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Response to: Proposal for a "Unified Approach" under Pillar One - Public consultation

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1. Introduction. Many of the key positions taken in this consultation document deserve our full support, as I believe they present the most fruitful way forward. Corporate taxation based on a separate entity approach is no longer suitable for taxing the profits of large cross-border enterprises. Hence, (i) distinguishing between large multinationals (e.g. EUR 750 million threshold) and SMEs, (ii) taking the consolidated GAAP or IFRS profits with pre-defined book-to-tax adjustments as a starting point, (iii) distinguishing between routine and residual profits for the purposes of re-distribution to taxing jurisdictions, and (iv) refining this approach by further segmenting these routine and residual profits into portions attributable to separate business lines within a large multinational enterprise, form a very solid basis for defining and globally harmonizing the corporate tax systems of the near future. All these key elements come close to a new system for Global Enterprise Taxation (GET); something I argued for in a Dutch article in June 2019 (an English translation of this article will be published soon).[1]

2. Market jurisdictions. It is perfectly clear why, in the current global and digitalized economic environment, market jurisdictions should be allocated taxing rights by means of new, non-physical nexus criteria. Again a key element of the consultation document that deserves our full support. However, defining a non-physical nexus does not necessarily lead to the conclusion that these market jurisdictions should be allocated a portion of <u>residual</u> profits. The consultation document does not provide a clear rationale for applying this version of a residual profit split. Why would market jurisdictions deserve a higher, more volatile upside, than those jurisdictions in which the multinational is physically present by operating baseline routine functions (e.g. contract manufacturing, distribution), benefiting from the social and economic infrastructure of this country of presence, as well as leaving a footprint in this country? I believe that it would be more appropriate to allocate a deemed routine sales profit (e.g. p% of turnover) to market jurisdictions in which the multinational is not physically present. In other words, a non-physical nexus with a jurisdiction does not justify the allocation of taxing rights over (a portion of) residual profit to that jurisdiction.

3. Alternative approach. As argued in the abovementioned article on Global Enterprise Taxation, I would suggest the following alternative approach, based on the same key elements as highlighted under 1 above. In summary, this alternative approach would consist of the following steps:

<u>A) Determine the worldwide consolidated profit</u>
In line with the consultation document, the total tax base to be allocated to taxing jurisdictions consists of the actual worldwide consolidated profits of an MNE, with a pre-defined bridge from GAAP/IFRS to arrive at the tax base.

[1] J.W. Bellingwout, 'Global Enterprise Taxation (GET)', in: *De toekomst van de vennootschapsbelasting: lessen uit 50 jaar Wet Vpb 1969*, Deventer: Kluwer 2019, p. 427-442.

B) Determine low/medium-risk routine profit, sales profit and residual profit

Step 1: Determine deemed low-risk routine profit

Step 2: Determine deemed sales profit.

Step 3: Determine deemed medium-risk routine profit.

Steps 2-3 happen insofar as the total consolidated profit had not already been absorbed in the previous step.

Step 4: Any profit remaining after step 3 is deemed to be residual profit.

To separate residual from routine profits, a distinction must be made between low, medium, and high-value creating people functions. For example, low-value creating functions could be deemed to earn a cost-plus 5% profit margin (TNMM), while medium-value creating functions could be deemed to earn a cost-plus 10-15% profit margin. Sales would also be regarded as a medium-value creating function, to be compensated with a percentage of turnover from sales (business to consumer), for example 2 or 3%, which can be expected to represent a significant portion of total worldwide profit. The precise percentages for these deemed income categories may vary per industry and per business line[2] within an MNE. The OECD TP guidelines could still be relevant here in terms of determining the relevant cost base and the appropriate profit margin. Profit in excess of these accumulated amounts of deemed routine profits is considered residual profit.

C) Profit allocation to taxing jurisdictions

The low and medium-risk routine profits, as well as residual profits (steps 1, 2, and 4), are allocated to taxing jurisdictions based on physical presence[3].

The sales profit (step 3) is allocated to market jurisdictions, based on new non-physical nexus criteria.

The nexus criterion for market jurisdictions can be found in the sales volume per country as a portion of total global sales, more or less similar to the proposal in the consultation document. The physical presence of sales activities in the same jurisdiction does not attract additional profit allocation to that jurisdiction.

The low and medium-risk routine profits, as well as residual profits, are combined in one 'basket', and allocated to taxing jurisdictions based on the number of employees (other than those involved in marketing and sales) physically present in that jurisdiction. If, out of a total worldwide workforce of 24,000 for the MNE (not including sales/marketing functions), 1200 employees (not including sales/marketing functions) are located in country X, then 5% of the total basket of routine non-sales and residual profits would be allocated to country X. This would be true irrespective of whether country X is the 'home country' of the MNE and irrespective of whether the 1200 employees in country X represent low, medium or high-value functionalities. Consequently, countries that only host low-risk routine functions earn an equal (proportionate) share of the medium-risk and residual profits as countries that predominantly host high-value creating functions. If the MNE were also to realize a sales volume of 5000 in country X as a market jurisdiction, out of a total sales volume of

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[2] For the purposes of determining a proper routine profit, a further analysis of functions performed within the separate business lines of an MNE might be required. See the publication referred to in footnote 1 for further details about this approach.

[3] This physical presence could be located in a market jurisdiction or in another jurisdiction.

50,000, then 10% of the deemed sales profit (e.g. 3% of 50,000 = 1500; 1500 x 10% = 150) would be allocated to country X as well.

As a final numeric example[4], if we assume, out of a total consolidated worldwide taxable MNE profit of 3000:
- a deemed low-risk routine profit of 250;
- a deemed sales profit of 1500;
- a deemed medium-risk routine profit of 500;
- hence a deemed residual profit of 750;

the 1500 deemed sales profit would be allocated to the consumer market jurisdictions, proportionate to the relative sales volumes (turnover) in those jurisdictions, and the other 1500 of profits, which includes the 750 residual profit, would be allocated (on a proportionate basis) to the jurisdictions in which the MNE's employees (other than marketing/sales) are located.

If, in this same example, the MNE earned a total consolidated worldwide profit of 1200, then only the deemed low-risk routine profit of 250 would be allocated to the jurisdictions in which the MNE's employees (other than marketing/sales) are located, and only 950 of deemed sales income would be allocated to the market jurisdictions.

4. Benefits of this alternative approach

Adding two more layers of deemed income (i.e. deemed sales income and deemed income from medium-routine activities) to further refine the Secretariat's proposals in the consultation document would simplify the allocation of the tax base to market jurisdictions, as it would avoid the highly complex issues addressed in paragraphs 57-59 related to distinguishing between 'w' and 'v'. It would also no longer be necessary to isolate functionalities around intellectual property and to allocate these to jurisdictions, as this would no longer be relevant for the attribution of income. At a more conceptual level, this alternative approach would move away from the historic residence country/source country principles, as residence would no longer constitute a nexus.

Obviously, in this alternative approach inter-company transactions would no longer play a role in the attribution of income, hence finding an appropriate 'price' in relation to these transactions would be unnecessary. Transfer pricing would predominantly serve to arrive at a proper distinction between business lines and the functionalities within business lines, and the purpose of transfer pricing would thus be to set a proper mechanism around 'cost base' and 'profit margin' in relation to the low/medium-risk routine functions and the marketing/sales functions found to be present in these business lines. By making the location of IP and related DEMPE functionalities irrelevant, as well as inter-company transactions as such, including financing transactions, I believe this alternative approach will leave less room for MNEs to influence their effective tax rates. Consequently, this alternative approach may also have an impact on (the need for) Pillar Two.

Where the consultation document applies a percentage ('z') of total global profits to find a proper compensation for baseline routine functions ('x'), the amount of this routine profit would, in fact, fluctuate with the global profit margin and the amount of total global profits of an MNE, which in my

[4] For more detailed numeric examples, see the publication referred to in footnote 1.

view would not be commensurate with the nature of low/medium-risk routine functions (including sales) as such. In my alternative approach, residual profit is the only element that fluctuates with the profit margin and the amount of the total profit, whereas routine profits (including sales profit) only correspond with total profit in the sense that these routine profits cannot exceed total global profits.

Another important benefit of this alternative approach would be the enhanced international solidarity resulting from a mechanism in which (i) each market jurisdiction would earn a fair, stable share of the MNE's profits, irrespective of physical presence, and have priority over the allocation of residual profit to taxing jurisdictions, while (ii) each jurisdiction[5] that forms part of an MNE's global physical footprint would be remunerated for the blended profits related to routine functions and receive its fair formulaic share of residual profit on top of that. In my view, this is a more balanced approach than the current concentration of residual profit in the home country of the MNE or in the country in which its main IP assets are located and managed, which, despite being a current shortcoming of the domestic corporate tax systems, is to a certain extent still part of the proposals in the consultation document. A positive side effect of this approach is that no additional formula apportionment would be required to allocate routine profits to taxing jurisdictions, as, apart from the allocation of sales income to market jurisdictions, only one formula would be required to catch routine as well as residual profit.

Furthermore, in this alternative approach, and based on the assumption that jurisdictions would apply the same harmonized formulas as stated above, double taxation should no longer occur in relation to these participating jurisdictions. Therefore, the double taxation and dispute resolution issues presented in the consultation document around 'Amount C' would be avoided.

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[5] Hence, compared to the consultation document, a wider group of jurisdictions than market jurisdictions only.