyright work should not be taken as having any implication for existing tax treaties. Many such treaties provide for the taxation of payments for the use of computer software as royalties under Article 12. A total of 474 treaties in force at present tax software payments as royalties, with many of them linking software to copyright. There should be a statement clarifying that the definition of copyright in the model rules is not intended to have any implication for or effect on other treaties.

7. Additional Suggestion

In several places within the Consultation Document there is the following: 'Another Reliable Indicator as defined in Part 2(3).' We believe this should read: 'Another Reliable Indicator as defined in Part 2(4).'