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with LOMBARDI

OECD – Tax Policy and Statistics Division, Centre for Tax Policy and Administration

To

BonelliErede

From

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Comments on the OECD Public Consultation Document – Secretariat Proposal for a "Unified Approach" under Pillar One

Reference

12 November 2019

Date

First and foremost, we would like to thank you for the work done in drafting the Secretariat Proposal for a "Unified Approach" ("**UA**") under Pillar One ("**Report**"). We are pleased to provide a preliminary set of comments and observations to contribute to the implementation of the work done so far by the Programme of Work ("**POW**") and the Task Force on the Digital Economy ("**TFDE**"), which is committed to providing a consensus on a UA to Pillar One in 2020[1].

The below table of contents is designed to facilitate the reading of our comments.

[1] The comments on the Report represent BonelliErede's view on the topic. We would appreciate it if our comments could be cited as follows: BONELLIEREDE, *Comments to the OECD Public Consultation Document – Secretariat Proposal for a "Unified Approach" under Pillar One*, November 2019, Milan.

Contents

Introduction

It is our understanding that the UA is based on the commonalities between the three proposals contained in the Report regarding the Public Consultation Document Addressing the Tax Challenges of the Digitalisation of the Economy 13 February–1 March 2019 ("**March Report**") and tries to reach a viable solution that avoids complexities. Although we appreciate that one of the Report's main aims is "simplicity, stabilisation of the tax system, and increased tax certainty in implementation"[2], we think that any serious deviation from consolidated international tax principles (related to both nexus and income allocation) warrants careful consideration of all possible drawbacks involved in its concrete implementation before proceeding.

Indeed, the introduction of new international standards (completely unrelated to the permanent establishment concept or to the arm's length principle) will inevitably increase complexity not only in the transitory period but also as follows: (a) MNEs will be placed in the condition to review the transfer pricing policy that has already been amended to reflect the BEPS recommendations, and (b) MNEs will be required to bear extra compliance burdens due to the implementation of the UA.

Furthermore, the introduction of a holistic and simplified approach should in any case take into consideration the ever-greater complexity of business models. Indeed, businesses are increasingly operating under matrix organisational structures in which the geographical and product scope are interlinked and the global functions of the headquarters perform relevant activities (and, thus, bear the related costs).

The proposed UA – for the reasons better explained in the sections below – may therefore: (a) lead to disputes with and among tax authorities, (b) increase the tax burden for taxpayers, and (c) increase the commitment of tax authorities.

In light of this, we would first like to reaffirm that, despite the changes reflected in the Report, we are still of the opinion that any amendment to the current international tax standards should:

(a) cover both physical and non-physical presence;

(b) confirm the arm's length principle ("**ALP**") as the cornerstone for allocating income among jurisdictions (especially in complex transactions such as those concerning the exploitation of intangibles); and

[2] See para. 10 of the Report.

(c) identify a solution that avoids any potential drawback in terms of double taxation.

I. Scope

As pointed out in our comments on the March Report, we still strongly agree with the following statement from the OECD:

> Because the digital economy is increasingly becoming the economy itself, it would be difficult, if not impossible, to ring-fence the digital economy from the rest of the economy for tax purposes[3].

We therefore reiterate our statement that any proposal to amend the current international tax principles should apply broadly to all businesses and not be limited to the digital economy – also to avoid inequalities among different businesses.

The broad definition adopted by the UA goes in this direction, as it will result in all businesses dealing with consumers being included in this new rule. Nevertheless, the broad expression "consumer-facing businesses" might trigger applicability issues when it comes to concretely identifying the categories of businesses covered by the UA.

For instance, in our view, distinction should be made between B2C and B2B businesses. Indeed, generally no interaction with consumers occurs in B2B businesses, as the products are supplied from one enterprise to another. Consequently, in principle, these businesses should not follow the UA. Further guidelines should be provided to understand the extent to which B2B businesses might fall under the UA.

As to B2C businesses, some groups may operate through different channels (i.e., wholesale and retail channels), and it should be verified whether the UA should also take this distinction into account. This is all the more true when it comes to sales to intermediaries (because in those cases it might be difficult to understand which entity creates the value in a specific market).

[3] See OECD (2014), *Addressing the Tax Challenges of the Digital Economy*, OECD/G20 Base Erosion and Profit Shifting Project, OECD Publishing; OECD, BEPS Action 1 Final Report Addressing the Tax Challenges of the Digital Economy, 2015.

Furthermore, cases could occur in which taxpayers operate both "traditional" and digital businesses that are not necessarily always related only to consumers[4] but also to customers[5]. In this case, in light of the mechanics of the UA proposed by the Report, taxpayers could be obliged to prepare ad hoc segmented accounts, which could lead to significant complexities and burdensome activities. This would not create any simplification as envisaged by para. 53 of the Report (i.e., use of consolidated financial statements). Indeed, as described in Section III, the majority of consolidated financial statements do not provide the level of detail needed for the application of the UA.

Finally, in relation to the possible threshold set by the Report, we believe that, in general terms, introducing a threshold to identify cases falling within the UA could lead to significant practical issues to the detriment of the sought-after simplification. Specifically, one example of the practical issues that could arise is that taxpayers might fall within the threshold only in certain years depending on their economic results, with all the related complications (e.g., keeping specific segmented accounts or not). This outcome is contrary to the need to apply the same approach to all businesses in order to avoid inequalities.

II. New nexus

We agree with the principle expressed in the Report that situations in which a physical presence does not exist must be analysed and covered for tax purposes through the development of a "new nexus". In this respect, the Report introduces a new nexus based on sales.

In our opinion, sales are not a proxy of a sustained and significant involvement in the economy of a specific market but could instead be a useful indicator for allocating taxable income to a relevant market (i.e., only subsequent to identification of the nexus).

In those circumstances, we believe that the identification of a new nexus should be based on functions/costs rather than local sales, in particular by emphasising the marketing efforts within a specific market (i.e., "functional nexus" based on marketing expenses).

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[4] As defined by the Report: "individuals who acquire or use goods or services for personal purposes (i.e. outside the scope of a professional or business activity)".

[5] As defined by the Report: "all recipients of a good or service (including business customers that are not end-users)".

Indeed, a local marketing effort (activities or expenses) may occur also if no physical presence exists (e.g., an MNE providing streaming service, in order to sell its services on a specific market, needs to carry out local marketing through advertising, regardless of whether it has a physical presence). Prescriptive rules/lists on expenses covered in the definition of marketing expenses should therefore be set out.

Moreover, a nexus based on sales takes no account of the issues involved in business start-up phases or of the effects of economic cycles. Therefore, in case the sales approach on the new nexus should in any case be envisaged, it would be advisable to apply at least a multi-year approach so that not only the sales made in a given year but also the sales made over a reasonable timeframe are taken into account (three–five years, depending on the business sector).

This approach may be applied also to account for the difficulties that an MNE may experience in smaller jurisdictions (in this respect, adjustments to sales should be carried out, such as considering the sales in relation to GDP per capita). A further factor to take into account is that it is not a given that sales directly relate to high margins in a specific country – and even when they do, the margins may be linked to some specific market conditions (e.g., a difference in wealth in the domestic market or an appreciation for the products in question that is due to the products being marketed by a well-known global brand).

III. Calculation of group profits for Amount A

According to the Report, the new profit allocation rules:

> taken together with existing transfer pricing rules, will need to deliver the agreed quantum of profit to market jurisdictions and do so in a way that is simple, avoids double taxation, and significantly improves tax certainty relative to the current position[6].

To ensure reconciliation between the two sets of international standards for profit allocation, the Report proposes a "three-tier mechanism" for which the starting point is assessing a portion of deemed residual profit attributable to the market jurisdiction (aka: Amount A).

[6] See para. 29 of the Report.

A preliminary remark in this respect concerns the envisaged interaction between a residual profit split method ("**RPS**") and a fractional apportionment method[7], given the current strict requirements under Chapter 2 of the OECD guidelines to proceed with selecting an RPS (the role of which appears to have become increasingly limited in both theory and practice).

Moreover, the measure of profits approach appears to be based on an oversimplification, to the extent that the Report recommends relying on consolidated financial statements[8].

Indeed, in our experience, although the information provided to create consolidated financial statements (aka: managerial accounting) can be the starting point for applying a two-/multi-sided approach (like the UA), the following concerns outlined by the OECD in the 2008 Discussion Draft on Transactional Profit Methods ("**2008 Draft**") are valid also for the UA:

> 176. There is wide recognition, among countries and business commentators who responded to the questionnaire on profit methods, of the significance of the issues posed by the lack of harmonised accounting standards when determining the combined profit to be split in a transactional profit split method. In order to determine the combined profit, the accounts of the parties need to be put on a common basis as to accounting practice and currency, and then combined. **Several commentators note that the determination of the combined profit is one of the most important and difficult issues when applying a profit split method**.
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> 182. The use of cost accounting should be permitted where such accounts exist, are reliable, auditable, and sufficiently transactional. In this context, product-line income statements or divisional accounts may prove to be the most useful accounting records. **Experience shows however that the use of multiple allocation keys to arrive at the expenses and/or income attributed to the product-line or division may lessen the reliability of the data for these purposes.** Care should be exercised in evaluating whether this cost accounting data is sufficiently reliable to be of use in the application of the arm's length principle. See also Section B of the Issues note "Access to the information needed to apply or review the application of a transactional profit method". [emphasis added]

In this respect, the following should be carefully considered:

(a) MNEs' businesses are not limited to one business unit, nor do they operate in only one specific geographic market. Indeed, those business tend to be very structured and diversified to properly manage entrepreneurial risks throughout the different product lines/regions where MNEs operate. Looking at the main US listed companies, the publicly available data filed with the SEC envisages: (a) the presence of several heterogeneous businesses (e.g., the same group may sell

[7] See para. 52 of the Report.

[8] See para. 53 of the Report.

physical goods, online services, software and videogames); and (b) a split of revenues only by product, without any split of profits by product or market.

(b) MNEs' consolidated financial statements do not provide the level of detail needed to apply the UA. Indeed, the segmentation is generally by either product or area/region. The possibility of obtaining a segmentation (at the level of profit) by both product and market is remote.

(c) Any combined base for applying the UA must – in light of the above – be determined with further elaboration of the consolidated financial statements. This will increase the subjectivity of the profit base and lessen the reliability of the data for the purpose of the UA.

(d) Accounting management is often centralised. This means that at local level (in cases in which a physical presence exists) the only available information is that provided in the statutory accounts. However, that information is not useful for the UA when a consolidation is needed of revenues from and costs of markets/products/users at local level, and these details are provided only by managerial accounting data (and thus not auditable at local level). Therefore, to apply the UA in a reliable manner, either the headquarter tax authorities will take the lead/burden to assess the reliability of accounting data or the MNE will be obliged to incur further compliance costs (and prepare, for instance, to enter into in an agreed-on procedure on the accounting base for applying the UA).

(e) The outlined complexity would further increase if the MNE has no local physical presence, but the "new nexus" is met. In that case, the local tax authority would not have the statutory accounts and would therefore have to rely solely on the information provided by the headquarter tax authority or MNE (with very limited possibility to verify and audit the information).

Therefore, we strongly believe that the above will constitute the main obstacle to the application of the UA (regardless of any concern regarding its appropriateness). Indeed, we see no way of easily finding the data necessary to apply a two-/multi-sided approach. At the same time, given the possibility to easily obtain and check data regarding revenues per market, we reiterate our position on the fact that revenues should constitute the basis for remuneration (instead of the basis for allocation within the two-/multi-sided approach) and that markets should therefore be remunerated based on a return on sales ("**ROS**").

IV. Determination of Amount A

We are of the opinion that the remuneration granted to the market should not consist in the deemed residual profit (aka: Amount A) identified by the proposed UA for the following reasons:

- Residual profit should generally be attributed only to high value-added contributions identified based on an appropriate value chain analysis. In this regard, the value embedded in a market is a bundle of economic and regulatory features that affect all the players acting locally (both independent parties and associated enterprises). Consequently, the sole factor that should be properly taken into account to determine the fair part of profits attributable to a specific market are the profits deriving from locations savings. This because it could be argued that these profits should stay where they are generated (e.g., if the products are sold at higher prices due to customers being particularly wealthy). This is the issue concerning the entitlement to the attribution of the market premium, which differs from the assumption that the market should, in any case, share part of the residual profit (or loss) generated by the overall business.

- The attribution of profits to the market must, in any case, account for further factors such as: (i) the development stage of the MNE business in that specific market (i.e., start-up phase, which differs from business to business); (ii) the time for returning the investments made to achieve the amount of sales in that market; and (iii) the presence of specific regulations that could trigger entry barriers and, consequently, distort competition.

Based on the above, we suggest the following two steps to reach an outcome aligned with value creation:

(a) First step: This is performed once the new nexus is met, to attribute a standard routine remuneration to the market regardless of whether a physical presence exists. This remuneration should be based on a return on the local sales (ROS) determined either by conducting a benchmarking analysis based on local comparables involved in distribution activities[9] and that have a limited risk profile or by applying a pre-defined return (i.e., safe harbour). The first solution is preferable as it is consistent with the ALP and should be applied by selecting the lower point in the interquartile range. Conversely, determining a safe harbour would reduce

[9] Different sets could be envisaged depending on the kind of distributor (e.g., retailer or wholesaler) and the kind of industry involved.

complexities and lessen the tax burden for both taxpayers and tax administrations to the extent that the OECD selects it as a simplified approach (likewise what is envisaged for intercompany services under Chapter VII of the OECD Guidelines). Assuming the market has specific local features that could justify an extra profit attributable to it, specific market comparability adjustments should be introduced to account for these elements.

(b) Second step: This step should be performed if the MNE has a physical presence. It is aimed at remunerating all functions performed locally in accordance with the ALP. If also distribution functions are performed, the return under point (a) should not be granted as it is already included under the arm's length return envisaged in this step (otherwise, a risk of double counting arises). Additionally, if non-routine activities are performed, the principles of para. 6.78 of the TPG[10] should be applied to reach an outcome aligned with value creation.

If only step (a) is performed (i.e., the MNE has no physical presence), the application of a sanity check (if the MNE so decides) could be considered to properly take into account the MNE's consolidated profits/losses. The check would be based on the profit split to ensure that the method proposed does not lead to an improbable profit attribution (see paras. 2.12 and 2.122 of the TPG[11]).

Clearly, to set the remuneration under point (a), amendments to Arts. 5, 7 and 9 of the OECD M.C.[12] will be needed.

Finally, the approach envisaged in the Report on Amount A would create complexity.

Indeed, considering that the residual profit would arise from several heterogenous contributions (e.g., R&D functions, managerial functions and, based on the UA, markets), it is very difficult to identify an appropriate allocation (or set of allocation) key(s) to split the residual profits.

For example:

(a) by considering costs, any non-physical presence will not be entitled to remuneration;

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[10] OECD (2017), *OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations 2017*, OECD Publishing, Paris ("**TPG**").

[11] As amended by the OECD (2018), *Revised Guidance on the Application of the Transactional Profit Split Method*, OECD Publishing, Paris.

[12] OECD (2017), *Model Tax Convention on Income and on Capital: Condensed Version 2017*, OECD Publishing ("**OECD M.C.**").

(b) by considering revenues, the R&D function will not be entitled to remuneration;

(c) by considering headcounts or salaries, any non-physical presence will not be entitled to any remuneration.

A final remark should be made on the system envisaged for implementing the UA. According to the Report, OECD members should enter into simplifying conventions[13]. We assume that these conventions would be implemented based on the experience gained in relation to the multilateral instrument. Further details should be provided in relation to the possible interaction between the simplifying conventions and existing MLIs (also considering that the scope of the simplifying conventions will be limited to the new nexus and profit allocation rules).

V. Prevention of double taxation in relation to Amount A

We understand that one of the concerns of the POW and TFDE is to ensure that the calculation of Amount A does not trigger double taxation.

As mentioned in Section IV, we believe that any new framework (or amendment to the existing framework) should be regulated through amendments to Arts. 5, 7 and 9 of the OECD M.C.

This should lead to Amount A being addressed as either: (a) an attribution of profits to a permanent establishment; or (b) an intragroup transaction between the local entity (physical presence) and the regional hub or the global headquarter. This would lead to the income under Amount A being classified as business income for treaty purposes.

In this regard, we would first like to point out that as Amount A (or any other form of remuneration to be given to the market once the nexus is met) is classified by the OECD M.C. as business income, any solution regarding the determination of Amount A to avoid double taxation should not depart from the consolidated international principles set out in Arts. 7 and 9 of the OECD M.C.

Additionally, the impact of amendments to other existing dispute resolution tools (e.g., Council Directive (EU) 2017/1852 of 10 October 2017 on tax dispute resolution mechanisms in the EU) to ensure double taxation is prevented in all cases should also be carefully addressed.

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[13] See paras. 35, 53 and 56 of the Report.

Moreover, to avoid double taxation, we consider the existing double tax relief mechanisms envisaged by Art. 23 of the OECD M.C. to be appropriate and, therefore, any new provisions should not depart from the current set of rules.

Finally, we would like to reiterate our position regarding the possible application of withholding tax. Indeed, in our opinion, withholding tax (also if covered by Art. 2 of the OECD M.C.) could trigger double taxation, particularly because where levied on gross revenues: (a) it would not take into account the material expenses borne (particularly for R&D); and (b) foreign tax credit is generally granted by the resident country within the limits of the resident taxation on net profit (known as limited foreign tax credit). The combination of points (a) and (b) could lead to an excess of foreign tax credit that will never be recovered.

VI. Amount B

We understand the underlying logic under Amount B and the potential benefits embedded in pre-determined fixed remuneration for marketing and distribution activities. Specifically, the approach proposed under Amount B would grant certainty by defining intercompany prices, reducing compliance costs and preventing tax disputes.

However, we believe that the suggested approach should be carefully evaluated as it would be extremely complex to: (a) identify all possible situations in which fixed remuneration should be applied; (b) set the fixed return percentage; and (c) provide guidance that can be accepted by taxpayers and tax administrations in jurisdictions worldwide.

It is our understanding that the mechanism to calculate Amount B would work similarly to the simplified approach adopted for the low value-adding services. However, in the case under examination, the marketing and distribution functions performed by a related entity are core activities and not "ancillary" as for low value-adding services.

Specifically, our concern is that the provision of fixed remuneration would lead to the definition of the profitability for the distributors in the absence of an adequate comparability analysis. It would therefore not be possible to attribute different remuneration depending on the functional profiles of the entity involved in the marketing and distribution activity. This aspect will be particularly significant in cases in which controlled entities are involved in non-routine distribution activities, as fixed remuneration may not be appropriate for the functions they perform. Indeed, although the three-step approach of the Report suggests Amount C to cover non-routine functions, we believe that (as addressed

in Section VII) this split of the remuneration of the local distribution presence could jeopardise the purpose of finding a simplified approach and, thus, could trigger several disputes/different interpretations among the relevant stakeholders.

In light of the above, evaluating the application of the simplified approach would be possible only in cases involving low-risk distributors.

Furthermore, we do not agree that the simplified approach for identifying Amount B should be based on a fixed return.

One option for low-risk distributors could be to apply the simplified approach based on a range of results, stipulating that if the low-risk distributor's margin is within the range, the remuneration should be considered appropriate.

However, identifying the range of results would be very complex. Given that the aim would be to identify the proper remuneration for core business activities (even if for a low-risk entity), the simplified approach would need to identify: (a) the correct range of results for the industry; and (b) the correct range of results for the jurisdiction or region. Furthermore, the different ranges of results would need to be regularly updated within a proper timeframe.

Finally, as the simplified approach is aimed at decreasing the number of tax disputes relating to distribution functions, the different ranges of results and the positioning in each point of the range should be accepted by all taxpayers and tax authorities in the different jurisdictions; otherwise, the proposed approach would automatically trigger double taxation.

VII. Amount C/Dispute prevention and resolution

We believe that Amount C should be eliminated as it re-opens wide margins of discretion and risks jeopardising the structure of the UA.

Furthermore, if Amount B is correctly determined, Amount C would overlap with it and could be adopted to attribute a higher (and inappropriate) remuneration to the distributor in a specific country (with a high risk of double taxation).

Given that tax authorities lack resources, the feasibility of them managing all the APAs and MAPs that would arise from the significant changes the UA would implement is, in our view, low.

Additionally, as the ICAP project is still in a pilot phase involving very few taxpayers and countries, the real risk is a misalignment between the implementation of the UA and the time when tax authorities will be able to examine dispute resolutions.

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Please do not hesitate to contact me or any of the individuals below if you require any clarification on these comments.

We look forward to discussing any questions you have on our comments or on other specific matters raised by other commentators on the Report.

Yours sincerely

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