OPINION STATEMENT

CFE Tax Advisers Europe Response to the OECD Public Consultation Document: Secretariat Proposal for 'Unified Approach' Under Pillar One

Submitted by CFE to the OECD on 12 November 2019
Endorsed by the Global Tax Advisers Platform

CFE Tax Advisers Europe is the European umbrella association of tax advisers. Founded in 1959, CFE brings together 33 national tax institutes, associations and tax advisers' chambers from 26 European countries, associated via the Global Tax Advisers Platform (GTAP) with more than 600,000 tax advisers. CFE is part of the EU Transparency Register no. 3543183647-05.

CFE Tax Advisers Europe together with the Asia-Oceania Tax Consultants' Association ("AOTCA") and the West African Union of Tax Institutes ("WAUTI"), established the Global Tax Advisers Platform ("GTAP") in 2013. GTAP is an international platform, representing more than 600,000 tax advisers in Africa, Asia-Oceania and Europe, seeking to bring together national and international organizations of tax professionals from all around the world. The principal aim of GTAP is to promote fair and efficient operation of the global tax framework, including recognition of the rights of taxpayers and advancing global cooperation among tax professionals.

CFE Tax Advisers Europe would be pleased to answer any questions you may have concerning our Opinion Statement. For further information, please contact Piergiorgio Valente, President of CFE Tax Advisers Europe and Chairman of the Global Tax Advisers Platform (GTAP), Stella Raventós-Calvo, Chair of the CFE Tax Advisers Europe's Fiscal Committee, or Aleksandar Ivanovski, CFE Tax Policy Manager at info@taxadviserseurope.org. For further information regarding CFE Tax Advisers Europe please visit our web page http://www.taxadviserseurope.org/ For further information regarding GTAP please visit http://www.taxadviserseurope.org/about-us_gtap/

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CFE Tax Advisers Europe welcomes the opportunity to contribute to the public consultation on the OECD Secretariat proposals for a ‘Unified Approach’ under Pillar One concerning the taxation challenges of the digitalising economy. We recognise the initial stage of the new proposals, and that many details are yet to be finalised depending on the direction taken by the members of the Inclusive Framework at political level. CFE would welcome the opportunity to provide more elaborate comments to any new detailed technical proposals in due course.

Key Remarks of CFE Tax Advisers Europe

In responding to the questions posed, we wish to give the following preamble to our reply. We are very much aware of the historic significance of attempting to recognise new taxation rights for jurisdictions, where under present rules no income could be attributed to any nexus not based on physical presence. If the project is successful, it will represent a new departure in the development of global tax policy and the principles it lays down will be used in fashioning future fiscal rules, the need for which we currently do not know. It will become a major precedent.

Considering these circumstances, and in order to make meaningful progress in due course, CFE calls for more clarity and early consensus at political level as to the outcome of this process, recognising the consequences of departing from well-established principles of international tax law towards a more complex international tax system which partly introduces formulary apportionment.

For this reason, we are of the view that a number of key elements must be embedded as part of this process and its outcome:

1. **The rights of taxpayers must be respected and ensured as a key bulwark supporting certainty and positive adoption of any new rules** that address the taxation challenges of the digitalising economy. Any new rules should take into account that tax certainty for taxpayers and tax administrations alike are recognised by international stakeholders as a key factor in investment and other commercial decisions, with significant impact on economic growth.

2. Ensuring fairness by recognising new taxation rights for market jurisdictions is an important element of the process, but **the outcome must result in rules which are workable on day-to-day basis for tax administrations, taxpayers and their advisers.** If new income allocation rules are added on top of the existing set of rules that govern the international taxation system, complexity will be even greater.

3. A related point follows, that **the process needs to take administrative capacity issues at the level of tax administrations and taxpayers as a key consideration in designing the new rules**. Simplicity in implementation and administration of the rules ought to take precedence over other criteria.

4. It is important not to underestimate **the resources needed by tax administrations and capacity issues within tax administrations of developing and/or smaller countries** to deal with multilateral disputes.

5. We also recognise that the agreed rules will need to **assuage countries who have unilaterally introduced or are introducing their own digital services tax rules**, otherwise significant double taxation is at risk.

6. The rules should be framed in such a way that it is clear whether a company falls within the scope of the rules. **A default position that all taxpayers are 'within scope' unless they are subject to an exemption (carve out) is unacceptable, as a matter of certainty**. We believe that the solution should apply only to highly digital businesses.

7. At a minimum, any new rules should only apply where the country-by-country threshold is exceeded (750 million euro), as these rules as designed will undoubtedly result in a significant administrative burden. We also **suggest a profitability threshold in addition to the revenue threshold, in order to qualify more precisely the scope of the new rules**.

8. **The issue of losses needs to be addressed in an equitable manner**. In smaller economies, companies outgrow their domestic market at a relatively early stage. Such companies will undoubtedly incur losses when expanding into new markets. These losses should not only be absorbed in the resident country, while paying tax on profits elsewhere.

9. **Preventing tax disputes, and building international consensus on binding effects of dispute resolution is critical**. These proposals will not work unless there is consensus for all countries to sign up to the binding effect of dispute resolution, which can operate on a multilateral basis and not just on a bilateral basis. This will inevitably require the development of a brand new multilateral treaty.

10. The security and integrity of taxpayers' data must be assured and computational outcomes should be subject to audit and/or assurance so that issues of conflict, dispute and double taxation can be satisfactorily and economically resolved. For instance, CFE suggests considering a **"one-stop-shop" mechanism to audit Amount A.** Still, further discussions should not underestimate the difficulties in departing from the current entity-based approach and moving to one which uses figures from consolidated accounts, then allocating the resulting tax liability to certain members of the multinational group.

11. **More time should be allowed in order to arrive at workable solutions that will withstand the scrutiny and test of time.** A comprehensive solution should be able to keep within scope the ever-evolving nature of the digitalising business models, resolving the taxation challenges, but equally ensuring the sustainability of the process, which will justify the resources spent by taxpayers, their advisers and tax administrations on making the new rules a reality.

12. Finally, the outcome of this process, from a policy perspective, should recognise that 'value creation' must surely be an equilibrium between two sides of the spectrum: **risks taken by decisions made in the investing countries balanced against any meaningful value derived in market jurisdictions, primarily due to the relative immobility of the purchasers of goods and services**.[1]

Impact Assessment

A comprehensive economic impact assessment is required before taking this process forward, in particular to assess the impact and the combined effects of Pillar One and Pillar Two, as these two projects serve distinct, but concurrent objectives.

[1] The IMF for instance, considers the notion of 'value creation' as an incomplete standard by which to assess multinational tax arrangements, IMF Policy Note 'Corporate Taxation in the Global Economy', 2019, p. 18

Considering the historic significance of this project, much greater information must be ascertained on the serious impact that is to be expected. The impact analysis should establish the economical and administrative-side consequences of this project. For instance, data and research gaps indicate that even for advanced economies, little is known about the nature and scope of residual profits.[2]

More generally, existing research demonstrates that the tax burden does not always fall on the taxpayer who is legally responsible for the tax payment:

"In practice, the discussion regarding who bears a tax is often linked to the assumption that the economic burden may align with the legal tax liability. In reality, there can often be large and unintended differences between legal tax liability and ultimate economic incidence. In fact, legal tax liability often bears little relationship to who actually bears a given tax. Moreover, the dynamics whereby a tax burden is reallocated among different actors in the economy are not reflected in tax collection amounts, making economic incidence difficult to analyse".[3]

Research indicates that further studies are required to shed light on the criteria and conditions affecting the allocation of the tax burden, and the related link between tax remittance structure and economic incidence.[4] Further studies would help to shed light on the ways in which the role of business taxation in the administration of tax systems differs in smaller or developing economies. These important aspects concerning the administration of the tax system and the impact of new tax policy measures merit further consideration from taxation policymakers.

Definition of Scope

CFE recognises the efforts of the OECD Secretariat to identify common features of the initial three-approaches to the taxation challenges of the digitalising economy, in an attempt to define the commonly acceptable elements of business models within scope of the proposed rules.[5] As a rule, the proposals should be framed in such a way that it is clear whether a company falls within the scope of the rules, as a positive obligation, rather than on the basis of excluding certain industries. At present, the Secretariat proposals do not define the precise range of the business models within scope of the newly proposed rules.

In addition, considering the nebulous nature of the concept of 'consumer-facing business' models, which extends beyond technology software companies, it is extremely difficult to define which taxpayers are within the scope, significantly affecting tax certainty. This process should take into account that tax certainty for taxpayers and tax administrations alike is recognised by international stakeholders as a key factor in investment and other commercial decisions, which have a significant impact on economic growth.[6]

From CFE's perspective, a default position where all companies are 'within scope' unless they are subject to an exemption/carved out is unacceptable (e.g. as is currently the case for extractive businesses). We recognise the policy intention to bring into scope businesses which derive meaningful value from customer interaction, and who through such interaction create value without physical presence in a market jurisdiction. Where a B2B

[2] IMF Policy Paper "Corporate Taxation in the Global Economy" (2019), IMF Publishing, Washington DC.

[3] Anna Milanez, "Legal tax liability, legal remittance responsibility and tax incidence: Three dimensions of business taxation", OECD Taxation Working Papers, No. 32, OECD Publishing, Paris.

[4] Idem, page 43

[5] Para 19 of the OECD Secretariat Proposals for Unified Approach under Pillar One (October 2019)

[6] IMF/OECD (2017), OECD/IMF Report on Tax Certainty, updated with OECD/IMF 2019 Progress Report on Tax Certainty, published on 8 June 2019

business model involves sales of consumer products through intermediaries, clarity is required as to whether those are in scope.[7]

Crucially, considering that the new rules would undoubtedly result in a significant administrative burden, these should only apply where the country-by-country revenue threshold is exceeded (750 million Euro), in addition to a profitability threshold.[8] The temporal element of a business presence in a jurisdiction is another important aspect, for example, whether the business has had sustained engagement with the market of a number of years of activity. Such a 'temporal threshold' would ensure maintaining the sustainability of the new nexus rules in an ever-shifting business landscape.

CFE believes that it is important that new laws should be restricted by such thresholds for only very large highly digitalised companies. Any new measures must focus on the formulation of growth-orientated approaches, which leverage on the opportunities of digitalisation for economic growth.

Finally, upsetting the international tax framework without clear economic impact analysis will inevitably lead to adverse outcomes and great uncertainty for all stakeholders. Uncertainty will result in non-uniform application to entities and practices beyond the anticipated scope of the new laws. To mitigate this risk, any new rules should be aligned, as much as possible, with existing international tax principles and practice.

The New Nexus and Profit Allocation Proposals

Under the Secretariat proposals, applying a market jurisdictions approach is quite novel, which as a result recognises new taxation rights for market jurisdictions. Conversely, under present international tax rules, zero profit could be allocated to any nexus not based on physical presence. Under the new profit allocation rules, a share of the deemed residual profits of the 'consumer-facing' multinational companies will be reallocated to market jurisdictions, partly through formulary apportionment and use of proxies such as sales.

In principle, CFE Tax Advisers Europe supports the direction under which a taxable nexus is created in market jurisdictions, as a result of which a share of the deemed residual profit shall be allocated to market jurisdictions. However, CFE expects that all stakeholders recognise the consequences of departing from well-established principles of international tax law towards a more complex international tax system which partly introduces formulary apportionment.

As a result of these fundamental changes, more complexity is added to the system which may undermine the policy intention of the proposals. We recognise that tax systems are inherently complex, often for valid reasons (such as achieving fairness and inter-nation equity), however, we do urge the OECD and other stakeholders to clarify certain elements of the proposals before going forward.

For instance, the differentiation between routine profits and residual profits, a fraction of which is intended to be allocated to market jurisdictions, remains complicated and a source of potential further conflicts and disputes in allocating deemed residual profits.[9] For these reasons, clear guidance which will take the form of appropriate

[7] Large technology software companies, who mostly sell to other businesses (B2B), may be left out of scope, which might not be the intended outcome of this process.

[8] For instance, under Amount A, one could determine the amount of profits made in the market jurisdiction by considering a 10/10 ratio or indeed 20/20 ratio. For example, companies with a 10% profit margin would be within scope, with 10% of their excess residual profits being allocated to markets.

[9] "Routine profit is the profit that an independent contractor would be expected to earn, given that it does not share the overall risk of the business. Residual profit is profit earned by the business in excess of this routine profit. It is tempting to equate this distinction between the routine profit and residual profit to the economic distinction between the normal return on an investment and economic rent, even though they would be calculated differently. However, while there is some overlap between the two distinctions, they should not be thought of as equivalent. In sum, therefore, it is possible that the residual profit may be greater than, or smaller than, economic rent of the overall enterprise.", Michael

revision of relevant soft-law such as the OECD Transfer-Pricing Guidelines is necessary for precise demarcation of lines between routine and residual profits.

We recognise that in order to avoid potential spill over effects, the proposals intend to implement the new nexus rules as a standalone treaty provision, independently from the existing Permanent Establishment ("PE") definition in the OECD Model Tax Convention. However, irrespective of this intention, the relationship between these two provisions (Article 5 of the OECD Model Tax Convention) and the new nexus treaty provision needs to be clearly defined. As the OECD is no doubt aware, the relationship between these two provisions can have significant consequences on the *modus operandi* of the whole tax system, so careful demarcation will avoid taxpayers being subject to double taxation.

More generally, as regards existing transfer-pricing rules and the operation of the Arm's Length Principle, any new rules should be aligned, as much as possible, with existing international tax principles and practice.

Specific Comments Regarding Amounts A, B, C

Specific Comments on Amount A:

Clarity would be welcome on the determination of the deemed non-routine profits, which are at present subject to tax at the residence jurisdiction. According to the proposals, on the basis of global consolidated financial information, a deemed non-routine profit will partly be allocated to the market jurisdiction on the basis of formulary apportionment. To avoid double taxation of such profits in both the residence and market jurisdictions, the taxation right under Amount A should be adjusted to reflect the balance of avoiding double taxation.

Typically, if the countries to which profits are allocated under Amount A do not have double tax treaties (and in absence of domestic provisions for cross-border tax relief), juridical double taxation would occur. In addition, profit attribution on the basis of formulary apportionment could also lead to double economic taxation, which is not at present relieved by double tax treaties.

A "one-stop-shop" mechanism to audit Amount A is also suggested, which would subject the amount to a single review, and be accepted by all relevant taxing jurisdictions.

Specific Comments on Amount B:

CFE understands that the purpose of Amount B is to solidify existing returns under transfer pricing, rather than generating additional revenues for market jurisdictions. In this respect, certainty regarding the baseline would be welcome. As these rules appear to cover a wider range of businesses, clarity would be welcome as to what extent Amount B intends to reward particular industries or regions.

If Amount B becomes established, it has the potential to also apply to smaller companies that fall outside the scope of the rules. This would be acceptable only if it could act as a safe harbour guideline. For example, the globally accepted baseline could be built upon as a template for safe harbour thresholds for smaller companies, to reduce complexity over taxing profits when breaking into new markets.

P. Devereux, Alan J.Auerbach, Michael Keen, Paul Oosterhuis, Wolfgang Schön and John Vella, "Residual profit allocation by income", WP 19/01 March 2019, Oxford University; *idem*, IMF Policy Paper (2019), fn. 6

Specific Comments on Amount C:

There is considerable uncertainty regarding Amount C, in absence of clear political consensus on the scope of the principles underpinning this element, which is in essence a mechanism to adjust the above amounts where the activities justify allocation of additional profits in market jurisdictions. In spite of the elements of Amount C aiming to provide additional certainty and ease of disputes, the calculation of C deviates from the formulary elements under A and goes back to the Arm's Length remuneration under ALP.

Preventing tax disputes and building international consensus on binding effects of dispute resolution is critical. These proposals will not work unless there is consensus for all countries to sign up to the binding effect of dispute resolution, which can operate on a multilateral basis and not just on a bilateral basis. This will inevitably require the development of a brand new multilateral treaty. It is important not to underestimate the resources needed by tax administrations and capacity issues at level of tax administrations of developing and/ or smaller countries to deal with multilateral disputes.

Addressing the Issue of Losses

The issue of losses needs to be addressed in an equitable manner. In smaller economies, companies outgrow their domestic market at a relatively early stage. Such companies will undoubtedly incur losses when expanding into new markets. These losses should not only be absorbed in the resident country, while paying tax on profits elsewhere. As a consequence, certain "unicorn" companies will come to the end of their loss-making phase when these rules are likely to be rolled out, which will affect countries in which such companies have invested early on, and may potentially not see a return.

Availability of Financial Information

CFE understands that the approach to calculate the amounts A, B and C is to start from the 'top holding' and then dividing the profit, but the primary issue with this approach is the availability and divergence of financial information and the differing accounting rules and standards in different countries. From CFE's perspective, a comparative exercise between jurisdictions seems in order, in order to align the different accounting rules to arrive at similar results.

It is also essential to have a transparent data source, which can be the consolidated financial accounts, but the complexity of drilling down in the profit and loss account to a divisional/ segmented business line should not be underestimated. Companies may not have designed their accounting models/systems to report in such segmented business or regional lines and therefore, it will be important to consult closely with business regarding this issue.

In general, if information is not required in a published set of accounts, then a company will not produce that information. Consultation should also be carried out with relevant stakeholders concerning the development of any system serving as a data source, either to comply with reporting obligations or to justify/verify calculations concerning amounts A, B and C. CFE strongly believes that any systems used in the process must be future proof, i.e. capable of seamlessly moving into a real time environment without a root and branch revision being required.