ICRICT

Independent Commission for the Reform of International Corporate Taxation

11 November 2019

ICRICT response to the OECD Consultation on the Secretariat Proposal for a "Unified Approach" under Pillar One

Att. OECD Tax Policy and Statistics Division, Centre for Tax Policy and Administration.

General comments

ICRICT welcomes the opportunity to respond to the OECD's request for input on the Secretariat Proposal for a "Unified Approach" under Pillar One[1].

As an independent Commission, since the beginning of the BEPS process we have urged governments to move away from the existing transfer pricing system towards a unitary approach to taxation of multinationals (MNEs), based on a system of **multi-factor global formulary apportionment, together with a global minimum tax**.

Different allocation formulae (i.e. choice of factors and weighting) could be developed for broad sectors of the economy (e.g. manufacturing, services, extractive industries) to recognise the principle that different supply and demand factors interact in creating MNEs' global profits (e.g. sales, employees, capital, natural resources). Distinctions and carve-outs should be kept to a minimum to reduce complexities and opportunities for tax avoidance.

We welcome the acceptance by the Secretariat of the principle that MNEs are global unitary businesses, and that the allocation of profits should begin from the MNEs' global consolidated accounts, hence adopting a unitary approach. We also welcome the move towards formulaic approaches to allocate MNEs' profits between countries and the acknowledgment that "*the current rules dating back to the 1920s are no longer sufficient to ensure a fair allocation of taxing rights in an increasingly globalised world*[2]" and of the need to move "*beyond the arm's length principle*[3]*"*. This is real progress.

We await with interest the outcome of the ongoing negotiations and will continue to engage with the OECD Secretariat and the Inclusive Framework, but as a Commission we do not regard the likely outcome in 2020 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.

[1] https://www.oecd.org/tax/beps/public-consultation-document-secretariat-proposal-unified-approach-pillar-one.pdf

[2] http://www.oecd.org/tax/beps/public-consultation-document-secretariat-proposal-unified-approach-pillar-one.pdf Page 6, paragraph 16

[3] http://www.oecd.org/tax/beps/public-consultation-document-secretariat-proposal-unified-approach-pillar-one.pdf Page 4, paragraph 10

With this in mind, we appreciate the Secretariat's effort to break the impasse in the negotiation by putting on the table a new proposal, but this has also, de facto, removed from the negotiation, the opportunity to further evaluate the feasibility and revenue impact of the three different proposals put forward by the UK, the United States and the Intergovernmental Group of Twenty-Four (G-24)[4].

Regrettably, the Unified Approach proposal in its current form is unlikely to deliver an outcome that is a substantial improvement over the existing framework and its expected modest revenue impact is unlikely to justify the ongoing political investment in the process.

Whilst the stated aim of the proposal is to "*deliver a solution that is as simple as possible*", the proposal introduces even greater complexity, leaving the current dysfunctional transfer pricing system (designed in the 1920s) largely in place, while adding a three-stage bolt-on solution just for a small percentage of global profits. Such additional complexity and uncertainty serve only to continue to undermine the credibility of international tax rules.

The current proposal should be amended to reflect sound principles and to encompass the whole economy so to generate significant additional tax revenues to be shared equitably between countries. Addressing these areas of concern will truly simplify the rules and increase the tax certainty in the system.

Principles

We welcome the proposal to start from the consolidated income of MNEs, and to develop agreed methods for defining global profits for tax purposes.

However, the approach of separating "residual" from "routine" profits to determine Amount A is flawed on three grounds:

1) It is not possible to distinguish conceptually, as the OECD proposes, between the 'routine' (i.e. locally generated) and 'residual' (i.e. internationally generated) profits of a MNE, as *all* profits are essentially the result of the global activities of the firm. Moreover, the OECD has not presented either a robust methodology for separating the two, let alone theoretical foundations on which such a distinction might rest, nor the data with which this might be rigorously done.
2) Existing transfer pricing rules are not fit to determine "routine profits" in the way that the OECD proposes, as demonstrated by the large number of associated tax disputes under the existing BEPS system.
3) In a well-designed corporate tax system the cost of capital is fully costed (with often more than economically justifiable deductions for depreciation and interest), so that there is no disincentive to enterprise investment and sustainable growth. Thus, for practical purposes, only excess "pure" profits (i.e. economic rents) are taxed, and those economic rents are associated with the global activities of the MNE.

As such, *all* profits of MNEs should be apportioned through a formula. This will truly simplify the system and obviate the need for additional profit sharing rules (i.e. Amount B and C).

[4] https://www.oecd.org/tax/beps/public-consultation-document-addressing-the-tax-challenges-of-the-digitalisation-of-the-economy.pdf Page 7, paragraph 9

Furthermore, under the current Secretariat's proposal, part of the identified "residual" profit will be reallocated in proportion to where the MNE has final sales. Choosing to allocate taxing rights by reference to sales alone will create winners and losers both between developed and developing countries, and disadvantage countries with relatively small domestic markets, or those with substantial exports, particularly of natural resources and tourism. As rich countries consume more, allocation of profits by sales only is likely to result in an unequitable distribution between countries, in favour of developed countries.

The choice of allocation factor is critical, as research by the International Monetary Fund shows that the tax base is significantly affected by the choice of the weighting of factors in the formula and that "*developing countries gain mostly if employment receives a large weight in the formula*"[5].

Excluding employment from the allocation formula inexplicably removes a major factor of production and inevitably skews the outcomes away from developing countries towards developed countries.

We support the allocation of MNEs' income that would take place under the proposal which was put forward by the Intergovernmental Group of Twenty-Four (G-24) of developing countries for fractional apportionment, as this would allocate *all* profits through the use of a **balanced** formula (including employment in particular, as well as digital users and the use of natural resources), which would reflect value generating economic activities along the supply chain of MNEs.

We urge the Secretariat and the Inclusive Framework to bring back to the negotiating table the proposal by G-24, which should form the basis to design a truly comprehensive solution.

Scope

What could be a comprehensive reform with new rules applicable to all businesses, is now reduced to new complex rules for only "*large consumer-facing businesses*", and likely to be further watered down by carve-outs for specific industries/business models. Such a proposal is likely to exempt a large proportion of MNEs and incentivise third parties sales to consumers.

We see no economic rationale to create special rules for yet to be defined "*large consumer-facing businesses*". The failure to come up with a comprehensive solution to the taxation of all MNEs is a serious limitation of the proposal, for which it is hard to see any rational justification. Moreover, no rational justification has been provided for special rules for this (still to be defined) group of enterprises.

In our view, the outcome of this negotiation should result in a new set of rules that is applicable to most if not all MNEs. Any revenue threshold, including country specific sales thresholds, should be set at a relatively low level, to ensure that all countries are able to collect their fair share of MNEs' profits.

[5] https://www.imf.org/en/Publications/WP/Issues/2019/10/11/An-Assessment-of-Global-Formula-Apportionment-48718 Page 27-28

Equity

The allocation of MNEs' profits between jurisdictions for taxation purposes is a fundamentally distributive task; revisions to the rules will result in redistribution of taxing rights, and this should take into account the impact on both developed and developing countries, their relative contribution to the global economy and their fiscal needs.

The distributive implications of this proposal are unclear, as the OECD has not published any economic impact analysis in order to support their proposal. This is especially of concern in the absence of any agreed upon principles with any ethical or economic basis for allocating profits.

Making matters worse, the OECD has not provided any detailed forecasts of the impact of its proposals on overall tax revenue, saying only that it would "*lead to a modest increase in tax revenue*"[1]. This is of especial concern because one of the motivations for the reform of the MNEs' tax system was a concern that MNEs had used the ability of current arrangements (including the transfer pricing system) to avoid paying taxes. Thus, a test of the efficacy of any reform should be a substantial increase in tax revenues to be shared equitably between countries and to ensure that those revenues are taxed commensurate with prevailing legislated rate (i.e. 20 to 30%), as corporate tax is levied for the most part only on excess profits (i.e. in excess of the normal returns to capital).

Countries are asked to sign up to a "consensus proposal" without the economic impact being made publicly available for scrutiny. Publishing this information is essential for countries and their citizens to understand the impacts of the proposal, including who are the winners and losers.

If the redistribution of taxing rights is to be seen to be fair and thus generate broad international support, the apportionment system, and the choice of apportionment factors, must at the very least reflect the contribution of each participant jurisdiction to the world economy, and hopefully contribute to the financing of the Sustainable Development Goals in poorer countries.

We urge the OECD secretariat to publish the economic impact analysis of this proposal before the Inclusive Framework meeting in January 2020, along with the full data from MNEs' country-by-country reporting. Without this, the 134 members cannot fully evaluate whether it is in their interests to sign up to this reform.

Dispute settlement

The current OECD proposal is also aimed at increasing "tax certainty", through binding and effective dispute prevention and resolution mechanisms. We acknowledge that a number of developed countries are also calling for tax certainty (i.e. mandatory arbitration or other dispute resolution mechanisms) to be a condition for a redistribution of taxing rights towards developing countries. We believe that developing countries should not accept stricter and opaque dispute resolution mechanisms (and in particular mandatory arbitration) as a condition for consensus to be found.

The real need is for rules which are fairer, clearer and easier to administer and the design stage of the proposed solution should therefore focus on dispute prevention. We are concerned that the complexity built in the Unified Approach will lead to an increase in disputes. Moreover,

in other arenas, such as the resolution of disputes under investment agreements, the deficiencies of arbitration are well documented and there is, therefore, a growing consensus in both developed and developing countries against arbitration, and towards the creation of public judicial systems.

Concluding remarks

The fast pace of the reform process and the OECD pressure to reach a consensus in the coming months means that the risk of unsatisfactory solutions is high. As corporate tax avoidance by MNEs continues unmitigated under the current system, the failure to deliver comprehensive and fair solutions will increase the fiscal incentive to introduce unilateral measures, alongside deepening public anger at tax avoidance. Any reform that does not significantly increase global tax revenues from MNEs does not adequately address these concerns about tax avoidance.

We therefore urge the OECD Secretariat to redouble its efforts and work with the Inclusive Framework representatives to come up with the comprehensive solution that is urgently needed, and meanwhile to publish country by country data on the actual and proposed distribution of the taxable profits of MNEs between jurisdictions so that the debate can be both transparent and objective.