SOUTH CENTRE TAX INITIATIVE

Comments on the OECD Secretariat Proposal for a "Unified Approach" under Pillar One

Background

The South Centre, an intergovernmental organisation of, by and for the Global South launched the South Centre Tax Initiative (SCTI) (https://taxinitiative.southcentre.int) in 2016. This is the organisation's flagship program for promoting cooperation among developing countries on international tax matters. The program aims at increasing collaboration among developing countries on international tax issues and reform processes.[1]

The SCTI offers its comments on the OECD Secretariat's Proposal for a "Unified Approach" under Pillar One. The purpose of the comments is to articulate some of the interests of developing countries in responding to the questions raised in the proposal.

Summary of Comments:

1. Profit is the outcome of **both** demand **and** supply factors and this should be kept in mind when devising profit allocation rules.
2. The scope of the proposal should be as wide as possible with minimal carve-outs and exemptions. Multiple carve outs such as non-consumer-facing business, financial services, specific business lines make the proposal difficult to administer and lend it open to a high degree of disputes which will benefit auditors and arbitrators rather than revenue authorities and taxpayers.
3. The OECD should release its country by country reporting data on MNEs headquartered in its member states so that all affected countries, especially Inclusive Framework members, can make an informed assessment of how the proposal will affect them.
4. The 'new nexus' should take into account revenue through sales **and** user base.

1 With a focus on network building, the SCTI is centered on the convening of an Annual Forum of developing country officials working in tax policy and administration, and to promote and support intensified, better coordinated, and more institutionalized approaches to South-South cooperation in tax matters, so as to enable developing countries to become full participants for substantive norm-setting in international taxation matters. The Third Annual Forum will take place from 9-10 December in New Delhi, India.

5. Once a nexus has been determined in a jurisdiction, all profits should be allocated to it, regardless of whether they are routine or non- routine.
6. The methodology proposed for determining Amount A irrationally and arbitrarily excludes a significant portion of an MNEs group profits from market jurisdictions. Further, it is highly vulnerable to profit shifting through abuse of existing transfer pricing rules.
7. Formulaic allocation to market jurisdictions should be based on the G24's "SAMU" variables – Sales, Assets, Manpower, Users. These reflect both demand and supply factors used in generating profit and, hence, provide an equitable and rational basis rather than looking at only sales.
8. Mandatory and binding MAP arbitration under Amount C is to be avoided. The complexity of the proposal lends it vulnerable to disputes and there are better alternatives to binding arbitration to provide tax certainty. One option is multilateral APAs with some transparency to prevent abuse.

General Remarks
It is important to reiterate at the outset that the OECD/G20 Inclusive Framework on BEPS is no substitute for a genuinely inclusive, intergovernmental tax body under the auspices of the United Nations. **The South Centre supports the call for upgrading the UN Committee of Experts on International Cooperation in Tax Matters into an intergovernmental body as outlined in UN draft resolution E/2010/L.10.**[2] Discussions on reforming the international tax system must take place in a genuinely democratic and inclusive setting.

The OECD Secretariat, an organisation of, by and for the OECD member states, has prepared the "Unified Proposal" claiming to include elements from the three proposals under consideration, which were by the US, UK and G24. However there seems to be a disproportionate emphasis on elements drawn from the US' proposal. This may significantly bias the trajectory of the ongoing discussions and is hence a matter of concern.

The South Centre reiterates its support to the G24 proposal for "Addressing Tax Challenges Arising from Digitalisation". The OECD Secretariat should prioritise an assessment of the revenue implications of the G24 proposal under various alternative assumptions about the factors to be included and release it at the earliest, preferably much before January 2019, so that countries can make more informed decisions on this crucial issue.

The South Centre will continue to engage with the OECD Secretariat and the Inclusive Framework. The likely outcome in 2020 should not be seen as an end point, but rather as the opportunity to take the first step towards creating a genuinely fair international tax architecture, which will require multilateral discussions extending well beyond the current process.

2 https://digitallibrary.un.org/record/685632?ln=en#record-files-collapse-header

Responses to Specific Questions

1. **Scope**.
It is unclear why the scope for Amount A will focus only on consumer (including user) facing businesses. The proposal has not given any justification for this carve-out. This has shaky foundations in theory and disastrous implications in practice.

Theoretically, no business can make profits without first producing or acquiring a good or a service. Only after selling the good or service which it has acquired or produced can it make profits. Thus, profit generation is the outcome of both demand ***and*** supply factors. By focusing only on the demand side and hence including only consumer facing businesses the scope has been arbitrarily and irrationally limited.

In practice this means that developing countries, where a great deal of modern production now takes place, will lose significant taxing rights. By excluding factors such as employment, the proposal shows a bias in favour of rich consumer economies (which also happen to be OECD member countries). Further, by prioritising intangible assets which are often located in tax havens, developing countries will lose a significant source of revenue as these are prone to profit shifting and abusive tax practices. The retention of transfer pricing rules exacerbate this risk. Conservative estimates by Alex Cobham, Tommaso Faccio and Valpy FitzGerald[3] show that the OECD proposal will lead to a drop of only 5% in profits booked in tax havens. OECD economies would disproportionately benefit, seeing a growth in their tax base by $5 billion while the tax base of G24 countries would collectively grow by $0.7 billion and the tax base of the G77 group of countries by just $0.3 billion. Thus, the OECD countries may gain a tax base that is around five times that of the developing world.

By contrast, according to the aforementioned study, the IMF's proposal has been estimated to result in a drop of 43% in profits booked in corporate tax havens. This is because unlike the OECD, the IMF proposal has applied a 7.5% set level of return on capital. Proposals put forth by some civil society organisations have projected a drop of more than 60%. Hence by any estimate the OECD proposal is falling far short of the radical changes required. **The South Centre supports the call for the OECD to make public its country-by-country reporting data on MNEs headquartered in its member states so that countries can carry out a more thorough assessment of how the Unified Approach proposal will affect their tax base.** At present the OECD has planned to release this data only after early 2020, potentially after key elements of the reform proposals have been pushed through.

Through carve-outs and differentiation for business models, the proposal also brings in a high degree of administrative complexity that opens the door for extensive disputes. This is certain to benefit auditors and arbitrators rather than revenue authorities and taxpayers. The goals of administrability, simplicity and tax certainty are all undermined through adding these layers of complexity. The G24's proposal,

3 https://osf.io/preprints/socarxiv/j3p48/

by contrast, takes a simple, stable and relatively easy to administer approach using a formula that takes into account both supply and demand factors in allocating profit.

2. **New Nexus**.

The proposal to go beyond the outdated concept of physical presence in determining nexus is welcome. The nexus is to be 'largely based on sales'. It should be clarified that the nexus be based on the 'Significant Economic Presence' concept as defined in the G24 submission. With regard to sales, consideration has to be given to the types of transactions to be covered, the *de minimis* threshold in absolute terms and its administration.

Revenue is certainly an important component but not the only one. **The nexus should also take into account the user base and associated data input.** As suggested in the Action 1 report, the Monthly Active Users (MAU) and online contract conclusion can be taken as user-based factors. The **volume of digital content** taken through a digital platform from users and customers habitually resident in that country in a taxable year can be another indicator.

Other indicators can be 1) billing and collection in local currency 2) website in a local language 3) delivery of goods to customers being the responsibility of the Enterprise 4) Enterprise providing additional support services such as after sales service or repairs.

Including this holistic set of factors will reflect the realistic participation of a digitalised enterprise in the economic life of a country. This will allow for a fair and just nexus which will benefit smaller economies as well and go beyond the narrow criteria of only sales.

3. **Calculation of group profits for Amount A**.

The proposal refers to the Generally Accepted Accounted Principles (GAAP) or the International Financial Reporting Standards (IFRS) accounting standards for calculating the MNE group's profits. However, it is questionable that the accounting standards are not easily manipulated. The GAAP standards are rather open-ended and prone to varying interpretations. More broadly, the accounting world is no stranger to high profile scandals through "creative" (but actually destructive) accounting techniques, some of which have even resulted in big firms being blacklisted from entire economies.

The other challenge is in the definition of the group profits. Marginal and average profit are related but not the same. The average profit is constituted by the surplus of total revenue over the sum of all the costs i.e. marginal cost plus the corresponding portion of the sunk cost. In case of a PE which is not owning R&D or assets, ideally no rent should be attributed to R&D or to assets in the form of depreciation. Thus, the operating margin valuation should exclude depreciation, interest and R&D costs.

4. **Determination of Amount A**.

Once a nexus has been determined in a jurisdiction, all profits should be allocated to it, regardless of whether they are routine or non-routine. This is the only rational line which is worth proceeding on. There is simply no rationale for excluding deemed routine profits from the tax base.

That being said, the problems of the Amount A approach are grave and manifold. The proposal states that "simplifying conventions" will be agreed upon to determine what is routine and non-routine. In the first place, it is important that the negotiations which would produce these conventions should effectively reflect the needs of developing countries. These should also contain safeguards against misuse. Developed countries, by taking unyielding stances, may obtain a pyrrhic victory through an unbalanced agreement that is in their favour but vulnerable to decay and revolt through increasing unilateral measures.

Profit allocation through Amount A first envisages excluding deemed routine profits from the pool of profits from which the allocation to market jurisdictions would be made. This itself raises challenges for developing countries and market jurisdictions by drastically reducing their share of the tax pie. It also raises questions on whether even developed countries will be able to tax this pool effectively. It will still be possible to continue profit shifting through existing transfer pricing rules such as the Residual Profit Split (RPS) method. Since the RPS in combination with the Transactional Net Margin Method (TNMM) is mostly likely going to be used for allocating routine profits, it is important to examine the risks involved.

The Authorised OECD Approach (AOA) uses an entirely supply-driven Functions Assets and Risk (FAR) basis for profit allocation. This itself is hugely problematic and has been rejected by some developing countries such as India. Using the TNMM, it will continue to be possible for MNEs to structure transactions with related parties in such a way that profit is shifted to tax havens.[4]

The remaining deemed residual profit which will be 'subject to the new taxing right' also comes with serious disclaimers. According to the proposal, this is to be further subdivided into the portion that is attributable to "other factors such as trade intangibles, capital and risk, etc". The leftover rump will then begin to be given to the market jurisdictions as a whole. As a concession, the proposal offers multiplying this amount by some fixed percentage (to be decided through negotiations). However, if the amount itself is miniscule, which is highly possible given the significant contribution of intangibles to non-routine profits, then it raises questions on what eventually will be given to market jurisdictions. Developing countries, which have the majority of the world's populations (India and China alone account for nearly half) will have to quarrel over the crumbs thrown to them.

4 https://www.taxjustice.net/2019/10/03/the-dangers-of-the-residual-profit-split/?utm_source=newsletter&utm_medium=email&utm_campaign=oecd_is_facing_a_crisis_oecds_reform_is_weak_on_corporate_tax_havens_harsh_on_poorer_countries&utm_term=2019-11-03

The final amount which will then be allocated to market jurisdictions will be based on a formula/allocation key "using variables such as sales". It is critical that other variables be included as well. As mentioned earlier, profit is the outcome of **both** demand **and** supply factors. Hence, profit allocation should take both into account. Ignoring supply-side factors will mean the producer economies and newly industrialising countries will lose out on their legitimate revenues. **The G24 proposal with its basis in SAMU (Sales, Assets, Manpower, Users) is an equitable and rational basis for an allocation formula.**

7. **Amount C/dispute prevention and resolution**.

The proposal of Amount C seeks to bring in an old and unfavourable demand of the OECD countries on mandatory binding MAP arbitration. This should be outrightly rejected for its structural imbalances against the legitimate interests of developing countries. The Unified Proposal, with all its complexity, lends itself vulnerable to endless disputes over aspects such as the margins between routine and non-routine profits; between consumer-facing and other business; between the definition of 'other factors' that contribute to deemed non-routine profits and over the definition of 'baseline' marketing and distribution functions. This would be an arbitrators' paradise, bleeding both revenue authorities as well as all but the richest taxpayers dry.

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