KRISTER ANDERSSON AND CLAES HAMMARSTEDT

New allocation international taxation rights among countries

– A review of the OECD Secretariat Proposal for a Unified Approach

Tax competition has appeared for a number of years. Smaller countries have challenged larger economies by lowering their statutory corporate tax rate, making more investments economically viable and at the same time, attracting some foreign direct investment. Since some years back, the larger economies have tried to limit tax competition. They managed to accomplish some refocusing and limitations through the BEPS project despite that remedies sought for base erosion and profit shifting was less than 0.4 per cent of GDP. The larger economies have now, also in a G20-effort, embarked on a project of how to openly reallocate corporate tax revenues to countries with large consumer markets. This article addresses how the efforts of how to split the tax revenues among countries is addressed within the OECD/Inclusive Framework.

1 BACKGROUND

The tax challenges of the digitalization of the economy were identified as one of the main areas of focus of the Base Erosion and Profit Shifting (BEPS) Action Plan, leading to the 2015 BEPS Action 1 Report. The new business models used and increased reliance of data have triggered a debate and reform efforts to change the allocation of taxation rights among countries. Countries with large consumer markets have in particular claimed that consumption should be the basis for allocating taxation rights, rather than innovation, production, risks, location of Headquarter and strategic decision making. While the BEPS project focused on anti-abuse measures and preventing profit shifting, the new initiative openly addressed the reallocation of taxation rights to source or market jurisdictions rather than residence jurisdictions.

A number of countries have initiated new forms of taxation of highly digitalized businesses. Such taxes have typically been levied on turnover and revenues rather than on profits. The European Union even presented a

directive with the purpose to tax such returns.[1] Such a distortive tax raised a lot of concerns in many Member States. The Nordic countries strongly opposed the proposal and the Directive was not adopted. Instead, a global solution involving the OECD with the Inclusive Framework (IF) was sought.

The OECD issued an interim report in 2018 and a public consultation document in January 2019. It has since been followed by a secretariat proposal for a Unified Approach addressing taxation rights among countries and proposal for a minimum corporate tax regime.[2]

2 THE SECRETARIAT PROPOSAL

The OECD Secretariat proposal is entitled "Secretariat Proposal for a Unified Approach under Pillar one" 9 October–12 November 2019. It was discussed at a public hearing in Paris at the OECD on 21–22 November, 2019.

The efforts made by the OECD in addressing the challenges from the digitalization of the economy is very welcome. All businesses are becoming digitalized making this a truly global issue requiring a global solution. When designing new methods, the objective must be to come up with a system that strikes a balance between complexity and compliance issues versus the policy objective to change taxation allocation rights among countries.

The Secretariat proposal aims to identify the key features of a solution already in 2020, which would include the following:

- Scope. The approach covers highly digital business models but goes wider – broadly focusing on consumer-facing businesses with fur-

1 European Commission COM(2018) 148 final 2018/0073 (CNS) Proposal for a Council Directive on the common system of a digital services tax on revenues resulting from the provision of certain digital services {SWD(2018) 81} – {SWD(2018) 82}, Brussels, 21.3.2018.

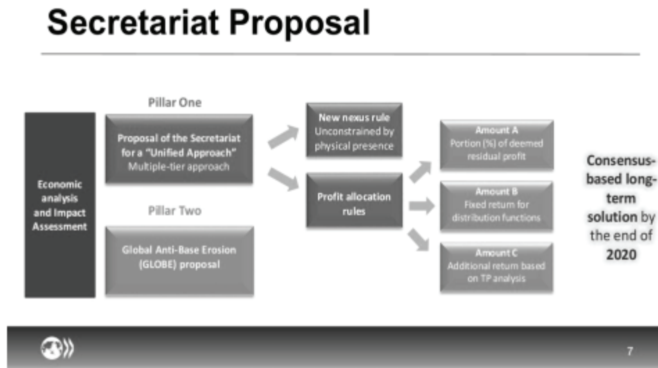
2 OECD, "Tax Challenges Arising from Digitalisation – Interim Report 2018: Inclusive Framework on BEPS" (2018); "Addressing the Tax Challenges of the Digitalisation of the Economy – Public Consultation Document" (2019); "Addressing the Tax Challenges of the Digitalisation of the Economy – Policy Note" (Jan. 23, 2019); and "Programme of Work to Develop a Consensus Solution to the Tax Challenges Arising From the Digitalisation of the Economy" (May 2019); "Secretariat Proposal for a 'Unified Approach' Under Pillar One – Public Consultation Document" (Oct. 2019); and "Global Anti-Base Erosion Proposal ('GloBE') – Pillar Two – Public Consultation Document" (Nov. 2019).

ther work to be carried out on scope and carve-outs. Extractive industries are assumed to be out of the scope.

- New Nexus. For businesses within the scope, it creates a new nexus, not dependent on physical presence but largely based on sales. The new nexus could have thresholds including country specific sales thresholds calibrated to ensure that jurisdictions with smaller economies can also benefit. It would be designed as a new self-standing treaty provision.
- New Profit Allocation Rule going beyond the Arm's Length Principle. It creates a new profit allocation rule applicable to taxpayers within the scope, and irrespective of whether they have an in-country marketing or distribution presence (permanent establishment or separate subsidiary) or sell via unrelated distributors. At the same time, the approach largely retains the current transfer pricing rules based on the arm's length principle but complements them with formula based solutions in areas where tensions in the current system are the highest.
- Increased Tax Certainty delivered via a Three Tier Mechanism. The approach is said to increase tax certainty for taxpayers and tax administrations. It consists of a three tier profit allocation mechanism, as follows:

  - Amount A – a share of deemed residual profit allocated to market jurisdictions using a formulaic approach, i.e. the new taxing right;
  - Amount B – a fixed remuneration for baseline marketing and distribution functions that take place in the market jurisdiction; and
  - Amount C – binding and effective dispute prevention and resolution mechanisms relating to all elements of the proposal, including any additional profit where in-country functions exceed the baseline activity compensated under Amount B.

The proposal can be depicted as:



The second Pillar is a global corporate minimum tax and the OECD has sent out a public consultation document on this proposal as well.[3] It was discussed at a public hearing in Paris at the OECD on 9 december, 2019. The two pillars are seen as one package and should be agreed on at the same time. It remains however to see whether that will happen.

The Secretariat's proposal is designed to address the tax challenges of the digitalisation of the economy and to grant new taxing rights to the countries where users of highly digitalised business models are located. However, the approach also recognises that the transfer pricing and profit allocation issues at stake are of broader relevance. It recognises that current transfer pricing rules, even in a post-BEPS environment, face challenges. While there seems to be adherence among Inclusive Framework members to the principle that routine transactions can normally be priced at arm's length, there are increasing doubts that the arm's length principle can be relied on to give an appropriate result in all cases (such as, for example, cases involving non-routine profits from intangibles).

The profit allocation rules would be:

3 Public consultation document "Global Anti-Base Erosion Proposal ("GloBE") – Pillar Two" 8 November 2019–2 December 2019. http://www.oecd.org/tax/beps/public-consultation-document-global-anti-base-erosion-proposal-pillar-two.pdf.pdf.

Profit Allocation

Model based on three separate returns to the market/user jurisdiction

Amount A	Amounts B & C
• New taxing right to market/user jurisdiction • Independent of physical presence • Formulaic approach based on group/business line profits • No links to ALP	• No new taxing right – merely a modified operation of the ALP • Follows the separate entity approach

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Profit Allocation
Amount A – new taxing right

Step 1: Determination of total profit
- MNE group or business-line calculations

Step 2: Exclude "deemed" routine profit to define residual
- Profitability threshold (i.e. fixed percentage(s))

Step 3: Allocate a portion of "deemed" residual profit
- Formulary (i.e. fixed percentage(s))

Step 4: Allocate the relevant portion of the deemed residual among market jurisdictions
- Agreed allocation key (e.g. sales)

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Profit Allocation
Amounts B and C

Amount B	Amounts C
Objective • Reduce disputes • Achieve greater certainty	**Objective** • Retain market jurisdiction right to tax profit above baseline activity • Prevent double counting of Amount A
Method • Fixed return for "baseline" or routine marketing or distribution activities in market	**Method** • Apply current ALP to activities beyond baseline • Introduce effective and binding dispute resolution mechanisms

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In the BEPS project, it was considered crucial to assure taxation in line with value creation. It can certainly be questioned whether the three-tier proposal and the combined system of the arm's length principle for normal profits and formulary apportionment for the residual profits as suggested according to Amount A in the Unified Approach, would be in line with value creation. Furthermore, it would be extremely complicated. Without clarity and agreed principles and definitions among all countries in the Inclusive Framework, it will be virtually impossible for businesses to get any kind of certainty at an early stage, i.e. at the time of the investment decision and/or transaction. This is even before the mechanism of how to reduce taxation in those entities showing such a high profitability that the entire Group will be subject to allocating profits to market jurisdictions, is outlined (see below). This will require extensive TP assessments and will probably have to entail the use of multilateral instruments.

It is obvious that the intent of the suggested Unified Approach in pillar 1 primarily is to reallocate taxation rights among countries and to increase profit distribution to market jurisdictions. This, of course, is a radical shift to the initial intention of Action point 1. The Unified Approach attempts to resolve this by re-allocating residual profits to the market jurisdictions without any clear reference to how profits and losses are shared in an open market economy. This would essentially mean an arbitrary shift of taxable income from smaller net exporting countries with high levels of R&D-activities and associated entrepreneurial risk taking to larger net importing jurisdictions with large consumer bases. It is furthermore unclear how accumulated costs should be addressed in the year in which reallocation of residual profits take place.

Such a policy would in our view disincentivise countries from developing a good and competitive investment climate to support innovation and entrepreneurship. The rationale for a country to spend public funds on advanced educations, technological developments and entrepreneurship would arguably decrease if the taxable proceeds from these activities are redistributed to where the consumption takes place. Conversely, the incentive for markets with large customer bases to ensure efficient and competitive investment climates would arguably be reduced if the proceeds will be taxed there regardless.

There is also a risk that countries losing revenues will try to recoup lost corporate tax revenues by increasing other taxes either on corporations or

on their employees. This would make the investment climate even more business unfriendly.

A report[4] from Copenhagen Economics in 2019 assessed the potential effects on corporate tax bases if residual profit is allocated to market countries. A conservative estimation suggests that 18–21 per cent of the current corporate tax base in the Nordics came from foreign residual profits in 2017. The report concludes that small, open economies with high R&D intensity in exporting services will lose significant net revenues. The Nordic countries clearly fall into this category with higher than average shares of life science and information and communications technology (ICT).

Furthermore, the report from Copenhagen Economics shows that most venture capital investments never generate any corporate tax revenue and that very few become global players. With a residual profit split approach, the costs for innovation and development for all the failed venture capital investments would likely remain in the exporting country, while future profits for the few successes would, at least partly, be taxed in other countries, without proper recognition of the costs or previous losses. It seems a fair question to ask why the country funding the R&D should not be allowed to symmetrically tax profits if and when they materialize. From a country perspective, in order to cover the average development cost, any successful investment would effectively have to cover the costs of all the previously failed investments. It is therefore important to provide enough profits in the innovator jurisdiction to reward R&D and incentivize discovery.

There are no impact assessments available from the OECD Secretariat. It is very important that political considerations are not included in such an analysis. It appears very likely that countries running a current account surplus will be losing revenues. The same goes for current account deficit countries with a high export content of sophisticated products and import of less sophisticated imports. A country like the US would therefore likely loose revenues despite its large present trade deficit and current account deficit. Any impact assessment must also address the impact on those businesses getting a higher effective corporate tax rate (with reduced employment levels as a result) as well as the effect of likely changes to their business models

4 Future Taxation of Company profits – What to do with Intangibles? by Sigurd Næss-Schmidt, Palle Sørensen, Benjamin Barner Christiansen, Vincenzo Zurzolo, Charlotta Zienau, Jonas Juul Henriksen and Joshua Brown, Copenhagen Economics, 19 February 2019.

(when more is paid to dependent distributors (Amount B) or countries claim taxation rights to the global return of a Group (Amount C)).

The Secretariat proposal does not sufficiently address the need for, and the methods of, how to allocate costs and losses among countries, so that the net profit of the Group is taxed over time. The unwillingness of countries to accept losses from other jurisdictions constitute a significant challenge. Rules need to address this issue and in general provide clarity of how costs, profits and losses should be attributed among countries over time.

3 SCOPE

The Draft states that Amount A in the Unified Approach broadly focuses on "consumer facing businesses". Admittedly, these are businesses that "interact with their consumer base and create meaningful value without a traditional physical presence in the market". In our view, it seems very unclear what a consumer facing business really is and what happens with companies that sell both B2B and B2C. The role of intermediaries will also have to be considered. Clearly, a narrow definition with specific criteria is needed in order to determine which types of businesses would fall into this category.

Would it be sufficient for a company to not finalize the product for it to be considered to be a B2B company? If a car maker stops selling the cars to consumers and instead sells the car to another company, which finalize the car for the consumer by putting on the wheels on the car, would that convert them into a B2B company? It is worth noting that the economic effect of the new tax order could still affect the company since the tax may be shifted to the producer (or on to the final consumer). Such tax incidence effects must be considered in the impact assessments.

4 NEW NEXUS RULE

The Unified Approach proposes a new nexus rule for taxpayers, granting taxing rights (based on sales) to countries where companies do not have a physical presence.

As we understand it, the new nexus only applies in relation to amount A in the three-tier approach. While the details of the new nexus rule, including thresholds, need to be developed, it needs to be ensured that the new nexus is triggered only where there is sustained and significant economic activity in a market jurisdiction. The nexus rule seems to a large extent to ringfence companies using internet sales or heavy users of data.

However, as more and more businesses engage in AI-activities (artificial intelligence), the use of consumer related data will increase drastically. It is therefore also likely that "brick and mortar" companies will have to adhere to vague concepts like "user participation". Presumably, German automakers and others are already deeply involved in collecting consumer satisfaction data to enhance their products.

5 NEW PROFIT ALLOCATION RULES – A THREE TIER MECHANISM

The proposed Unified Approach comes with a lot of complexity. It creates a new three-tier profit allocation mechanism that goes beyond the arms-length principle and is based on fixed percentages. Such a system will be extremely complicated from a compliance, administrative and dispute perspective. A new system for how to allocate international taxation rights among countries is launched. Proposed thresholds, limitations and carve outs will change over time. For companies active in exporting hubs like the Nordic countries, considerable effective corporate tax increases may materialize and the Nordic governments, together with many other well- functioning competitive exporting countries, will lose substantial revenues as the corporate tax rules shift to be based on consumption rather than on innovation, production and key functions.

5.1 Amount A

An allocation in accordance with Amount A would result in a portion of the deemed residual profits being allocated on a formulary basis to market jurisdictions according to sales. Although this might sound simple, we are concerned that profits will be allocated on a disproportionate basis, not based on value creation and activities performed. This would harm countries which are net-exporters and would not recognize the legitimate taxation rights of countries where innovation, risks, HQ, strategic decisions or where production take place. Consequently, there is a need to strike a balance between the revenue impact for net-importing countries and net-exporting countries.

The proposal for Amount A combines the residual profit split method (splitting profits into deemed routine/non-routine profits) with the fractional profit split method by allocating a share of the deemed residual profits (primarily based on sales) to market jurisdictions.

While recognising that the 'the arm's length principle' is becoming an

increasing source of complexity', the OECD should retain 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 for companies.

How to split profits into routine/non-routine profits has always been a controversial issue and a cause for different legal interpretations in various jurisdictions. Consequently, it is important to define a clear boundary between the two. In order to avoid legal disputes such rules need to be as detailed as possible.

It is also essential that an agreement under Amount A on how to re-allocate a share of the non-routine profits to market jurisdictions includes clear rules for determining which entities in a multinational group earn such non-routine profits under existing transfer pricing rules and consequently should be entitled to double taxation relief. 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 would also be under assessment 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.

Another issue in relating to the allocation of Amount A is the fact that costs and losses may occur for previous years while sales and profits occur in a particular year. Given the significant risks, timeline and capital investment to develop a product and the difference in the timing of expenditure incurred and profit arriving, an allocation of the profit in one single year does not make sense. Such allocation would not align with the value creation which is built up over many years and does not reflect the risk undertaken by the innovator in terms of substantial expenditures on unsuccessful products resulting in losses. The "above normal profit" would, for many R&D intensive industries, be practically impossible to apply in an equitable way, mainly as the costs and key risks assumed which result in the current year's sales have been incurred in previous years.

5.2 Amount B

The fixed remuneration for baseline marketing and distribution activities in Amount B would apply to all companies, without any size limitations. A fixed percentage rate for Amount B may probably not be the most propor-

tionate way to address this issue. It also seems to indicate that marketing and distribution functions never can be loss making? 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. Since all companies are targeted, it could potentially involve considerable changes to tax revenues of countries. It is of utmost importance to have a clear definition of what is considered baseline activities. 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.

5.3 Amount C

There is an almost absolute lack of clarity regarding the profit allocation in Amount C. The right to tax according to such rules must be based on clear principles agreed by all countries. It is important that a Pandora's Box is not opened for tax claims on brand names etc. from various countries. In this respect, the interaction between Amount C and Amount A and B needs to be clarified. Without such clarity, 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. 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). Disputes are mainly between governments/revenue authorities and must be addressed from the outset in any agreement. In order to provide greater certainty there is a need for a commitment from all countries in the Inclusive Framework to agree to Mandatory binding arbitration for all measures (A, B and C).

6 ELIMINATION OF DOUBLE TAXATION

The new proposals are likely to result in a number of new disputes, potentially involving many countries simultaneously. As mentioned under Amount A above it is likely that the non-routine profits will also be arising in different legal entities in multiple jurisdictions. It is yet to be decided, in these circumstances, who should be responsible for allocating profits to market jurisdictions. One suggestion is a one-stop shop where this is handled by the tax authority in the resident state of the parent company. In any event, an increasing number of double taxation incidents will need to

be addressed through a multilateral instrument, since 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 likely to lead to further controversy and an incorrect end-result. Furthermore, not all countries that will be allocated profits in accordance with Amount A will necessarily have all tax treaties required to resolve the double taxation that may occur. 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.

7 IMPACT ASSESSMENT

Considering the potential implications that the new proposals could have on investments and revenue streams, a comprehensive economic impact assessment is essential in order to provide all the participating countries with relevant information before deciding on any agreement unanimously. The impact assessment 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, R&D etc.

8 CONCLUDING REMARKS

It is of course very difficult to achieve an agreement on how to change international taxation rules of how to divide tax revenues among countries in such an extremely short time period as is called for. There will be departures from the generally agreed concept of value creation. The new rules must however also be based on principles generally accepted. These rules or principles are not clear. They need to be expressed in a new world tax order. In any case, it is important that the analysis behind the decision to transfer taxation rights to market jurisdiction is made publicly available. How much need to be transferred to market jurisdictions? There are now expectations in consumer-market-jurisdictions that they will be able to collect much more in corporate tax revenues at the expense of residence countries, which fear that considerable revenue losses are unavoidable. It would therefore be valuable to have an analysis made, equivalent to the one in BEPS Action Point 11, assessing the magnitude of the "problem". Action Point 11 assessed that the global revenue losses amounted to some 0.4 per cent of GDP (100–240 bn USD). Is the present project transferring taxation rights of the same magnitude? Individual countries may nevertheless lose more than the average tax revenue amount relocated. The

provided estimate would however be an anchor for expectations and for possible revenue tax authority actions.

The introduction of unilateral measures in many jurisdictions has fueled the debate on the necessity of reaching international consensus. Should the Inclusive Framework reach an agreement, such an agreement must also require the removal of any current unilateral measures in force and a political commitment by the members not to introduce such measures in the future.

Furthermore, agreement on a swift and simultaneous implementation through the MLI is also of utmost importance.

Pillar 2 may recover some of the corporate tax losses of residence countries, but the cost of capital is likely to increase. This will hurt investment and job creation globally but may be more pronounced in net-exporting countries. It is important that any measures taken are socially acceptable to the public at large, in particular in net-exporting countries. The OECD has often considered the corporate income tax the most harmful tax to growth and jobs. Any increase in effective tax rate will affect job prospects negatively and low-income earners are likely to be the most affected.

We live in interesting times.

Krister Andersson is the founder of Intare AB, Chairman of the Tax Policy Group of BusinessEurope, vice chair of the Business at OECD Tax Committee and Vice-President of the Employers' Group of the European Economic and Social Committee (EESC). Claes Hammarstedt is Senior Advisor International Tax Policy, Confederation of Swedish Enterprise. Views are personal and should not be attributed to any organization.