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OECD Secretariat Proposal for a 'Unified Approach' under Pillar One

Response by the Chartered Institute of Taxation

Executive Summary

We welcome the public consultation on the *Secretariat Proposal for a 'Unified Approach' under Pillar One* published on 9 October 2019, which is progressing the conversation around the impact of digitalisation of the economy and is continuing the work towards a consensus-based, long term solution which address the tax challenges raised. The consultation document builds on the Pillar One proposals in accordance with the Programme of Work adopted by the Inclusive Framework on base erosion and profit shifting (BEPS) in May 2019.

There is still much outstanding regarding how the work under Pillar One might coalesce around a political and policy consensus which addresses the various challenges that concern policy makers, which are a result of the impact of the digitalisation of the economy and globalisation of businesses generally on tax bases. This makes commenting on the technical and/or practical implications of the Unified Approach at this stage very difficult. We have, however, drawn out some key points that arise from the consultation document.

Principles underlying the Unified Approach must be articulated.

The Unified Approach to Pillar One presented in the consultation document (the proposal) contains some profound ideas which challenge the existing principles that underpin the current international fiscal philosophy and which, if adopted, would result in considerable upheaval within the international tax system. However, as currently presented, the proposal does not set out a coherent vision of the principles underpinning the solution to address the challenges that have been identified[1]. Before substantive progress can be made, we suggest that there must be clarity and consensus at a political level as to the how the challenges should be addressed, rather than seeking to address the impact of several different challenges simultaneously that are not underpinned by a unifying principle (and may not be pulling in the same direction). The temptation to move to a formulary (or partially formulary) system is understandable given the different challenges being addressed at the same time, but without a single underlying principle, a partial move will be inherently unstable.

The practical challenges arising will require a bold solution.

Notwithstanding these broader concerns regarding what it seeks to achieve, we welcome the opportunity to comment on the actual proposal made by the secretariat, as there are a number of design choices available with different trade-offs. The challenges involved in working through the proposal, firstly in order to achieve political agreement as to what is within scope, and agreeing the scale or amount of profits reallocation and, then, translating

[1] The challenges identified in paragraphs 16 and 17 of the consultation document are, primarily, that the allocation of taxing rights can no longer be exclusively circumscribed by reference to physical presence and that the arm's length principle is becoming an increasing source of complexity (particularly around 'non-routine' profits from intangibles) and simplification would be welcome to contain administration and compliance costs.

the concepts into something that is practicable, should not be underestimated; although the proposal seems in some respects conceptually simple, it is legally and technically complex, and a significant departure from the current international tax framework. We cannot over-emphasise the very real technical and practical difficulties that will arise from implementing the proposal and these are discussed below.

It is our suggestion that, in order to address the practical challenges it may be necessary for the proposed solution to include administrative systems and multilateral cooperation that is even bolder than currently envisaged. A fresh approach is required to solve the issues that have been identified, and a radical change may be preferable than an attempt to shoe-horn a solution into existing concepts. We discuss below several ways to meet the policy objectives and recognise the trade-offs of each that will need to be considered.

Mandatory, multilateral, binding arbitration is paramount.

We welcome the focus on dispute prevention as, while dispute resolution is necessary, it is not the best solution for business because of the time it takes; businesses need certainty from the outset. To achieve this the rules and definitions should be agreed and set out in an OECD publication, with limited room for states to adopt different, and potentially inconsistent, interpretations.

It is inevitable that the fundamental changes proposed to the international tax system will give rise to disputes. It is our strong view that countries which sign up to the new taxing right in respect of Amount A must also sign up to a new mandatory, multilateral and binding arbitration process.

Resourcing these changes by the OECD and national tax authorities will be key.

It is also clear that the implementation of a proposal delivering these aims will require significant resource from the OECD and national tax authorities, as well, of course, from taxpayers. Countries should be encouraged to commit to providing the additional resource that will be required.

Part 1 of this response explores these key points in further detail, as well as raising the other complicating factors around Pillar Two and losses. In Part 2 we address the *Questions for public comments*.

Part 1 – Key Points

1. The basis, rationale and principles underlying the 'Unified Approach'

1.1 We remain strongly supportive of consensus-based, long term reform of the international tax system. We welcome the ongoing efforts to achieve a consensus on the way forward; reaching this is important because we are increasingly facing an international tax landscape of unilateral actions being taken independently by countries, which lead to less alignment of tax bases globally, resulting in double taxation and a significant compliance burden for businesses and, consequently, stifling economic growth and innovation. The discussions in this area began as a result of the tax challenges of the digitalisation of the economy being identified and addressed under Action 1 of the BEPS project. It is recognised that these challenges remain an important part of the international agenda. However, we suggest that these discussions have prompted a discussion around the allocation of the global tax base more generally as a result of the globalisation of the worldwide economy.

1.2 We appreciate that it has not been possible for the Secretariat to set out much detail around the framework of the proposal, as there is much still to be decided at a political level before there is an agreed way forward. However, in our view, the fundamental difficulty with the proposal set out in the consultation document is the lack of any coherent underlying theory or principle. There is an inherent difficulty in developing an approach that is not rooted in a core principle.

1.3 We recognise the difficulties faced in reaching an international consensus on the way to tackle the perceived challenges arising from the digitalisation of the economy and, more generally, globalisation of businesses. The Secretariat has drawn on the commonalities of the three proposals presented to the Task force on the Digital Economy (TFDE) and set out in the Policy Note in January 2019: 'user participation', 'marketing intangibles' and 'significant economic presence'. However, in doing so, and trying to satisfy supporters of all three approaches, the Unified Approach fails to adopt or articulate its own underlying principle or rationale, which makes the proposal inherently unstable.

1.4 The challenges identified as arising from the digitalisation of the economy in the work under BEPS Action 1 were around nexus, data and the value of data obtained from users. It is not clear what challenges, or what activities or businesses, the Unified Approach is now seeking to tackle. The starting point is an, as yet, undefined group of activities referred to as 'consumer-facing', but not all of these businesses are high margin business or would generate 'above normal' profits. Although we do not necessarily disagree with the using the concept of consumer-facing businesses as a starting point (if indeed the principle for why such activities cause policy concerns can be defined), it is not clear why a marketing business which operates business to business is fundamentally different from a marketing business which operates business to consumer; these fundamental differences will be critical to distinguish in drawing the scope. Further boundary-issue complications will arise if the scope is to also include supplies through intermediaries, of component products and franchise arrangements. The features, activities, interactions and value chains of such businesses that are causing policy concerns should be made clear if they are to be treated differently by the international tax system. This would helpfully contribute to the discussion around how the scope can be drawn appropriately.

1.5 The Unified Approach seems to have drawn on some (but not all) of the elements of the three approaches set out in the TFDE Policy Note, resulting in a net which will be cast around some businesses from each of the three approaches, but will not capture all of the businesses that would fall within any of them. This makes developing the rules around where the dividing line is intended to be drawn very difficult.

1.6 For example, it is our reading of the proposal that Amount A will be tested largely by reference to jurisdictions in which sales occur, irrespective of whether there is a traditional permanent establishment based presence in that jurisdiction, but will not be tested by reference to depth of user base in a jurisdiction. Some clarity on what is to be tested (and coherence between the nexus threshold and the profit allocation rules) is very important.

1.7 We suggest that in order to devise a proposal which can be translated into practice, it is necessary to first articulate the underlying principles and theories around the challenges that are being tackled and the reality of the businesses which are intended, therefore, to be caught.

1.8 In our view the starting point should be identifying the factors that connect a consumer-facing business with a market jurisdiction, such that a tax liability in that jurisdiction should arise; then consideration can be given to the profit to be allocated to those factors. In other words, a proper economic justification of the connecting factors is first required. The fact that the Secretariat starts with profit allocation, indicates a desire to deal with particular profit, but without providing the necessary reasoning for doing so. This likely to give rise to irrational allocations that are more likely to increase tensions between states than relieve them.

1.9 As such, we think it would be helpful to provide a coherent foundation for the proposal by articulating clearly the economic principles or rationale that underpin what it is trying to achieve. In our view this could be formulated as an intention to capture a proportion of the above normal profits that some multinational enterprises (MNEs) are able to generate not simply through their own efforts and intellectual property (IP), but also through market imperfections, the size of these above-normal profits also being partly driven by living standards and infrastructure in consumer markets, which public expenditure helps foster.

1.10 Paragraph 2 below sets out our understanding of how the process would broadly be applied in practice. This highlights some of the difficulties which will arise in a practical setting and helps to demonstrate where principles need to be developed further.

1.11 It is recognised a balance must be struck between accuracy/certainty and simplicity. We would venture to say that a long term solution to the challenges being addressed will never be simple and that it will be more important to ensure that the rules are clear and certain for taxpayers, even if achieving certainty increases the complexity of the rules. We have a preference for rules that are clear (even if the cost of that clarity is some complexity) over a simplified position which relies on interpretation and guidance. In any event, the rules must be backed up by effective dispute resolution mechanisms, which should be based upon mandatory multilateral arbitration in order to be effective.

1.12 The importance and potential impact of this work is recognised in the consultation document: paragraph 8 notes that '*the stakes are very high*'. We suggest that consideration should also be given to the amount of tax that may be raised by a particular jurisdiction and that a sense of perspective needs to be kept when considering whether and when to introduce changes to the system, given the relatively small amount of tax that may be at stake. It may be difficult for tax administrations and the OECD to defend introducing a significant amount of new complexity into the tax system if, in practice, the changes make little overall difference to how taxing rights are allocated; but we also recognise that devising changes which do cause a material shift in taxing rights will be harder to negotiate. It is stated in the consultation document (paragraph 35) that many aspects of the Unified Approach will be informed by an impact assessment of the Unified Approach. We agree that an impact assessment will be key to the decision making process of many jurisdictions and would be interested to hear more around the timetabling of an impact assessment. We believe this is a critical component of achieving a consensus outcome.

2. Process and practical application and administration

2.1 We appreciate that it is not possible for the Secretariat to set out much detail around the framework of the proposal, and how it will work in practice, whilst there is still so much to be decided at a political level, and the challenges of formulating detailed proposals, after political agreement is reached, should not be underestimated. In particular, in our view the proposal underestimates the difficulties of departing from the current entity-based approach, and moving to one which uses figures from the consolidated accounts and then allocates the resulting tax liability to one or more members of the group.

2.2 Notwithstanding the lack of detail, a consideration of the outline of the process, and how this might work in practice, is helpful to identify some of the key, overarching difficulties that the proposal presents.

2.3 While the intention on ordering is not clear, we believe that the challenges with starting with Amount A would be significant. As such, a more rational process of the proposal should be:

- Firstly, determine Amount B - a fixed return for 'base-line' or 'routine' activities; a proxy for the arm's length profit for certain activities that are deemed routine (presumably on the basis that they are low value and thus there is a low risk of base erosion from them).

- Secondly, determine Amount C - for all 'non-routine' activities (that is to say all activities not covered by Amount B), using the arm's length principle in full (as is the case now), and to strengthen certainty of this allocation through improved dispute resolution mechanisms.
- Thirdly, to overlay an agreed reallocation of profits based on accounting data, albeit the amount, how it should be allocated, and where it should be reallocated from are still under discussion.

In reality, these steps are going to be far from straightforward.

2.4 In the first instance the dividing line as between Amounts B and C is not clear. These Amounts are discussed further in Part 2 below in our responses to the *Questions for public comments*. However, at this stage we would comment that it is also not clear whether it is intended that (a) individual companies/permanent establishments within each jurisdiction will be awarded either Amount B (if they undertake only the agreed routine activities) or Amount C (in all other cases) or (b) companies will be awarded Amount B (for the agreed routine activities) and then also an Amount C for any other activities. If (a) is correct, it would mean in reality that there will be limited incentive for inbound tax administrations to accept that any business should qualify for Amount B. If (b) is correct there will be a significant implication for the calculation of Amount C and this will not be a simplification of the current system. The transfer pricing analysis that would have to be undertaken will be made more difficult by the requirement to split out the 'base-line' or 'routine' functions into Amount B and then put a price (based on the arm's length principle) on the artificially segregated, non-routine functions which are to fall within Amount C. In either case there will be difficult discussions around what activities should be within scope of Amount B and the fixed return that should be delivered.

2.5 That said, although it appears that the ultimate definitions of Amounts B and C may result in some modification to the terminology and concepts recognised under the current transfer pricing system, we do not envisage that they will be materially different; rather, as we understand it, the objective is to provide greater certainty and reduce (i) long running controversies and (ii) double taxation that currently arise under the application of the arm's length principle, in part by strengthened dispute resolution mechanisms. We can see the benefit in principle from using simplification conventions for determining arm's length profit for routine functions, but, as we discuss in Part 2 below, the simplification may prove to be far from straightforward if different conventions are required for different business arrangements and because they may need to adapt over time.

2.6 Following on from the calculation of Amounts B and C is Amount A. This is an entirely new concept and nothing to do with the arm's length principle. It is presented as sitting on top of the existing system, and would be looking at global profits to determine an amount of profit that needs to be shared in a different way. It is called 'above normal' and 'residual' profit in the proposal, but it is unclear how this interacts with the 'baseline/routine' vs 'non-routine' distinction between Amounts B and C, this is discussed further in paragraph 2.11 below. Essentially, however, this Amount A is calculated once, allocated based on pre-agreed metrics, and credited to wherever the 'residual' profit is.

2.7 Although described as the first tier of the mechanism in the proposal, it seems logical to us that Amount A would be calculated after Amounts B and C; firstly because it relies on global accounts and thus will come after many 'ordinary' tax returns are filed (although this is not universally true, many domestic filing deadlines would be after a large business had to publish global accounts); secondly (and more importantly) the deemed residual profit on which Amount A is based has to come 'from' somewhere, and this cannot be determined until all of the arguments about arm's length allocation of profits, and, therefore, we assume, Amounts B and C, have been agreed.

2.8 As currently presented, there will be Amount A allocated to wherever there are consumers/users (with nexus for the new taxing right somewhat incongruously to this proposition, currently being considered by reference to sales – see the further discussion in paragraph 2 of Part 2 below) and there will be Amount B and/or Amount C only where there is a resident entity or a permanent establishment. It is unclear whether Amount A is supposed to represent an alternative proxy for Amount C, that is the 'non-routine' profit (after Amount B only has been allocated), or is some other 'residual' or 'above normal' profit, to be shared after both Amounts B and C have been allocated. It is also unclear whether the intention is that countries that are already receiving Amounts B or C can also be allocated an Amount A. It is our view that the most sustainable position is for all countries with consumers/users to be awarded Amount A, regardless of whether they also have companies or permanent establishments liable to Amount B and/or Amount C. The fundamental difficulty with how the

proposal could operate in practice is where the Amount A deemed residual profit comes 'from'. We suggest that the most realistic options to address this are to either (i) identify the entities where most of 'it' sits, or (ii) come up with a formula that takes from all companies within the MNE group that have an Amount C profit.

2.9 On balance, option (ii) seems economically preferable (albeit it may be more complicated to administer) for a few reasons:

(a) because even under option (i) there will need to be a formula, as 'it' will often sit across multiple entities,

(b) because otherwise it would be necessary to work out which allocations of Amount C are 'residual' and which are merely 'non-routine', and

(c) because it would relieve the pressure on countries to try and maximise their Amounts C (because the more Amount C they have, the more they end up giving away).

However, we recognise that there will not be a 'best' answer that applies to all businesses and MNEs. In particular, option (ii) may not be appropriate for businesses with different products that have different margins.

2.10 Notwithstanding this point, a more significant problem around reallocation could arise where there simply are not the requisite taxable profits to reallocate from the entity or entities that are supposed to surrender them. This could be as a result of timing or permanent differences between accounting and taxable profits in various jurisdictions, as well as group accounting adjustments (for example non-taxable gains arising at group level that have nothing to do with market jurisdictions).

2.11 In paragraph 30 the consultation document says that the Amount A deemed residual profit will be the profit after allocating a deemed routine profit on activities to the countries where the activities are performed. Paragraph 54 of the consultation document says that the routine profits that are to be excluded (from total profit) in calculating Amount A will be determined by applying a fixed percentage to total profit ('possibly with variances by industry'). This amount of 'routine profits' will not necessarily be the same as the 'baseline' or 'routine' profits of Amount B and/or the profits to be taken into account under Amount C, that is to say the profit over and above Amount B that arises under current transfer pricing rules. In our view a formulaic approach for Amount A, along the lines discussed above, will be necessary regardless of the eventual split between pots of Amounts B and C and, therefore, A, because in practice it will be very difficult to identify where the Amount A deemed residual profit arises within the individual entities of the MNE group as a result of the realities of how businesses grow, develop and organise themselves. Without a formula, it would be challenging to identify those entities that make an 'above normal profit' and then identify the counter party entity/entities with whom an adjustment should be made.

2.12 Other practical issues emerge as it is considered how the proposal would work in practice. A key question arises around the timing of the calculation of Amount A. Presumably, this can only take place once Amounts B and C, and any disputes arising in respect of these amounts, have been settled. This will, of course, put pressure on the existing mechanisms for dispute resolution in respect of transfer pricing. Based on how the system works currently, this approach would result in sometimes substantial delays in an MNE being in a position to determine its Amount A, and the allocation of it. This will be an important consideration in relation to the mandatory multilateral arbitration mechanism discussed in paragraph 3 below.

2.13 The practical mechanisms for administration, collection and enforcement of the new taxing right of Amount A will also need careful thought. This is discussed further in our response to the question on Nexus in Part 2 *Questions for public comments* below.

2.14 If the basis of the proposal is to ring fence a portion of global profits and deal with this formulaically and at a global level, then it would be easier to do this (although maybe not politically so) through taking a fresh look at how countries would need to work together to achieve it multilaterally, rather than trying to shoe-horn into existing concepts (such as bilateral treaties, bilateral dispute resolution, nexus, etc). In reality it is a political challenge to embrace a solution around countries agreeing a separate mechanism that reallocates a portion of post-transfer pricing tax base among themselves; such an allocation would be far simpler than MNEs allocating Amount A to individual taxpayer entities, and then all of the countries having disputes with the relevant taxpayer entities about it. We recognise that some form of internationally agreed 'clearing system'

where one country (likely the MNE parent country) has to audit, collect, and distribute the taxes, may be unattractive to countries which may not want to cede this power to the large head quarter countries, although the possibility of over 130 other countries arguing about the allocation with the head quarter country would be a deterrent to them not acting in good faith.

2.15 If, however, it is not possible to reach a consensus around an international clearing system, we suggest that further consideration should be given as to whether it is possible to achieve the policy aims of the proposal within the current framework of giving source states, through the model treaty, taxing rights over particular entities, in return for agreeing compulsory binding arbitration of all disputes about (at least) profit allocation. The profits that the new taxing right applies to will accrue to one (or more) entities in the group; therefore, it should also be possible for the new taxing right to simply allow a state to tax part of the profits of an entity (wherever resident and regardless of whether it has a permanent establishment in the jurisdiction) that is a member of a group that (a) carries on the in-scope business and (b) exceeds the financial thresholds. This new taxing right could apply to a percentage of the residual profits of that entity, with the percentage being the product of the percentages referred to in paragraph 30 of the consultation document (and see also the example at paragraph 55) to (a) determine how much of the residual profit is the deemed residual profit (that is, the above normal profit) and (b) allocate between market jurisdictions. For example, if deemed residual profit is 10% of actual residual profit and it is allocated between jurisdictions based on sales, with total sales being 100, of which 50 are in the US, 25 in the UK, 15 in Germany and 10 in France, then the US would be able to tax 50% of that entity's deemed residual profit (that is, 5% of actual residual profit) the UK would be able to tax 25% of that entity's deemed residual profit (that is, 2.5% of its actual residual profit), Germany 15% of its deemed residual profit (1.5% of its actual residual profit) and France 10% of deemed residual profit (1% of actual residual profit). We recognise that this approach of granting new taxing rights directly to individual countries would create additional compliance burdens – both within and outside of tax (that is to say once 'nexus' is established, there may be problems around consumer law, environmental law, etc – plus any changes to indirect taxes that countries subsequently choose to introduce). The other difficulty is that the 'residual' profit will be located in many separate countries. On the positive side, it does solve the tricky area of having local entities having to make payments on behalf of other group companies.

2.16 It is clear that whichever of these alternative approaches (in paragraphs 2.14 and 2.15) is followed, there are huge issues to overcome. The discussion also highlights that the current 'middle-road' approach that is being taken in the Unified Approach is a difficult one that will be hard to sustain without a clear principle. Clearly the approach that is taken is closely linked to the question of nexus which we discuss further in our responses to the *Questions for public comments* below. Another positive arising from an approach of an international, centrally administered system would be that it would not be necessary for the MNE to file a tax return in every country which may have an Amount A allocation. In our view, local filing of tax returns would give rise to a debate about thresholds, below which registration and filing is not required. If the MNE is only dealing with Amount A in one country, and there is one central calculation, then a threshold is less of a concern. Having a threshold would also raise questions as to what would happen to small Amount A allocations that countries are not entitled to because they fall below the threshold. Where do these Amount A allocations go? Do they stay where they are or do they get spread out across the countries who are getting a big enough Amount A allocation to breach the threshold?

2.17 As mentioned above, the political discussions around digitalisation have prompted a discussion around the global tax base, which now goes wider than the perceived challenges arising from the digitalisation of the economy. The brief discussion of process and possible approaches above indicates that, in order to address these challenges it may be necessary for the solution to be even bolder than currently envisaged. A fresh approach is required to solve the issues that have been identified, and a radical change may be preferable than an attempt to shoe-horn a solution into existing concepts. There are several ways to meet the policy objectives and the trade-offs of each will need to be considered.

3. Certainty and mandatory multilateral arbitration

3.1 There are two aspects of certainty that we would like to discuss in this paragraph. The first is around clarity of the rules, in order to prevent disputes so far as possible, and the second is around resolving disputes that will inevitably arise.

3.2 We recognise that many of the concepts in the proposal are not yet able to be defined, pending an agreement as to what these should be. However, as a general point, in our view it will be important that, where possible, definitions of, for example, 'group', 'consumer-facing business' (if this is the term that is used), and (if there are going to be different tests for different sectors) what each sector is, what is a 'baseline activity' (for Amount B) should be agreed and set out in an OECD publication, with limited room for states to adopt different, and potentially inconsistent, interpretations. We welcome the focus on dispute prevention as, while dispute resolution is necessary, it is not the best solution for business because of the time it takes; businesses need certainty from the outset.

3.3 It seems inevitable that, despite aspirations to the contrary, the changes to the international tax system which are made under Pillar One will not be a simplification. For example, the interaction and determination of Amounts B and C may lead to a larger number of tax disputes than is currently the case, before overlaying the allocation of Amount A and the interaction of it with Amounts B and C.

3.4 The consultation document recognises that that there will have to be new approaches to dispute prevention and resolution; we agree. The current dispute resolution systems (and dispute avoidance through Advanced Pricing Arrangements (APAs), for example) would need to change completely - bilateral systems would not be effective in a system that seeks to reallocate profits from multiple countries to other, different multiple countries.

3.5 There needs to be a clear, strong and effective multilateral arbitration process agreed by tax administrations. We suggest that countries which sign up to the right to tax Amounts A (and the resulting changes to the existing system represented by Amounts B and C) must also sign up to binding multilateral arbitration. It seems that this is what the proposal is suggesting, and, if this is correct, we strongly support this, notwithstanding that it will be difficult for countries opposed to mandatory arbitration on grounds of sovereignty.

3.6 The timing and process of the mandatory multilateral arbitration system should also be clearly established to address the current delays that taxpayers currently face in obtaining relief from double taxation (for example, under the mutual agreement procedure (MAP)). This will take on further importance if we are correct, as suggested above, that disputes around Amounts B and C will have to be determined before Amount A can be calculated and allocated.

3.7 It should also be acknowledged that some jurisdictions will continue to follow the unilateral measures currently being adopted and may not sign up to the approach on which general consensus is reached; resulting inconsistencies between competing systems may need to be resolved.

4. Resource and stability/ future proofing

4.1 This proposal will significantly increase the pressure on tax administrations and on the OECD.

4.2 We commented in response to the consultation on the three proposals presented in the January 2019 Policy Note, that we envisage that the OECD would have to provide capacity to co-ordinate international standard setting. We remain of the view that a proposal along these lines will only work well if there are dedicated OECD staff who can give advance rulings – on methodology and/or on numbers – to assist MNEs and tax administrations agreeing the various amounts and resulting re-allocations. As mentioned above (at paragraph 3.2) it will be important that, so far as possible, concepts are defined and determined by the OECD to ensure certainty and consistency for taxpayers.

4.3 To the extent that the function of determining the allocation is undertaken by tax administrations, this would have to be based on detailed OECD guidance and should be exchanged with other tax administrations.

4.4 It has previously been recognised that there are different levels of development and capacity between tax administrations. It now needs to be recognised that this proposal will place a significant additional burden on

tax administrations, and countries should be encouraged to commit to providing the additional resource that will be required.

4.5 It should also be recognised that a brand new taxing mechanism such as this is likely to result in unforeseen consequences in the early years; these consequences will have to be addressed by a dynamic, responsive system, at least initially. This is especially the case because the new taxing right is addressing a particular business area which is subject to rapid change. There should be, therefore, some agreed procedure for reviewing and updating principles, definitions (including new exclusions to the scope if it becomes clear that existing (or new) businesses are within the definition that ought not to be) and fixed rates etc on a reasonably frequent basis.

5. Interaction with Pillar Two

5.1 There is ongoing work in relation Pillar Two; a consultation document was published on [8] November 2019. The interaction of the two pillars will have to be considered in due course. Not least, the interaction between the two will make dispute resolution and treaty changes even more important – there will need to be multilateral mechanisms to be effective where payments / treaty benefits are being denied under Pillar Two based on effective tax rate, if the effective tax rate is based on a payment that is subsequently spread across many jurisdictions under Pillar One.

5.2 Similarly, it will be difficult to establish, for the purposes of Pillar Two, the rate of tax has been paid on a particular receipt in a country if, globally, MNEs are not necessarily being taxed on a particular receipt in that country – because it is allocated to another jurisdiction.

6. Losses

6.1 The consultation document recognises that the treatment of losses will have to be considered and agreed upon in order to fully develop the proposal. This is much more complicated than the allocation of profits. If currently residual profits are allocated to intangible assets, this is generally in return for the risk that the IP owner takes. If the tax system is changed to allocate some of these profits to a country that is not taking any risk at all in relation to the IP, then unless the system also allocates a portion of the risk (that is to say a portion of losses if or when these arise) then the IP owning jurisdictions are effectively subsidising the market jurisdictions - they are not getting the full reward that accrues on the IP but they still have to bear all the losses. Accordingly, it will be necessary to allocate losses as well as profits to the market jurisdictions. This will be particularly difficult for the transition into the new system (the losses incurred before the new rules come in) or when a business enters a new market (the losses that may arise if IP is developed in one country at a loss and is then spread out across the globe in terms of market). Similarly, there should also be recognition of losses arising as a result of the development of products over a long time period, with significant investment expenditure (including research and development) in the early years; it can be a significant period of time before a product may be profitable.

6.2 In addition, if the rules were to take an asset (say a portion of some income earning IP) away from one country and giving it to another for tax purposes, that first country might treat this as a transfer of an asset and charge tax on the gain. We suggest that this would not be a desired outcome, but if it is going to be permissible, it would at least be less damaging if the country that is 'acquiring' the portion of that IP is deemed to have purchased it, and then allows amortisation against its future profits. This would also go some way to solving the issues mentioned above regarding the losses.

6.3 A similar point arises in relation to the costs of the head office function. When considering where value is created - in a group rather than a country concept – the value created by head office functions should also be recognised. The costs of these functions may not be tax deductible in the head office country, and often cannot be recharged to subsidiaries. It is possible to see this current position the 'quid pro quo': the head office jurisdiction has non-deductible costs, and the market jurisdiction less taxing rights. If taxing rights are transferred to the market jurisdiction, a proportion of these costs should also be transferred.

Part 2 - Responses to Questions for public comments

1. Scope.

Under the proposed 'Unified Approach', Amount A would focus on, broadly, *large consumer* (including *user*) *facing businesses*. What challenges and opportunities do you see in defining and identifying businesses in scope.

1.1 The proposal recognises that further work is required on scope and any carve-outs from it. As discussed above, the lack of clarity around the principles underpinning what businesses should be included is making ascertaining the scope difficult. We recognise the political considerations in determining the scope of the new taxing right remain unresolved, which is resulting in a lack of clarity; if there were a clear theory setting out what should be included, which was reflective of business reality, the task of scoping would be easier.

Question 1 a – interaction with consumers/users

1.2 The Unified Approach introduces a concept of 'consumer-facing businesses', specifically incorporating 'users' within the concept, thus covering highly digitalised business models, but also going somewhat wider.

1.3 Broadly the CIOT welcomes the focus on an interaction with consumers as it is the closest element to an overarching principle against which a solution can be developed, although, as it stands, what is encompassed within the concept of 'consumer-facing', and why that is an appropriate principle against which to address the policy challenges is far from clear. In due course, we would prefer a precise definition that sets out what is included within the scope of the new taxing right, rather than a definition which is very broad and focuses on exclusions, with the default position being that if a business is not within an exclusion it is within scope. An inclusive approach to the definition would, in our opinion, provide a better focus. However, we recognise that an approach of having exclusions only, with the remainder of businesses being in, could be simpler in its approach and drafting, and some businesses may prefer simplicity, and the resulting certainty, on the basis that the new taxing allocation will not in any event be very costly for them.

1.4 Also, without clear drafting, there is a risk of loopholes being created that could increase the scope for tax avoidance as groups may seek to structure their activities to fall outside the proposals which would otherwise be within the spirit of what should be caught.

1.5 Which approach is, in the end, clearer will depend on political decisions around which businesses should be brought into scope and the extent of consumer interaction which is required. Many questions arise as to the extent of interaction with, or engagement of, a consumer that is required to put a business within scope. For example, is a distinction to be drawn between technology enabled, and technology driven, businesses.

1.6 In terms of defining the scope, if the consensus is that businesses that supply components of the end consumer product, (including intangible components such as data or content) are to be included, it might be simpler to include all businesses in scope except for activities that are specifically excluded. This could be simpler and fairer, and would remove some of the boundaries; it is also more likely to be future-proof.

1.7 It is possible that certain businesses could be within its scope in some countries and out of it in others. For example, in most of the countries in which pharmaceutical companies operate (notable exceptions being the US and New Zealand) it is not permissible to advertise or promote medicines directly to customers, meaning that the pharmaceutical industry is not consumer-facing in these jurisdictions.

Question 1. b. defining the MNE group

1.8 We suggest that the MNE group should be defined by reference to the consolidation rules for the MNE's global accounts. Its size should be determined by reference to its consolidated global accounts.

1.9 Further consideration will be required in relation to joint ventures and collective investment vehicles (although we would expect the latter of these to be largely below the threshold).

Question 1.c. different business models and sales to intermediaries

1.10 The consultation document recognises that further work is required to draw out how complex business arrangements around supply of goods and services through intermediaries, the supply of component products and the use of franchise arrangements should be treated.

1.11 It will be very difficult for a manufacturer of a well-known product which is intended to ultimately be sold to a consumer, who sells in bulk to a third party wholesaler, which, in turn, sells to sub-wholesalers in various territories which then on-sells to retailers in various other territories, to be able to determine where its products have gone. Perhaps it may be possible for the very largest MNEs. We can envisage that they may do market surveys to get statistical information about where their products are selling. However, smaller groups capture data on a larger scale – for example, 'Europe' or something similar.

1.12 The position is also complicated in respect of component products working their way from the manufacturer to a consumer through a supply chain. It is not clear the extent to which an MNE supplying a component will have to 'track' it to the ultimate consumer and fall within the scope of this proposal.

1.13 *Question 1.d. size of the MNE group*

1.14 The intention is that the new allocation of taxing rights will affect only 'large' consumer-facing businesses. There is some discussion in the proposal of thresholds; the €750million revenue threshold used for country-by-country reporting (CBCR) requirements is mooted.

1.15 In our view, a threshold at this level for this proposal is too low. CBCR is intentionally spreading its net quite widely, in order to get information. The proposal here is to create a new taxing right and should, in our view, only target the largest businesses which have a significant impact on the markets in which they operate. Before deciding upon appropriate thresholds, there should be clarity over what the new taxing right is intended to capture and further work undertaken on the impact of the proposals. A threshold at the level of CBCR would bring a large number of MNEs within its scope which will have a consequential impact on the requirements for resource discussed in paragraph 4 of Part 1 above. This must be balanced against the expected amount of reallocation relative to the amount of effort. A global revenue threshold of €750million spread over, say, 30 territories may not result in a more than minimal reallocation.

1.16 The Secretariat will also be aware of current discussions around whether to lower the CBCR threshold, which would also indicate that a direct link to this threshold for this new taxing right would be unwelcome.

1.17 In any event we suggest that the thresholds should not operate as a cliff edge. It would be preferable for MNEs to have to be above the relevant thresholds for a number of years before becoming subject to the new rules. Consideration should also be given to whether the threshold should be linked to all turnover or relevant turnover. From a policy perspective, the threshold should apply in respect of relevant turnover (with clarity around which sales are to be included as relevant, for example, including domestic as well as foreign revenue), but we recognise that the rules would be simpler if the threshold test was applied to all turnover, as it would be easier for an MNE to decide whether it is within scope or not.

1.18 However, as we mention above, complexity is not necessarily bad if there is a sufficient trade-off. Provided that there is sufficient certainty within the rules, a more complex, but better targeted scope determined by appropriate thresholds would be beneficial for taxpayers and fiscal authorities. A threshold that is set too low by reference to all turnover could bring in large businesses that have low relevant revenue and/or low profit margins, resulting in unnecessary work for the businesses and for tax authorities with no, or little, resulting tax re-allocated. We would like to see consideration given to a double turnover threshold test: a very large total turnover threshold and a smaller relevant turnover threshold – if a business has revenues (or relevant revenues) of higher than either threshold, they are within scope. As to quantum, we suggest that the threshold for relevant revenue should itself be higher than €750million and the threshold for total global revenues much higher.

1.19 We can also see the benefit of an exclusion for entities that are members of a group that is <u>not</u> required to comply with CBCR. That should provide certainty for those businesses that are not subject to that regime.

Question 1.e. carve outs

1.20 It is assumed in the proposal that extractive industries will be outside of the scope, with other possible industries to be carved out including financial services and commodities. From a definitional perspective, and in order to maximise certainty, even if industries are de facto excluded from scope as a result of the definition of what is included, it would be preferable to have specific exclusions for such sectors as well.

1.21 In considering whether other carve-outs for an industry or sector should be formulated, the starting point should be to decide on the principles as to why an industry or sector should be excluded. The consultation document says that extractive industries are assumed to be out of scope, without saying why. We assume that it is because this sector is not characterised by digitalisation and/or profit allocation issues that are being addressed by Pillar One. Financial services and commodities are also mentioned: are these being considered for exclusion on the basis that, although these are, or can be consumer-facing, they are subject to regulation and, therefore, the profits are generally where the consumers are? We suggest that other industries and sectors should be considered for exclusion if it can be established, that they similarly do not have high-risk profiles in relation to the nexus and profit allocation issues or, for example, that there is unlikely to be a material reallocation of profits.

1.22 As part of the work defining the scope of the new taxing right, and the concept of consumer-facing, clear rules excluding business to business activities should also be developed.

1.23 There could also be a carve-out for domestic activities, such as patent boxes.

1.24 It will also be necessary to reach agreement on whether exempt entities (for example, not-for-profit enterprises and charities) are in or out of scope. These are treated differently in each country, so a lack of clarity as to which are actually in the scope could have a particularly detrimental impact on them.

2. New Nexus

2.1 As a general matter, we believe that nexus thresholds should be determined after the economic principles underpinning taxing the allocation of taxing rights, and the corresponding profit allocation rules embodying those principles are defined. A major purpose of a nexus threshold is to ensure that companies are only liable to tax where they have breached a threshold of activity that indicates that the corresponding tax they should pay is likely to be worthy of both their engagement with a jurisdiction, and the resources of the tax administration. For a nexus threshold and a corresponding amount of tax to be commensurate, they must be based on the same underlying principles. This is why the permanent establishment threshold has worked so well with regards to the existing OECD Model Convention (regardless of whether it remains appropriate); both profit allocation and the nexus threshold were based upon degrees of physical activity.

2.2 Accordingly, while we welcome the simplicity of a threshold based on volume of direct sales into a jurisdiction, it is not possible to say at this stage whether it is appropriate, and it will not be until it is determined whether direct sales (vs indirect sales, or users, for example) are likely to lead to a significant enough allocation of profits to warrant the administrative and enforcement burden.

2.3 The creation of a new 'nexus' without a physical presence raises significant issues around the administration, collection and enforcement of the new taxing right. The potential impact of nexus and the compliance burden that can result in the creation of a 'nexus' in the traditional sense, requiring registration and/or a legal presence, in each market jurisdiction, the implications from a non-tax perspective (for example, consumer rights and environmental liabilities etc.) could be substantial.

2.4 There are clear issues around the collection and enforcement of any tax liability for a jurisdiction in which there is not a permanent establishment or registered entity. It will generally be difficult and costly to pursue a liability from a non-resident even following existing international agreements.

2.5 We suggest in paragraph 2.14 of Part 1 above that some form of international clearing system should be considered. A global administration mechanism could go a long way to address the concerns that arise as a result of the creation of a large number of new taxable entities through nexus. Simplification is preferred to minimize the compliance burden however there are still a lot of unanswered questions as to how this could

be achieved. A mechanism by which one company within a group audits the new rules and assesses the Amount A arising and its allocation could build on the mechanisms already in place in relation to CBCR. We recognise that many countries may not wish to rely on a central administrating country to collect tax on its behalf, but that country is not losing its right to challenge the allocation or what is paid over to it.

2.6 As mentioned in paragraph 2.15 of Part 1 above, if a central administration system is not possible, and taxpayers are required to file a tax return in every country in respect of a potential Amount A liability, then thresholds should be considered in order to avoid a proliferation of new taxable entities and reduce the compliance burden in respect of jurisdictions where the Amount A allocation would be minimal.

2.7 New compliance burdens could become barriers to trade and would inevitably be taken into account when businesses are making decisions about whether or not to enter (or remain in) a particular jurisdiction.

2.8 In relation to the identification of nexus, it is suggested that the test may be largely based on sales. It must be recognised that it may be difficult for many companies to gather the information on sales within specific jurisdictions where there is not a physical presence (for example, export sales through third party distributors where the sale is recorded in the exporting entity) as this information is not likely to be recorded as revenues against the end market country in the consolidated financial statements. The CBCR only records sales where there is a physical presence. Additional analysis will be required to calculate sales where there is not a physical presence which will be an additional administrative burden to taxpayers and will be undertaken solely to meet these requirements. In addition, it would be challenging to compare MNE sales in a country to a sales threshold. It is unclear what metric or data points would be appropriate to determine the size of the market relevant to the MNE's business. For example, it could be determined on general industry data within the country or based on data of deemed competitors operating in the country. There will be challenges around consistent sales recognition as different entities within an MNE group may recognise and account for sales in different ways which could potentially distort the sales threshold.

2.9 Inevitably, it will also be the case that the underlying data used will not be held in the companies' accounting systems, but will come from other sources (for example marketing data bases) and will not, therefore, be tied to any figure in the audited accounts. Consequently this data will be very difficult for tax administrations to audit.

3. Calculation of group profits for Amount A

3.1 The calculation of amount A requires a starting point – which we will call 'total profit' out of which 'routine profits' are to be stripped out to leave 'residual profit'. At paragraph 53 of the consultation document it is stated that:

'*The relevant measure of profits could be derived from the consolidated financial statements under the accounting standards of the headquarters jurisdiction prepared in accordance with the Generally Accepted Accounting Principles (GAAP) or the International Financial Reporting Standards (IFRS)*'.

We agree, for the reasons given immediately after that statement, that this is a sensible starting point for total profit, although in our view and experience, any concern that an MNE might manipulate their accounts in light of these new rules is to overestimate the importance of tax within the overall management and financial reporting of MNEs.

3.2 The paragraph goes on to mention that '*standardised adjustments to the reported profit*' may need consideration, and that the relevant measure of profit may need to be determined on a business line and/or regional/market basis.

3.3 We recommend that any standardised adjustments are kept to a minimum, but, in the interests of ensuring the policy intent of reallocating a certain type of profit is achieved, some specific situations/expenses need to be considered:

- Items included in IFRS profits, but commonly excluded from the 'headline' or 'adjusted' profits that are reported by the company, and which are also excluded from the 'adjusted' tax charge. Such items are commonly restructuring costs following an acquisition or disposal, or closure of a business line. They also

include one-off write-downs of assets including goodwill, which may not necessarily accompany a restructure.

The argument for excluding such items from 'total profit' would be that they represent decisions made by management outside the normal course of business. Whilst they do represent a charge against residual profit, it should be taken against that portion of residual profit left 'centrally' after an allocation to market jurisdictions. This could result in a central residual loss whilst market jurisdictions still reported a taxable residual profit allocation, but this would seem more consistent with the policy intent than reducing an allocation to market jurisdictions for reasons unrelated to those markets.

- The document suggests costs of financing should be excluded from total profit – in paragraph 57, the return to capital is to be taken into consideration in determining the split between residual profit to be allocated and that to be retained 'centrally'. This makes sense, as it will ensure there is parity between groups with differing financing models.

3.4 On the question of whether to use total profit or division into business lines, we should suggest that the ultimate consensus approach needs to make a principled case for its choice. At the moment we are told that there might be a distortion between a business that is purely high-margin tech and a conglomerate with mixed businesses. We understand that the high-margin business inside the conglomerate might give rise to less (or no) 'Amount A tax' than the equivalent business in the pure tech MNE, but is that necessarily the wrong result? If the other businesses inside the conglomerate are reducing the size of the profit available to shareholders, is that not relevant? Would singling out the tech business in the conglomerate simply lead to a different distortion this time in the effective rates of tax on profits? If so, is that distortion justified? We would also note that if business lines are not identified separately in the consolidated accounts, seeking to identify these, and the profit resulting from them, would be very complicated.

3.5 It is not clear how losses and/or regional differences between loss making and profitable regions/jurisdictions would be dealt with.

4. Determination of Amount A

4.1 The methodology for the second and third step in the determination of Amount A will largely be driven by political decisions. We discuss in paragraph 2 of Part 1 above the inevitable complications around the allocation of Amount A.

4.2 There is a political risk that by the time you have finished slicing up the deemed residual profit, the amount actually allocated could look quite small. The fixed percentages for second step envisaged by paragraph 55 of the consultation document should be subject to some agreed procedure for reviewing and updating them on a reasonably frequent basis.

4.3 With regard to the third step – that is allocating between jurisdictions – do you allocate the whole of the deemed residual profit to those jurisdictions that are above the threshold or do you only allocate the fraction of the total based on sales to the jurisdiction divided by total sales? There could be quite a difference if the MNE sells to a range of countries but only some of those countries meet the threshold envisaged by paragraph 22 of the consultation document.

4.4 As discussed in paragraph 2 of Part 1 above, the Amount A calculation currently seems to exist in isolation. This is not necessarily a problem in itself, but the next stage of this work needs to develop some principles as to how it fits into the wider picture.

4.5 Amount A assumes that a routine return is deducted before the allocation of the deemed residual profit but it is not clear how it interacts with Amounts B or C; it is not clear whether the routine profits that are to be excluded (from total profit) in calculating Amount A will be the same as, or are intended to be the equivalent of, the 'baseline' or 'routine' profits of Amount B and/or the profits to be taken into account under Amount C, that is to say the profit over and above Amount B that arises under current transfer pricing rules. On the assumption that the end result is that tax is paid on no more than 100% of the total profits (though it is not clear whether this would be 100% of taxable profits or accounting profits), it will be challenging to identify those entities that make an above-normal profit and then identify the counter party entity/entities with

whom the adjustment will be made. Some principles will be required around which jurisdictions’ tax claims on the old permanent establishment basis get dislodged/scaled back. We suggest in paragraph 2.11 of Part 1 above that some sort of formula would be the preferable option to dealing with this. Further, as discussed in paragraph 3 of Part 1 above, this type of allocation will not be resolvable using the existing bi-lateral dispute resolution mechanisms, at least not in anything like a timely or satisfactory manner.

5. Elimination of double taxation in relation to Amount A

5.1 It is not possible to answer this question until there is a proposal on how the tax will be charged, collected and enforced. These administration considerations are currently not included in the proposal. It is not possible to know which taxpayer to give a relief to until it has been decided which of them is going to pay the tax and in respect of which bit of the overall profit the tax is being paid.

5.2 In addition, the question of double tax arising in respect of Amount A cannot be considered separately from the question of what constitutes Amount C and the dispute prevention and resolution around that. There is, of course, an overlap between Amounts A and C – which is why an enhanced dispute resolution mechanism is required; we are pleased to see that this is acknowledged. The double taxation will arise in two main ways: (a) different interpretations of the amounts that should be reallocated, and (b) different assertions of where the relevant Amount A profits it should be taken from. Clarity in the rules is key to solving the former problem. For the latter, there seem to be two options: either selecting a particular company (or particular companies) in the group from which to take the entire amount (and seeking to avoid double taxation by capping the amount allocated to other countries already recognising a degree of above normal profit), or genuinely attempting to devise a pro rata Amount A allocation across all Amount C allocations (or proxies to that effect such as total taxable profits). The more mechanical this is, the less dispute there will be (but perhaps also the less flexibility there is).

5.3 As discussed above in paragraph 2 of Part 1, in our view, without a formula, the allocation of Amount A profits and identification of the counter party/parties will be inordinately difficult because an MNE group does not generally have a pool of ‘residual’ or ‘above normal profits’ from which an allocation can be carved out of and there will also be complications arising from the differences in treatment between acquired and self-generated IP. Amount A is so incongruent with the rest of the international system – in part because accounting profits are so different from tax profits, and the calculation of Amount A is being based on an accounting fungible pool of profits - that there will be no sensible or obvious way of deciding where the amount of profits has come from and, therefore, where to allocate it back to.

5.4 In due course the administrative processes around this new taxing right will need to be developed. Following on from decisions about which companies within an MNE group should have the obligation to pay the tax will be questions around which companies within the group have the cash to pay the Amounts A tax which are due. Rules will be required to permit entities within the group to move money on a tax free basis in order to fund the tax due. Practicalities would point to the appointment of paying agents (within the taxpayer group) and a multinational ‘clearing system’ (on behalf of taxing authorities).

6. Amount B

6.1 Currently the policy objectives of Amount B are not clear. Is it intended that Amount B will be regarded as a minimum return that a country in which an MNE has a permanent establishment or an entity can claim and retain without argument? Is it intended to use simplified conventions (safe harbours) to determine the profit from particular, as yet undefined, activities such as distribution activities? We can see the difficulty as determining what those conventions are, and the policy objective is unclear as the proposal does not articulate the basis on which such activities should be remunerated. If it is intended to be a proxy that delivers a result anywhere near the arm’s length principle return then, if it is kept simple, but is to apply in a wide enough range of circumstances for it to be meaningful for any scenario, and regardless of profitability, the range of activities within its scope would have to be so limited that it is unlikely that any business would fall within it. Or it will be necessary to introduce more rules to account for differences in profitability between

different businesses, markets and geographies, thus defeating the simplification aspect and increasing the chances of disputes.

6.2 We can see merit in an approach akin to Low Value Added Services in BEPS, with it being accepted that Amount B is a minimum return for the relevant country in respect of profits on 'baseline activities' or 'routine' profits. Although it should be recognised that this approach will push many of the difficult points around transfer pricing into discussions around Amount C, this may be acceptable because countries will be getting something under Amount B, they will also get part of Amount A and then can push for an allocation in respect of Amount C.

6.3 We have also mentioned in paragraph 2.4 of Part 1 above that, arguably, splitting the transfer pricing analysis in this way between Amounts B and C is actually creating a complication, rather than being a simplification of the current system.

6.4 In addition, it is recognised that clear definitions will be required around the baseline activities that would be taken into account for Amount B. We suggest that defining these will be complicated and difficult.

6.5 It will also be difficult to decide the fixed returns and whether each industry should have its own fixed return. For some businesses the rate could reduce or eliminate the residual profit. In addition, fixed rates will quickly become out of date as an industry develops and they will also vary throughout the economic cycle, as well as varying from country to country. For example, another variable in determining what a routine return is, is labour cost which varies from country to country. It should also be recognised that the allocation of fixed rates will generate a need to define the industry or activity that the fixed rate is to be attributable to. For example, if there is a fixed rate for, say, distribution, it will be necessary to define what distribution is. An activity such as 'distribution' also varies from industry to industry.

6.6 There are many reasons why fixed percentages should be industry specific and based on industry considerations; however a global fixed percentage would be preferable for administrative ease and to reduce the amount of disputes. In short, there is a balance between simplicity and fairness; the simpler (and less flexible) the ratio, the greater the risk of unfair results, whereas if more adjustment can be made, the result may be more fair at the cost of potential disputes and cost of implementation. We would err on the side of keeping things as simple as possible, with a baseline return, possibly with an adjustment on a sliding scale depending on level of profits.

6.7 Amount B is not actually, legally or structurally connected to Amount A. We imagine that the thinking is that there will in practice be no overlap, because Amount B is focusing on baseline activities which ought to command a routine return. Maybe that will prove to be right in the vast majority of cases. However, if you take total 'profit' and allocate one amount of it (taxable profit) amongst traditional permanent establishment jurisdictions on an arm's length basis and another amount of it (a proportion of accounting profit) on a different basis, there must be some risk that some profits are going to be allocated twice or not at all. Thus Amount B should not be completely disregarded in the discussions around dispute prevention and resolution and double taxation.

7. Amount C/dispute prevention and resolution

7.1 In paragraph 64 of the consultation document, it appears that Amount C is the amount in addition Amount B that can be justified based on existing transfer pricing principles in respect of the activities in the territory over and above the Amount B 'baseline' activities. Further detail on how Amount B will interact with Amount C will have to be developed. For example, there may be additional functions performed in marketing jurisdictions that are closely linked to the baseline marketing and distribution functions, for example, local manufacturing. The additional functionality may result in tax disputes over whether it relates to baseline activities and/or the level of additional profit that should be earned on an arm's length basis under traditional transfer pricing methods.

7.2 The policy will set the distinctions which will have to be determined by definitions in due course of the various activities and what is, for example, 'distribution' and 'routine'. It is difficult without detail around this to work

through the practical implications and interactions of the different amounts, and where disputes are most likely to arise.

7.3 However, it is clear that an effective dispute prevention and resolution mechanism will be required to avoid double taxation. We welcome the recognition that dispute resolution must take a holistic approach. Any dispute should be subject to legally binding and effective dispute mechanisms (which should also be prompt and cost-effective). The administration of the new rules will also be critical.

7.4 As we say in paragraph 2 of Part 1 above, in our view a proposal along the lines of the Unified Approach (or, indeed, any proposal which seeks to carve up the global profit other than by way of the existing arm's length principle) will only work with a high level of multilateral co-operation. The existing mechanisms such as (unilateral or multilateral) APA, International compliance assurance programme (ICAP) and MAP will not be sufficient because ultimately a proposal which will result in a reallocation of profits in every case from a number of countries to a number of other countries, and an interaction between the current transfer pricing system and a new formulary overlay, will require a mechanism that provides a decision where agreement cannot be reached between multiple tax authorities and an MNE.

7.5 We suggest that countries signing up to the new taxing right in respect of Amount A must also sign up to mandatory multilateral arbitration. The Multilateral Instrument introduced under BEPS Action 15 allows states to benefit from the principal purpose test and other measures, whilst reserving on arbitration. Such optionality should not be a feature of whatever is agreed in relation to this new taxing right; if a country wishes to tax Amount A, it must agree to multilateral arbitration. It seems that this is what the proposal is suggesting, and, if this is correct, we strongly support this, notwithstanding that it may be difficult for countries opposed to mandatory arbitration on grounds of sovereignty.

7.6 Also, the mechanism should be developed to reconcile the dispute resolution mechanism between Pillar One and Pillar Two. Any attempt to resolve double taxation issues in Pillar One without taking into account of impact of Pillar Two would be counterproductive.

7.7 It is recognised that the proposals will require a change to most, if not all, treaties and that this cannot be done through the existing multilateral instrument because of its sign up mechanism which means that different countries can introduce things at different times. We agree that a fixed starting point for all countries and all treaties is required. This will require a new treaty overlay to effect changes to all bilateral treaties in relation to Amounts B and C and Article 7 in particular. It is also not clear how existing bilateral tax treaties could resolve the conflicts or work for foreign tax credits etc where multiple jurisdictions are involved.

8. Acknowledgement of submission

8.1 We would be grateful if you could acknowledge safe receipt of this submission, and ensure that the Chartered Institute of Taxation is included in the List of Respondents when any outcome of the consultation is published.

9. The Chartered Institute of Taxation

9.1 The Chartered Institute of Taxation (CIOT) is the leading professional body in the United Kingdom concerned solely with taxation. The CIOT is an educational charity, promoting education and study of the administration and practice of taxation. One of our key aims is to work for a better, more efficient, tax system for all affected by it – taxpayers, their advisers and the authorities. The CIOT's work covers all aspects of taxation, including direct and indirect taxes and duties. Through our Low Incomes Tax Reform Group (LITRG), the CIOT has a particular focus on improving the tax system, including tax credits and benefits, for the unrepresented taxpayer.

The CIOT draws on our members' experience in private practice, commerce and industry, government and academia to improve tax administration and propose and explain how tax policy objectives can most effectively be achieved. We also link to, and draw on, similar leading professional tax bodies in other countries. The CIOT's comments and recommendations on tax issues are made in line with our charitable objectives: we are politically neutral in our work.

The CIOT’s 18,500 members have the practising title of ‘Chartered Tax Adviser’ and the designatory letters ‘CTA’, to represent the leading tax qualification.

9.2 As an educational charity, our primary purpose is to promote education in taxation. One of the key aims of the CIOT is to work for a better, more efficient, tax system for all affected by it – taxpayers, their advisers and the authorities. Our comments and recommendations on tax issues are made solely in order to achieve this aim; we are a non-party-political organisation.

9.3 In our view objectives for a tax system should include rules which translate policy intentions into law accurately and effectively, without unintended consequences. The tax system should aim to provide simplicity (so far as possible) and clarity, so businesses can understand how much tax they should be paying and why, and also to provide certainty so that businesses can plan ahead with confidence. It is also important that there is responsive and competent tax administration, with a minimum of bureaucracy.

The Chartered Institute of Taxation

11 November 2019