BUSINESSEUROPE

8 November 2019

Comments on the OECD Public Consultation on the Proposal for a Unified Approach under Pillar 1

KEY MESSAGES

1 We welcome the OECD's public consultation on Pillar 1 and the ambitious efforts the OECD is making in the area of digital taxation. Only through a global consensus can we hope to reform the global tax system in a coherent way in 2020.

2 The outcome of the OECD/Inclusive Framework (IF) negotiations should provide clear rules for businesses, in particular related to the distinction between residual profits and routine profits, and the treatment of losses and should contain from the outset more efficient methods of mandatory and binding dispute resolution and dispute prevention mechanisms. The reform should be focused and proportionate, recognising that the current rules are working well for activities with a physical presence.

3 Any agreement made should be informed by a thorough impact assessment on a country-by-country basis, covering the effects on tax revenue, investment, growth, employment and business models. We are particularly concerned that an allocation key based on sales would strongly disadvantage smaller countries, in particular advanced, open economies with high R&D intensity and net exports, who may lose considerable net revenues.

WHAT DOES BUSINESSEUROPE AIM FOR?

- Any solution found in 2020 should only tax net profits once and never tax revenue, with the new rules being as simple and easy to administer as possible, focusing exclusively on B2C-transactions (with considerably strengthened mechanisms to solve double taxation), whereby the current transfer pricing rules and the arm's length principles are retained as much as possible. Any new rules, whether on definition of scope, determination of what and how to re-allocate to market countries, correction-mechanisms for residence countries, as well as dispute management should be aligned and designed prior to any agreement and introduced once in the same way and at the same time.

- Countries must make a clear commitment to repeal the existing unilateral measures, such as the so-called digital services taxes, when the OECD/IF finds an agreement. An increase in the effective corporate tax rate should be avoided as it would harm growth, R&D and thus the development of innovative business models.

AV. DE CORTENBERGH 168
BE-1000 BRUSSELS
BELGIUM
VAT BE 863 418 279

BUSINESSEUROPE a.i.s.b.l.
WWW.BUSINESSEUROPE.EU
Follow us on Twitter @BUSINESSEUROPE

TEL +32(0)2 237 65 11
FAX +32(0)2 231 14 45
E-MAIL: main@businesseurope.eu
EU Transparency register 3978240953-79

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To: OECD - Tax Policy and Statistics Division, Centre for Tax Policy and Administration.

BusinessEurope is the leading advocate for growth and competitiveness at the European level, standing up for companies across the continent and campaigning on the issues that most influence their performance. A recognised social partner, we speak for all-sized enterprises in 35 European countries whose national business federations are our direct members.

The Tax Policy Group in BusinessEurope, under the chairmanship of Krister Andersson, has been actively engaged in and supported past BEPS-work and we continue to believe that the global nature of the issue of taxation in the digitalized economy requires a global solution at the OECD. Only through a global and deep consensus, and not through unilateral initiatives, can we hope to reform the global tax system in a coherent and lasting way, without risking a competitive disadvantage for companies as they adopt new business models and get digitalized.

The recent public consultation shows that the OECD is making significant and ambitious steps forward in addressing this issue, and we urge all participants in the Inclusive Framework to cooperate closely in order to agree on time on the final report in 2020. As we are steadily nearing the deadline for the final report, one of the objectives, while respecting the sole competence of the participating countries in the field of taxation, must continue to be to avoid unilateral actions by individual countries which only lead to a rapid fragmentation of the international tax system, and to avoid a further increase in international double taxation.

This work undertaken by the OECD should be focussed and proportionate. Any further agreement should find the right balance between allocating taxing rights to market countries - to address tax challenges linked to remote business activities without a physical presence – and recognising that value is created in the residence countries. In addition, the risk of investment in a new, innovative good or service is also borne by the (investors in) residence countries.

We believe that the implementation of the principles of the unified approach, as described in the consultation draft, will require a multilateral approach, to be captured in a multilateral agreement. Only if countries agree multilaterally on the determination of the scope, the allocation to market countries and how to make corelative adjustments in the countries of residence, and on measurement, review and auditing approaches, can the 'unified approach' limit the administrative burden and legal uncertainty for businesses.

Given the limited time provided to respond to the consultation and given the complexity of the proposals put forward which themselves will require further development and elaboration, our comments should be seen as preliminary.

Scope

- While the proposed unified approach moves away from 'ring-fencing the digital economy' by targeting the Amount A towards 'broadly consumer-facing businesses', the question remains to what extent 'consumer-facing businesses' can be defined. If the concept of a consumer-facing business cannot be well-defined, we are concerned that the scope of the unified approach will not be in line with the concerns of the OECD/IF, leading to an outcome which is neither focused nor appropriate, resulting in an increase for tax liabilities in market jurisdictions for both 'consumer-facing businesses' as well as other businesses. Uncertainty regarding the scope is likely to result in an increased risk of disputes and double taxation. It will be essential that a clear definition of 'consumer facing business' is worked out, recognising that the current tax rules, regarding transfer pricing and the arm's length principle, for traditional activities with a physical presence are working well. The role of intermediaries in B2C needs to be looked at in depth as well, to see to what extent they may be classified as a 'consumer-facing business'. The question also remains to what extent the proposal can remain up to date in an economy where B2C-interactions are changing rapidly. After all, at the end of each value chain, there is always a consumer.

- Clear, proportionate and aligned rules should underline the exclusion of B2B-activities from the scope of the proposal. Carving-out specific sectors not characterized by high-risk profiles in relation to the nexus and profit allocation issues addressed by the pillar 1 (such as the extractive, financial, commodities and manufacturing sectors physically present in market countries) is appropriate. We would also welcome carve-outs for merely domestic activities and patent boxes.

Calculation of group profits under Amount A

The intention of the proposed unified approach is to use a combination of both the residual profit split method (by splitting profits into routine and non-routine profits) and the fractional apportionment method (by relying on formula-based solutions) to allocate a share of the deemed non-routine profits to market jurisdictions, reviewing fixed return for distribution functions and additional return based on TP analysis (Amount A, B and C).

While the Inclusive Framework will still need to work out the proposal in full, some fundamental challenges are already foreseeable and would need to be addressed:

- **How to calculate residual profit?**
  The splitting of profits into residuary/non-routine/'above normal' profit and routine profits has always remained contentious and can cause many legal disputes unless very clear guiding rules are in place. Therefore, it is essential that a clear

demarcation of what is routine and what is non-routine is defined. Further rules have to be provided for accurate delineation in the OECD Transfer Pricing guidelines for splitting profits as routine/non-routine. In order to provide businesses with legal certainty in today's globalising economy, the Inclusive Framework should make sure that the adopted rules on the split of routine/non-routine are as detailed as possible in order not to provide too much leeway for different (legal) interpretations in the participating countries.

Examples:

a) A defined methodology will need to make clear the treatment and allocation of interest expenses between routine and non-routine profits. The same applies to headquarters costs.

b) In addition, guidelines are needed for MNE's performing highly integrated functions of work within the group situated in different jurisdictions, wherein segregation between routine and non-routine becomes difficult.

Further development on Amount A should provide clear rules for determining which entities in a multinational group earn such non-routine profits under existing transfer pricing rules and should therefore be entitled to double tax relief. The principles governing this re-allocation should be included in the political consensus as we see them as a fundamental requirement to ensure a deep and broad consensus on re-allocation. The public consultation starts from global consolidated financial information to determine a deemed non-routine profit, which is, in part, re-allocated to consumer markets on a formulary basis.

However, such deemed non-routine profit is currently already taxed in other countries under existing rules. Amount A should not create a new taxing right on the deemed non-routine profit without reducing the taxing right elsewhere. If there is to be a formulary approach to allocating income under Amount A, there needs to be a similar binding approach for allocating the equal and opposite deemed expense and thus both allocations need to be binding to avoid double taxation.

In addition to wanting to target only a share of residual return, a primary goal of Amount A should be to act on the challenges identified by the OECD/IF in a focused and proportionate way. Thus, the Amount A threshold should be set at a high level.

It is important to highlight as well that determining profit at product level, segment level or country or region based on financial consolidated accounts would be extremely challenging as the way revenue and costs are segmented and allocated to different sectors depend on the individual company and its structure.

- **Transfer pricing and the arm's length principle**
  While we recognise the public consultation's notion that 'the arm's length principle' is becoming an increasing source of complexity', we would support the OECD in retaining the current rules based on the arm's length principle as much as possible in cases where they are widely regarded as working as intended. In

cases where the mechanism will be changed, it will be essential to provide clarity as soon as possible to companies.

The existing transfer pricing mechanism (of function, assets and risks analysis) provides a reasonable appropriate classification of businesses and it is advisable that the existing transfer pricing mechanisms are also integrated in order to determine the allocation keys.

- **Allocation key**
  We are concerned that a mere allocation of profits on a formulary basis, in particular based on sales, may appear simple, but this can cause profits to be allocated on a disproportionate basis, and not on the basis of value creation and activities performed, for non-digital and more traditional activities. Thus, we regard this approach as against the value creation principle as the location creating value (or who took all or most of the risks, invested in R&D, etc) may be allocated a disproportionate lower profit. This may cause the relocation of the company's activities from the country of residence to larger market jurisdictions and countries of consumption. We should not forget in this discussion that market countries already receive value added tax/sales taxes on sales made. Any allocation key under the proposed unified approach can also not be made on an arbitrary basis if value creation should be adhered to.

  In practice, it is likely that the non-routine profits will also be arising in different legal entities in multiple jurisdictions. Reallocation of such profits will therefore require a multilateral instrument that covers all jurisdictions impacted. An increasing number of double taxation-occurrences will need to be addressed with a multilateral instrument. An agreed change in one bilateral situation will likely lead to multiple changes in other bilateral situations, using a string of bilateral tax treaties is unlikely to lead to the correct end-result. Furthermore, not all countries that will be allocated an Amount A will have all double tax treaties required. Finally, a re-allocation on a formulary basis may well lead to 'economic' double taxation, which is typically not resolved by existing double taxation treaties.

- **Other:**
  With regards to market countries where an MNE does not have any presence, introducing user criteria could create new problems, including technical and privacy complications for businesses in tracking user location, including the possible manipulation of user numbers/'clicks' by foreign actors.

  Adjustments between accounting rules and tax rules must be accomplished in order to identify the net profits to be distributed. Harmonized tax accounting rules would be needed in order to ensure there is no mismatch in determination of profits.

  From a business perspective, the rules will have a significant impact on the business supply chain and IT-systems as cost and accounting policies have to be redesigned to ascertain the 'non-routine' profits in the affiliate market country.

Further consideration is required over how the regime will ensure that Amount A is only allocated once all functions have been rewarded cumulatively on a routine basis – this is especially relevant for R&D intensive businesses where R&D is incurred and expensed many years before commercial sales and profits giving the illusion of returns in excess of a routine amount.

It should be clarified that capital gains and losses, for example from the sale of a subsidiary of the MNE group, are not included in Amount A. These types of profits are subject to particular profit allocation and taxing right allocation rules and they should not be included in Amount A nor in the components and numbers from the consolidated financial accounts used to allocate Amount A.

Calculation of group profits under Amount B:

- A fixed percentage rate for Amount B may probably not be the most proportionate way to address this issue. A more varied percentage rate (by industry or region) would be preferred. It is not clear from the proposal to what extent tax revenues should be transferred to market jurisdictions. These rules appear to apply to all companies, without any size limitation. It could therefore potentially involve considerable changes to tax revenues of countries. If remuneration to local distributors is increased significantly, incentives for using independent distributors would be present and the business model of companies will be affected. Such changes must be addressed in the economic impact assessment.

Calculation of group profits under Amount C:

- We are concerned about the lack of clarity regarding 'Amount C'. The right to tax according to such rules should be based on clear principles. These principles must be spelled out and agreed by all countries. It is important that a Pandora's Box is not opened for tax claims on brand names from various countries. There is likely to be a proliferation of bilateral and even multilateral discussions and negotiations that the current dispute mechanisms are ill-equipped to deal with even after important recent initiatives and improvements.

  It is therefore essential that work is done on developing a faster and comprehensive method of both dispute resolution and dispute prevention (i.e. advance clearance of differences), which should be included from the outset in an upcoming agreement. We would also encourage the introduction of Mandatory binding arbitration for all measures (A, B, C) which must substantially reduce taxpayer uncertainty.

Nexus rules

The unified approach would set up new nexus rule for taxpayers, granting taxing rights to countries where companies do not necessarily have a physical presence.

- **Administrative challenges**
  While the final details of the new nexus still need to be developed, the creation of a new nexus are likely to come with significant administrative challenges. If MNEs are required to file additional tax returns, make payments of tax and in some instance require fiscal representation in additional jurisdictions, this will represent a significant additional compliance burden and could give rise to treasury issues in terms of cash-flow.

  The necessity to define and apply country specific sales thresholds to deal with this burden will be driven by the extent of the additional compliance burdens arising from Amount A. If the administration can be centralised and applied under one set of rules (for example through a One Stop Shop, similar to the one in place in the VAT-system), to simplify as much as possible the interactions between the taxpayer and the variable number of new tax administrations that will claim the new taxing right, this would reduce the need for such thresholds and lower the administrative burden.

  Determining local sales may also be challenging to some companies, both digital and traditional, who operate under a mix of supply to end-customers, local affiliates, retailers, third party distributors in a number of countries (where some of them have regional rights). On top, some companies are faced with so-called parallel export (a situation where a retailer buys more goods than they need and sell the excess to other domestic/foreign retailers. The IF should provide clear guidance for companies in these situations.

- **Nexus determination**
  While we agree with the threshold of 750 million EUR of turnover, it has to be ensured that there is in any case significant and voluntary economic activity, initiated and sustained by the MNE, in the market jurisdiction to trigger a nexus. A sale threshold can be a primary indicator for this purpose but others should be explored as well.

  A strong interplay of the revised profit allocation rules with the new nexus proposal is essential to ensure that not only market countries but also origin countries get their fair share of the profit. The development of robust administrative and exchange of information mechanisms must be encouraged within the tax authorities in order to determine the residual profit by the market countries in situations where companies fall under the 'new' nexus.

  Considering that the digital economy is very dynamic, the new PE definition must withstand the dynamic element or else will become obsolete in a short span of time, triggering hurdles for tax payers and administrators.

Clarity is also required that any new nexus (and associated profit allocation rules) is only applicable for direct tax purposes and will not give rise to additional filing or tax requirements for other types of taxes (e.g. VAT-registration) or customs duties.

Double Taxation Disputes and Unilateral Initiatives

- The proposal put forward in the Public Consultation document, and in particular the so-called three-tier mechanism, will bring a significant shift in current taxation rules and legal understanding and interpretation, leading to a proliferation of both bilateral and multilateral discussions on taxation rights. As highlighted in our response, this is likely to bring an increase in the volume of double taxation cases.

  This issue should not be taken lightly. Not only may double taxation lead to reduced foreign investment and tax uncertainty, in the long-run, it can also lead to reduced employment and lower economic growth. We therefore urge the Inclusive Framework to include both appropriate dispute resolution and dispute avoidance mechanisms from the outset in any agreement, with significant ambition in terms of scope, enforcement, effectiveness and timeliness. It would in our mind not be enough to rely on existing agreements on dispute mechanisms already reached in the BEPS work, nor would slight modifications to existing mechanisms bring sufficient relief. The main goal should be the introduction of Mandatory binding arbitration for all measures (A, B and C) which must substantially reduce taxpayer uncertainty.

- Countries must also make a clear commitment to repeal the existing unilateral measures, such as the so-called digital services taxes and diverted profits taxes, when the OECD/IF finds an agreement.

Allocation of losses

- It is essential that the treatment of losses in the proposed profit allocation rules are included as well. If loss in one jurisdiction cannot be fully set off with profit with another jurisdiction, it may put a drag on countries supporting risky R&D investments (as only 'profits' will be shared with others) and may question the support of OECD-economies for measures in R&D and innovation. Costs may occur during many years while the sale and profit may only take place in a particular year. How to include this in the allocation is not clear from the proposal but it is an essential part in achieving a fair allocation of taxing rights among countries.

- The risk of very complex rules is obvious and we would therefore advocate limitations of transfer of taxable profits to market jurisdictions. This can be done by applying a relatively high normal profit threshold and limiting the share of residual profit being transferable to market jurisdictions.

Impact assessment

- As the development of new profit allocation rules and a new nexus would be one of the most significant steps in taxation history, it is important that all the participating countries have relevant information before deciding on any agreement unanimously. The impact study should cover the proposal in the broadest way possible, and address not only the effect on (corporate) tax revenue, but also on investment and growth, employment, business models, etc. The impact assessment should also look at the relationship between Pillar 1 & Pillar 2. If the proposal is judged to increase tax revenues on a net basis for all countries (which was not the intention of Pilar 1) the effect on growth and jobs must be assessed as a consequence of increases in the effective corporate tax rates.

  We urge countries to take due account and not to increase corporate taxes as unemployment is high and rising in many countries. The tax incidence literature further calls for careful consideration as workers and consumers are the most impacted[1].

We hope the OECD will take these considerations in hand when developing any more detailed proposals in this area and the Tax Policy Group of BusinessEurope stands ready to provide further input to the policy decisions needed to ensure a successful and timely outcome of this important initiative from the OECD and the Inclusive Framework.

[1] https://www.eesc.europa.eu/sites/default/files/files/qe-03-19-343-en-n.pdf