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Response to Public Consultation Document Secretariat Proposal for a "Unified Approach" under Pillar One

We take this opportunity to respond to the Secretariat Proposal for a "Unified Approach" under Pillar One in respect of taxation of the digital economy.

We agree that this is an area in which multilateral agreement is vital in order to avoid the double taxation which is likely to result under the range of "interim" digital taxes being introduced by a number of jurisdictions. Such taxes may not qualify for double tax relief under tax treaties and in addition, at least in the European Union, they may in fact contravene the law.

It is a pity that many enterprises and jurisdictions have spent the last few years dealing with the other BEPS topics and that these proposals result in both having to readjust yet again. This does not provide the stability which business needs.

We have a number of comments on the proposals. The relatively short period for a response means that we have limited these.

Where possible we have suggested ways in which the issues might be mitigated.

General comments

The objective of the proposals is to simplify and stabilize the tax system and provide increased tax certainty. We support this objective as for businesses these are probably the most important aspects of a tax system but we believe that as they stand the proposals create significantly more complexity and uncertainty.

Comprehensive acceptance of new rules
It is of paramount importance that all countries embrace the new rules. It will not be sufficient if, as is the case with the Multilateral Instrument, the United States does not participate as it is one of the countries which potentially will be most adversely affected by the rules as they stand.

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Smaller countries which are often nervous about the introduction of formulary apportionment will want to know who will determine the figure for Amounts A and B.

On the basis that the proposals are the result of a political decision rather than an economic one it is a necessary condition for all stakeholders to understand that that this is basically a reallocation of taxing rights away from what has been accepted up to now.

The role of the customer
The proposals assume that the customer and the market play a significant role in creating profit and that this should be remunerated. While this is a political decision, we do not consider it to be self-evident. Newspapers and other media have never paid tax in the countries where most of the news is created (at least not on that basis) and we are not aware of anybody ever raising that issue until the last few years. Should the media pay more tax in countries where there are more criminals or more disasters simply because more news is created there?

Fault lines
New fault lines are created. A notional difference between "large" MNEs and other businesses arises. Differences are created between bricks and mortar situations and digital situations. Enterprises which are not "consumer facing" do not fall under the proposed new rules. Certain industries are carved out.

There is little reference to the Internet of Things and the fact that bricks and mortar are increasingly themselves providing data. Not just mobile phones but cars, refrigerators and shipping containers. Splitting these activities between a digital element and a bricks and mortar element is arbitrary.

A division which is arbitrary inevitably leads to arbitrage.

Where is value really created?
Further attention also needs to be given to the fact that different types of digital business are likely to create value in different ways and in different places. In many cases there is an appropriate "bricks and mortar" analogy.

- A platform may rely on business participants in a range of countries and users in a different range of countries (such as hotel booking platforms). "Use" can therefore be divided into separate parts, one being the consumer and the other being the "product". A booking platform with only consumers will have no value.
- Some enterprises may simply store data. This is a routine activity.
- Subscription arrangements (e.g. for a streaming system) may be entered into in the country where the consumer is located, irrespective of where use takes place.
- Collection of data may in fact be a routine activity which only results in value in the location where it is processed (the analogy with raw materials and manufactures is appropriate here: the higher margins are usually made where the manufacturing takes place)

The pure scale of some of these businesses may itself create higher margins.

There are also many bricks and mortar businesses with a strong brand which do not necessarily need their own local organisation to sell goods profitably in a jurisdiction without having a presence there.

Soft drinks manufacturers with a strong brand may suddenly find themselves liable to tax on an allocation of profits to other countries.

Monopolies can also make superprofits without necessarily paying tax in the countries where they sell. This may apply particularly to the extractive industries.

Cooperation
It should also be clear that the proposals create a significant obligation for jurisdictions to cooperate with each other.

Consumer taxes
Potentially, any reallocation should also take account of consumer taxes. One could surely argue that a value added tax should be levied where the value is added and not just where the consumer is located and thus allocate some of the tax to the countries where the "production" takes place, particularly where consumers play only a passive role in the profit creation.

Exit taxes
The new proposal should have an effect on exit taxes since the value of an intangible asset will effectively be allocated across a number of different countries. It could be argued that if an enterprise changes its residence but continues to carry on business in the same jurisdictions as before, there is no basis for any exit tax on a deemed realisation of the intangible asset since its value remains allocated across the same jurisdictions. This will depend on how the allocation of Amount A is determined and to what extent and extra amount is allocated to the jurisdiction which owns the intangible asset. If the proposals come into effect it could be argued that the concept of residence should also be reviewed as with globalisation it has become a somewhat arbitrary concept.

A formulary system

The proposals introduce a formulary apportionment system, albeit one which is different from the traditional arrangement which takes account of assets, turnover and personnel. That is positive, in that the traditional formulary arrangement is not appropriate for the digital world where assets and personnel are much less relevant than in the bricks and mortar world.

The proposals intend to allow the arm's length system to continue side by side by the formulary system. In our view a formulary system for just part of the economy does not fit together well with the traditional arm's length approach which has been the norm to date and are unlikely to work well where certain industries are "carved out" to be taxed only on the arm's-length basis or where enterprises are excluded on the basis of size. Competitors may be taxed on a different basis which does not result in a level playing field.

The exceptions and exemptions are likely to result in a much more complicated system than we already have. Large businesses would be treated differently from small businesses, more digitally oriented businesses would be treated differently from less digitally oriented businesses and there will be many opportunities for arbitrage or disputes, depending on one's point of view.

Specific issues

Scope

Interaction with consumers/users
In the comments above we have discussed different types of business model and the question of to what extent the proposals would apply to traditional businesses for instance where they have a strong brand or another reason for making significant residual profits. Any business transaction must involve a marketing intangible to some extent, either in the form of trust or power. Arguably therefore almost any business would need to carry out the procedures under these proposals (subject to the size threshold).

Defining the MNE group
We have doubts as to whether consolidation is the right basis for determining the size of the group and the situation can become complicated, especially if the threshold is high.

1. A consolidated group is also not an ideal basis for determining the size threshold where there are significant minority interests (or even in certain cases external majority interests where a minority owner has control, which is not uncommon). How should the taxes be allocated in such cases? Is a pro rata basis appropriate? Is it reasonable to hold an entity liable for taxes of another entity which may be part of the same consolidated group simply because there are a small number of voting shares providing control and a large number of shares held by parties outside the group? Joint ventures are also difficult to deal with under this system.

2. Enterprises can be related parties for transfer pricing purposes or coordinate their activities without being part of the same consolidated group.

3. We see the possibility for disputes where one jurisdiction considers that an MNE has exceeded the threshold and another does not believe that this is the case. This is particularly complex where there can be discussions as to which activities of an MNE fall under these proposals and which do not.

The fact that it may be almost impossible to determine the total turnover of a collection of related parties not in the same group supports our arguments in favour of not restricting the new proposals to large businesses.

Size
We believe that restricting the new rules to large consumer-facing businesses and especially the high threshold mentioned are likely to result in a number of issues, some strategic and some administrative:

1. Certain jurisdictions may have the perception that the new proposals are directed against enterprises located in those jurisdictions and therefore be less likely to cooperate.

2. Similar situations will be treated differently on the basis of size, industry or whether parties are in the same group.

3. The digital economy is an area where frequent acquisitions take place and under the proposals these could result in sudden changes in the tax position of entities because they may suddenly be part of a group which exceeds the threshold for falling under the proposals.

4. Joint ventures may be an issue since they may fall outside the groups participating in the joint venture.

A low threshold eliminates many of the issues relating to the definition and size.

Admittedly, a low threshold may mean additional administrative requirements for smaller enterprises but in many cases such enterprises will already be required to prepare filings allocated across countries for VAT purposes and to prepare transfer pricing documentation. Possibly a clearing arrangement as set out below would keep the additional administrative requirements to a minimum.

For VAT purposes the European Union manages to deal with cross-border situations for sales to consumers using a threshold of EUR 10.000 (in certain cases EUR 100.000) per country. From 2021 it should be possible to pay the VAT in just one country and for this then to be allocated across jurisdictions. A low threshold which would include almost all businesses would be more likely to result in a level playing field than one which is limited to relatively few very large businesses.

Even if this arrangement is considered too radical, a significantly lower threshold of, say, EUR 1 million or EUR 5 million would go much further towards creating a level playing field.

Collection and information
Since the proposed system is based partly on a political decision to change the allocation of profit between jurisdictions it would seem fair for the jurisdictions themselves to incur some of the administrative burden rather than this being largely on enterprises themselves.

It is reasonable to expect cooperation between jurisdictions such that the tax authorities of one jurisdiction, possibly, but not necessarily, the jurisdiction where the entity at the top of the MNE structure is located, would collect the relevant information to determine Amount A and send it to the other jurisdictions concerned so that they can issue the necessary assessments. CbC reporting already provides a precedent.

It would also be possible to have a clearing system, whereby the reporting jurisdiction collects the tax and allocates and pays it to the entitled jurisdictions. The European Union is moving in this direction with respect to value added taxes.

Different types of business
We have referred above to the issues arising from different types of business model. A “one size fits all approach” has the benefit of simplicity but the differences in the types of business model are such that this is not appropriate.

New nexus

Country specific thresholds
We believe that by having a low overall threshold, the issues of country specific thresholds are not significant and they ensure that jurisdictions with smaller economies can benefit.

Liability issues
Under the proposals, tax could be levied in a jurisdiction, even though there is no activity there. If tax is to be collected from entities which have not created the profit those entities could easily end up in financial difficulty.

Company law may restrict certain transfers of funds between companies or payments by a company for the liabilities of another. Indeed, if the existing local entity is in a financially poor state it could be held liable for tax which it cannot possibly pay.

Consideration needs to be given to the position of directors and others who might be considered personally liable for the debts of company which goes bankrupt when the bankruptcy is caused by the activities of other entities outside their control. This could be a particular difficulty where acquisitions or spin-offs occur. New liabilities could arise or potential residual liabilities remain with the spun-off entity for many years for activities they know nothing about.

Who determines allocation keys and fixed remuneration?
Determination of Amounts A and B are essential to the new proposals. In order to gain acceptance it is imperative that there is clarity as to who would determine these and on what basis.

For routine profit, this will be especially complex where the allocation takes account of circumstances and is not simply a fixed percentage.

Similarly, the allocation of the residual profit between jurisdictions will not be easy to determine since it will have to take account of different circumstances.

Since these elements are integral to the amount of the taxable profit in each jurisdiction, agreement on this is essential in such a way that small jurisdictions do not feel threatened by larger ones.

Calculation of group profits for amount A

Determination of amount A
The determination of the MNE Group's profits is not straightforward, especially where one is not simply dealing with a line of business but elements of a line of business because only part of the activity falls under the definition. Should one extract certain aspects of the residual profit which do not relate to the digital part of the business? For instance, if goods are sold, should part of the sales price of that good be extracted on the same basis as it might be if only goods with an attached brand were sold? This is likely to cause complicated and uncertain calculations.

Residual profits are a complex calculation and the allocation key should not always be sales, since certain jurisdictions may not have significant sales but may be considered to make a significant contribution (for instance the hotel booking platform referred to above). We believe that this should be taken into account in the proposed system.

Consideration also needs to be given to costs relating to different jurisdictions, particularly in the case of marketing intangibles but also where significant effort is required to collect data (for instance in the case of a worldwide mapping system where arguably the costs are inversely related to the population density and therefore sales may not be the appropriate measure). These costs should be deducted from the residual profit allocated to the relevant jurisdiction.

Elimination of double taxation

Many acquisitions concern loss-making companies. If the group has profitable and non-profitable companies in one jurisdiction how should residual profit be allocated between them? There is a case for providing loss relief between separate entities within the jurisdiction in view of the fact that a loss-making line of business may provide benefits to the profitable line. Indeed, since in many respects the MNE is being treated as a single unit there is an argument that there should be a (possibly optional) system of loss relief between entities of the same MNE in each jurisdiction. This would reduce the requirement for double tax relief across borders.

Relief needs to be given for tax paid by one entity for the liability of another. Jurisdictions should agree that exchange controls will not apply to transfers between entities to cover such liabilities.

Amount B

This figure must surely take into account different industries and regions. A single fixed percentage would not reflect reality. Most likely this return should be based on costs.

Many internet businesses never make a profit. Should a profit nevertheless be taxed in the country where the routine activities are deemed to occur? Although there is a case for such an approach we would hope that there is no intention to tax entities which are in total loss-making. This needs to be clarified.

Conclusions

The proposals are a substantial move away from the system which has been in existence for the last 100 years. The reallocation of taxing rights is a political decision and the proposals need to be formulated such that they are accepted and implemented by all jurisdictions (including those which are effectively giving up rights) but also other stakeholders. This includes the question of who determines (and can change) the allocation keys and fixed remuneration. If this is not achieved then the proposals will not work and double taxation is likely to be commonplace.

The objective of the proposals is to achieve simplicity and tax certainty. The large number of exceptions and exemptions do not achieve this. If the system is to be implemented, we believe that the threshold for application of the new proposals should be as low as possible.

The determination of what constitutes an MNE and how profit should be allocated within it, especially where there are significant minority (or external majority) interests in subsidiary entities needs further consideration.

A “one size fits all” approach is not appropriate in view of the fact that there are many different business models.

Non-tax matters need to be dealt with such as liability and exchange control issues. A clearing system might assist in this.

There are significant issues with respect to loss relief including the fact that losses in one entity should be offset able against profits in another.

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