November 9, 2019

Comments of the G-24[1] on the OECD Secretariat Proposal for a Unified Approach to the Nexus and Profit Allocation Challenges Arising from the Digitalisation (Pillar 1)

General Comments

1. G-24 appreciates the efforts by the OECD Secretariat in coming up with a Unified Approach (UA) to build a consensus solution under Pillar 1 and looks for a multilateral solution that recognizes that digitalization enables firms to have a significant economic presence in our economies, even without physical presence.
2. G-24 favours rules that are fair and simple, and are capable of being implemented effectively by developing countries. The agreed solution should be flexible enough in capturing new/emerging business models, as these are under constant change. The profits must be allocated according to rules that take into account the contribution of both demand-side and supply-side factors in creating these profits.
3. G-24 would like to point out that at least three different standards relating to profit attribution are found in existing tax treaties in the form of Article 7 of the UN Model Tax Convention, Article 7 of the OECD Model Tax Convention (as it stood prior to 2010 update) and existing Article 7 in OECD Model Tax Convention. Therefore, any new profit attribution rule must keep in view these different versions of Article 7 and their interplay with such (proposed) new rule for any particular jurisdiction.
4. G-24 considers that a combination of non-physical nexus like Significant Economic Presence, along with flexible profit attribution approaches based on a formula (like a fractional apportionment method), coupled with a withholding tax mechanism, can be a possible simple solution for addressing the nexus challenge related to digitalisation. A withholding tax regime appears to be an appropriate and simple solution for the taxation of services being rendered remotely through digital means and merits serious consideration, particularly keeping in view the resource and capacity level of the developing countries in 130 plus members of the Inclusive Framework.
5. G-24 does not support the linkage of the solution to the dispute resolution measures as proposed in the Public Consultation. Recognising the need for certainty in tax matters and the fact that new rules are being designed, G-24 proposes that the focus should be on dispute prevention rather than on dispute resolution. This can be achieved through clear and simple rules and by adopting a formulaic approach.

[1] This note was prepared by the G-24 Working Group on Tax Policy and International Tax Cooperation, and is being submitted on behalf of the Intergovernmental Group of Twenty-Four on International Monetary Affairs and Development (G-24). Argentina, which is also a member of the G-24, does not subscribe to these comments. This note may therefore be taken as representing the views of member countries: Algeria, Brazil*, Colombia*, Congo (Democratic Republic of), Cote D'Ivoire*, Ecuador, Egypt*, Ethiopia, Gabon*, Ghana, Guatemala, Haiti*, India*, Iran, Kenya*, Lebanon, Mexico*, Morocco*, Nigeria*, Pakistan*, Peru*, Philippines, South Africa*, Sri Lanka*, Syria, Trinidad and Tobago* and Venezuela (www.g24.org). Please note that countries indicated with an asterisk (*) are also members of the BEPS Inclusive Framework.

Specific Comments on the Paper

Nexus

6. G-24 supports the view taken in the Public Consultation document that the simplest way of defining the scope for the application of the new nexus rule will be to define a revenue threshold that takes into account the size of the group and the market. However, the nexus threshold should be kept at a sufficiently low level so that the benefits for developing countries from the new rules are meaningful. Accordingly, we are of the view that the threshold should be fixed at a maximum of EUR 500 million at the group level. In all cases, and in line with the recommendation to avoid ring-fencing attempts discussed in the Action 1 report released in 2015, the scoping measures shall not exclude relevant business models that erode the taxable base of market countries by performing activities remotely through the use of new technologies.

7. As per the Public Consultation document the in-scope businesses shall be large consumer-facing businesses, which have been defined as businesses that generate revenue from supplying consumer products or providing digital services that have a consumer-facing element. This approach builds in a layer of complexity and moves away from simplicity. Such an approach might, for example, be said to exclude substantial revenues flowing from business-to-business transactions involving intermediate products, even though these products may have their own brand values that could constitute a large proportion of the value of the final product. We feel that definitional issues and the calculation of revenue from the portion attributable to the consumer-facing business will be a major source of disputes. A simpler solution will be to have all businesses in the scope of the new rule with specific carve outs for specific sectors such as the extractive and commodities industry.

8. It is the G-24's view that nexus gross sales thresholds at the local (jurisdiction) level should be set at the lowest possible level, as the agreed percentage of the deemed residual profit should be allocated to market countries in its entirety. If the thresholds are set on a medium or high level, most of that percentage will be allocated back to the jurisdiction where the multinational enterprise (MNE) has decided to locate its residual profits. This outcome goes against the recognized objective of redistributing taxing rights to market jurisdictions as per the Programme of Work. An alternative solution could be to attribute the entire agreed percentage of the deemed residual proportionally to those jurisdictions that meet the established threshold.

Profit Attribution

9. The profit allocation method envisages the division of consolidated profits of an MNE group into routine and residual. It seeks to allocate a part of the deemed residual

profit to jurisdictions based on sales in those jurisdictions, including to jurisdictions where the MNE may not have a physical presence but meets the new nexus criteria based on sales. The method proposes a series of formulaic apportionments to arrive at the portion of the residual profit to be allocated to market jurisdictions. Simultaneously, the method also envisages application of ALP for the determination of the routine profit to be taxed by various jurisdictions. This method is quite complicated and would pose serious difficulties for many developing countries to implement.

10. We strongly believe that fractional apportionment is a simpler method than the one that has been proposed in the Public Consultation document as it starts from the revenue within the jurisdiction and, therefore, does away with the complex task of consolidating the profit of an MNE and reconciling with multiple jurisdiction accounting standards and subsequent adjustments. It does not distinguish between routine and residual profit but still respects the transfer pricing principles, which can co-exist and apply with fractional apportionment method. G-24 countries do not generally share the view that only non-routine, above-normal results should be attributed to market jurisdictions. This distinction complicates the allocation of profits, and increases disputes and the complexity of dispute resolution in the local courts. We believe the solution should involve a political compromise on the total profits, preferably through a simplified bottom-up approach as described below.

11. The profit to be allocated to the market jurisdiction can simply be calculated by multiplying the jurisdiction revenue by the appropriate indicator for operating profit. Once the profit is determined, a part of the profit will be allocated to the market jurisdiction on the basis of a formula (which can be finalised by consensus) consisting of participation in global sales, assets, payroll factors and users (in case of a remote presence only sales and users will be factors).

12. Fractional apportionment does away with the complex steps proposed in the calculation of Amount "A" of determining the routine profit percentage (reaching a consensus on a single percentage or variable percentage industrywise can be a challenging task) and splitting the above-normal profit or residual profit into trade intangible and market intangible (reaching an agreement on the split ratio can again be a challenging task). The bottom-up approach of fractional apportionment is much simpler than the top-down approach advocated by the Secretariat paper. We strongly feel that fractional apportionment would lead to fewer disputes compared to any type of profit split even if based on a formula.

13. More important, the approach allocates a portion of "above-normal profit" to market jurisdictions irrespective of physical presence of the enterprise. However, no part of

the "normal profit" is allocated to a jurisdiction even if an enterprise has significant economic presence, but does not have a physical presence. We seek to point out that the objective of the present exercise is to address the direct tax challenge posed by digitalisation. This challenge is not limited to the 'residual profits' over which taxing rights are often claimed by the resident jurisdiction under the functional, asset and risk (FAR)-based approach of profit attribution. The challenge of digitalisation relates also to the usual or regular profits of the enterprise. In any case, as per preliminary indications, the net flow of additional revenue to developing countries under Amount "A" appears to be minimal. In such a situation the outcome may not be satisfactory for all members of the Inclusive Framework, particularly for the developing countries.

14. Further, the paper ignores the fact that taxpayers can simply sidestep the new nexus rule by using remote presence for the supply of goods and services and conduct the marketing and distribution functions from low-tax jurisdictions. With the advance in technology, the need of physical presence is no longer necessary to carry out marketing and distribution activities. As goods and services are becoming dematerialised, the need for having a physical presence is diminishing. For example, for sale of music and movies physical stores are no longer required and can be transmitted remotely on pay-per-listen or -view basis or on subscription basis. Similarly, in the future, goods may be transmitted virtually through 3D printers. Therefore, the G-24 strongly urges that an amount based on a formula be allocated to a remote taxable presence for remote marketing and distribution activities which should be analogous to the Amount B where there is a limited risk distributor (LRD) as proposed in the paper.

15. G-24 would like to point out that the issue of profit allocation in case of multisided models where user contribution is an important element has not been addressed in the paper. The digital economy is enabling a new model of value co-creation involving the customers/users as unconscious pivotal contributors and value creators. Any profit allocation method seeking to address the challenges of digitalisation must take note of and address this issue.

On Amount B

16. The Amount "B" proposes a fixed return for marketing and distribution functions. We note that Amount B shall apply only if the enterprise has a physical presence in a jurisdiction performing such marketing and distribution functions. The margin needs to be carefully fixed along with delineation of relevant activities/functions. To take care of the possibility of marketing and distribution functions being conducted remotely to get around Amount "B", we suggest that market jurisdictions should be given the right to tax an amount equivalent to Amount "B" for such remote marketing and distribution activities.

17. In any case, establishing a safe-harbour for Amount B requires a corresponding remuneration for the legal certainty given to taxpayers that they will not be audited if complying with the safe-harbour. Past experiences show that safe-harbours are set at a slightly higher than market range in order to compensate for the inability to audit transactions falling under the safe-harbour.

On Amount C

18. We are of the view that the Amount "C" can only be an extension of "B" that allows additional profit attribution to an entity if it performs additional functions/activities beyond what has been delineated for the purpose of Amount "B" or for assuming more risks. "C" in any case, cannot and should not cover other routine functions like manufacturing, R&D or services, which should continue to be governed by existing profit allocation rules and provisions of double tax avoidance conventions of the respective countries. Care should be taken to ensure that Amount "C", by its very design, should have limited, if not zero, interface with A. Otherwise, we will be opening floodgates for disputes.

Dispute Resolution

19. We feel that the focus should be on dispute prevention rather than on dispute resolution. This can be achieved by making the new rule simple and formula based. G-24 considers that sufficient work has already been undertaken on dispute resolution under Action 14 of the BEPS Project and we should allow some time for these measures to stabilise before we discuss new measures. In any case, a majority of G-24 countries do not support mandatory binding arbitration for the resolution of tax disputes.

Concluding Comments

20. The G-24 hopes the process of designing new nexus and profit allocation rules remains truly inclusive in nature. It is necessary that the view and concern of all, particularly of the smallest developing countries, should be taken care of so that every member of the 130 plus Inclusive Framework feels that it is actually, and not notionally, participating in the decision-making process on equal footing.