THE 100 GROUP

Taxation Committee

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

By email: TFDE@OECD.org

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Dear Sirs

Public Consultation Document - Addressing the Tax Challenges of the Digitalisation of the Economy

We welcome the opportunity to comment on the OECD public Consultation Document 'Addressing the tax challenges of the Digitalisation of the Economy'.

The 100 group is a representative body made up of large UK businesses from a variety of sectors. The vast majority of our members are multinational groups and as such these proposals have the capacity to impact them significantly. Whilst the specific impacts may vary from business to business there is a broad consensus across our membership on the principles that should govern any reform. The main focus of our response is on these principles rather than any business or sector specific impacts.

The consultation itself is at a high level and the timescale for responses relatively short. Both of these factors mean that many businesses will not have time to think through the proposals and their implications in full. We think that all options warrant further consideration. We think this particular consultation should be used to inform further debate and development. The OECD should also keep the door open to new solutions not currently being considered to the extent any become evident during the consultation and further development.

We recognise that the digital economy and how it is taxed is of concern to governments around the world and this has led to a proliferation of unilateral and uncoordinated measures. The number of these unilateral measures has been gradually increasing but started with the introduction of the Diverted Profits Tax in the UK in 2015. This was quickly followed by a similar measure in Australia in 2016. Since then different jusridictions have introduced or are considering measures targeted more specifically at digital activity, for example, India, Israel and Italy. Other jurisdictions are considering changes including the UK's proposal for a Digital Services Tax based on user participation. The more this continues the more it is likely to affect economic decisions and behaviour and produce market distortions. We therefore think that the work the OECD is undertaking to move forward on an international consensus solution is vitally important. We recognise the need for taxpayers and governments alike to arrive at a workable solution as soon as possible.

Summary comments

In our view any solution should be built on the principles of certainty and consistency, eliminating double taxation, and minimising disputes. Across both pillars and all solutions the primary concern of our members is that any risk of double taxation is eliminated using a robust, mandatory and binding dispute resolution process that can provide both certainty and timely outcomes.

In relation to the Pillar 1 proposals, a number of key concerns underpin them all as follows:

- There must be consistency across all jurisdictions and all aspects of the project. In our view this starts with consensus on the issues that this project is seeking to address, continues through the definitions applied and measurements adopted in any final solution, and extends to how the solution is administered.
- In our experience, most businesses are relatively agnostic as to the location in which a tax burden might arise but they are clear that they should only pay tax once on their profits. This principle must be adhered to if a workable solution is to be found and key to this will be the dispute resolution mechanism. It is critical that any solution has a robust mandatory dispute resolution mechanism that is binding on the parties concerned. We include more detail on dispute resolution later on in the paper.
- The solution that is ultimately proposed should maintain economic integrity by which we mean that it should be aligned with economic decision making and produce results that are coherent from a real world perspective. Proposals that build on the Arm's Length Principle (and therefore respect economic rationality) are seen as being more workable than those that adopt a formulary apportionment approach or an arbitrary allocation key in a residual profit split.
- There is a tension between the more formulaic approaches outlined in the paper and approaches which build on more traditional methods of transfer pricing. The paper implicitly assumes that a more formulaic approach may increase simplicity and reduce controversy however this is only true to the extent that (a) international consensus can be built around mechanistic approaches (eg allocation keys) which has historically not been the case; and (b) the simplicity provided by such an approach more than makes up for the distortions that it will inevitably produce.
- Current transfer pricing models allow the reward for contributions to value to lie with the source (or development) jurisdiction. Under all of the proposals, the reward for these activities will shift to a greater or lesser extent to the market jurisdiction. The paper is broadly silent on how contribution and/or development costs will be rewarded under these alternative proposals. Often development costs will have a higher risk profile, be early in the life cycle and involve aborted spend. Any solution needs to ensure this is rewarded to ensure that the incentive to innovate is not diluted.
- Any solution should also be efficient so that it does not act as a barrier to trade or economic decisions. The cost/benefit of implementing must make sense for governments and taxpayers alike. Compliance burdens should be manageable so as not to disincentivise businesses from operating in any given economy (this is especially true for smaller economies).
- Consideration should be given to whether thresholds would be beneficial and whether those thresholds should be applied on a global or a country by country basis.

- Any solution should replace and not supplement existing unilateral measures. There should be a clear commitment from jurisdictions involved in the Inclusive Framework to repeal unilateral measures once an international solution has been found.
- Wherever possible the OECD should take this as an opportunity to simplify the international tax system.

In relation to Pillar 2 we believe there are arguments for this to be put on hold pending the rest of BEPS bedding down so that the need for any Pillar 2 measure can be properly assessed. The interaction with Pillar 1 is not clear and ultimately any Pillar 1 solution would impact significantly on how Pillar 2 might operate in practice.

Questions for public comments

1. **What is your general view on those proposals? In answering this question please consider the objectives, policy rationale, and economic and behavioural implications.**

User participation

Approach

The first proposal around user participation adopts a form of ring-fencing although we note that the OECD has previously concluded that it is not possible to ring-fence the digital economy. The reason for the change of approach is not clear from the document.

The approach targets certain business models whilst not reflecting that digitisation may occur throughout a given supply chain or operating model. This will lead to different taxation approaches for businesses within the scope compared to those outside of the scope of this approach and could lead to an uneven playing field between the two types of business.

The key practical concern with this proposal is that it adopts a series of definitions that will need clarity and focus if the approach can be applied with any certainty.

The definitions in this document are aligned with those in the UK's proposals for a Digital Services Tax (although the latter is based on revenues). From our work considering the UK DST proposals many businesses with traditional business models rather than 'digital' business models are concluding that they may be inadvertently caught by the scope of the proposals. The definitions adopted have broader application than the stated policy intent implies. In practice the proposals are raising complex boundary issues and significant reliance will need to be placed on subjective judgements.

In the context of applying this to an international tax system, boundary issues and the use of subjective judgements will trigger multiple taxation with the consequential disputes.

Furthermore, a definitional approach of this nature is unlikely to be flexible in adapting to future business model developments and it may therefore become rapidly obsolete. In our view, even if the rules could be carefully drafted to narrowly target 'digital' business models, they would rapidly stop capturing those businesses as their models developed and would progressively catch more and more traditional business models.

As a result, if this method were to remain viable for a sustained period it would need regular updating or it would lead to a further rash of unilateral measures by governments.

One core element of the proposals is the need to identify and track users by location. This raises conceptual and practical issues which range from how a user is defined (eg how to distinguish an 'active' versus a 'passive' user, and does a user have to be human?) to practical matters regarding tracking.

Many businesses potentially within this approach will not currently track the location of the user because such information is not critical to their business model and is not required in order to provide the relevant service to the user. Doing so would entail a considerable compliance burden, including building systems to *try* to track users.

Further, it is difficult to identify user locations to any degree of accuracy. For example, a high proportion of individuals access digital platforms through VPNs or other routes that legitimately mask their location. There are also significant data privacy and security issues regarding tracking users (eg EU GDPR and similar regimes elsewhere).

Methodology
The methodology in the OECD document allows the allocation of non-routine or residual profits to users based on a simple pre-agreed percentage (though we note that there is no indication as to how such a percentage would be arrived at, nor are there any academic studies supporting such an allocation to users). It also allows the allocation of 'user profit' to jurisdictions on an agreed allocation metric such as revenues. This essentially brings in elements of formulary apportionment.

The paper implies that this would be a pragmatic approach but, as explained above, it will be very difficult to 'approximate the value of users' in practice. Any form of formulary apportionment approach is always a blunt tool but in this situation it would be applied to a sub-set of data that has already been subject to the application of a pre-agreed percentage. As the data set is repeatedly narrowed through inaccurate filters the likelihood of the process producing results that are at a variance with economic reality increases. Achieving consensus on such an apportionment basis would, we think, be very difficult to achieve.

It is also not clear how complexities such as losses or start-up costs should be treated. It is not clear how ongoing maintenance costs of the user base should be allocated (ie should this be on a global or a country by country basis) and whether that choice would result in arbitrary importing or exporting of these costs between jurisdictions.

Marketing Intangibles

Approach
The Marketing Intangibles approach changes allocation and nexus rules as the user participation proposal does, but with a wider reach. In our view this Pillar 1 proposal is the most likely to achieve international consensus although some members would prefer to see a hybrid approach that

considers different elements of the three Pillar 1 options, provided such a solution could be sufficiently narrowly scoped and clearly defined

It potentially applies to data, relationships or anything that contributes promotional activity. It therefore has the capacity to impact on traditional models, for example, where the brand is maintained through on-line means.

One of the benefits of this approach is that it does not seek to ring-fence digital activities and therefore may better reflect the way in which digitisation is increasingly impacting across business models rather than in specific defined ways (as the user participation approach implies).

One key area that will need to be developed is to clarify what is included within the definition of a 'marketing intangible' and how a marketing intangible differs from a 'trade intangible'.

One particular point that has been raised by many members is how R&D or other costs of development should be treated under this proposal. Under current pricing approaches the rewards from these contributions are taxed in the jurisdiction which incurred them. However, there is a danger that the marketing intangible approach will lead to a disproportionate reallocation of at least some of those rewards to the market jurisdiction.

This could produce spurious results. For example, a pharmaceutical group could find its global profits allocated to jurisdictions where the majority of its patients are resident without any acknowledgement for the R&D spend involved in the relevant drug development. This could disincentivise development.

In this example the market jurisdiction would also benefit from the R&D spend via non-tangible rewards of, for example, a cure and/or improved health of its citizens. How should this be acknowledged within the pricing models proposed?

There is no detail in the document on how the investing location incurring the bulk of the costs and risk of innovation (including failed innovation) would be rewarded.

This is particularly relevant in long life development projects. Often the earlier spend in the life cycle is the most speculative and attracts the highest risk and if this is not properly rewarded in the source location it runs the risk of undermining economic decision making and could act as a disincentive to investment both for the taxpayer and also for government who will stop encouraging investment. For example, if a group spends £1 on highly speculative R&D at an early stage in the lifecycle and spends £2 on advertising much later in the lifecycle when the product is approved (and is formally ready to go to market), does this mean that 2/3 of the profit on that product should be attributed to the marketing intangible created by the advertising rather than to the actual product R&D, which might be speculative and ground breaking? Without thorough consideration of how to treat development costs, including the time value of money involved in development of long lifecycle products, this approach runs the risk of elevating one element of the value chain economically and producing incoherent results when considered across the entire operating model.

Thought will also be needed as to whether allocation of costs should be on a global or a country by country basis. If done on a global basis using a relatively arbitrary profit split this could lead to distortive outcomes.

It is easier to see how the methodology would apply to more 'traditional' marketing spend such as advertising or brand development, which occurs later in the life cycle and comes to fruition more quickly. Even here, however, there are questions. Often businesses will apply global brand development or advertising campaigns (which may be tailored in terms of language but the core campaign is multi-jurisdictional). How should this cost be split between jurisdictions? Does a global advertising campaign get treated differently to a local execution campaign?

This may to some extent be resolved by careful articulation of the difference between a marketing and a trade intangible. However, there will be some situations where the distinction is not clear. For example, where product development is inextricably linked to its marketing (eg low-fat products or gluten free products etc).

In places the document seems to make the assumption that the use of Limited Risk Distributors (LRDs) is primarily a tax motivated choice. There are many examples of third party distributors acting with similar functional profiles to LRDs. The use of LRDs is often driven by commercial reasons (such as ensuring that stringent regulatory standards are upheld across the globe). Care needs to be taken that the use of LRDs is understood before introducing proposals that impact on such arrangements.

The document seems to be written with B2C businesses in mind and it is not clear how B2B business models would be impacted or whether the intention is that B2B models are excluded. As a matter of principle we consider that activities that have the same underlying activities should be taxed in a consistent manner.

Methodology

The document seems to prefer a formulary apportionment approach by stating that the more the determinations are based on conventional transfer pricing analysis the greater the risk of disputes and uncertainty. However, formulaic answers will be reliant on political agreement around allocation keys and weighting which have historically proved difficult to reach. The result from applying a formulaic approach may also produce results that deviate from the economic reality. Many taxpayers may prefer to adopt a profit attribution method that aligns with existing transfer pricing principles and the Arm's Length Principle, as being closer to economic reality and being more 'tried and tested' in terms of approach. The benefits of using principles that align to economic reality should not be underestimated.

We are concerned by the potential for this approach to result in the allocation of significant levels of profit to marketing intangibles which could lead to results that arguably turn the Arm's Length Principle on its head. An alternative is to somehow minimise the economic distortions that could happen in allocating profits to marketing intangible by calculating this first and then allocating any residual element to a trade intangible. Or it could be done by taking a relatively modest proportion of residual profit to the Marketing Intangible leaving the bulk to be allocated in accordance with the Arm's Length Principle.

The allocation of marketing profit across jurisdictions based on relatively blunt measures (eg sales or revenues) runs the risk of failing to adequately reflect the actual contribution of particular markets to the global profitability of an MNC. It could shift the benefit of such a contribution from one jurisdiction to another which is likely to create more disputes as governments seek to be more fairly rewarded for the contribution they perceive to have been made by their jurisdiction. It also ignores geographical profit margin deviations which can vary depending on market conditions.

The proposal states that all other income would not be affected and we think that further guidance is needed on the interaction of this statement with the split of Marketing Intangibles and Trade Intangibles and any profit split methodology.

The Marketing Intangible approach arguably allows a more flexible (and therefore more sustainable) approach and it has the advantage of building on the existing Arm's Length Principle which gives increased certainty to taxpayers and increases the chances that the solution will be more aligned with economic reality. However, it does allow non-routine work to be taxed regardless of ownership, DEMPE functions or where the risk is controlled or managed.

Significant Economic Presence

The third proposal, Significant Economic Presence, takes the premise that existing nexus and profit allocation models are out of date and a company can be involved in the life of a jurisdiction without physical presence. To establish a Significant Economic Presence would require revenue on a sustained basis but also, some form of persistent interaction with the relevant jurisdiction.

The paper sets out a few factors that might be considered to establish nexus but is relatively short on detail which makes it difficult to comment. We think the lack of detail also reflects that this option is the proposal which is least developed and therefore the least viable in its current form. It does more generally lead to concerns that this approach has the potential to combine a low bar (eg when a website in a local language is maintained) with a broad base.

At its core this third option represents a global formulary apportionment basis of taxation. It could be attractive as (if it was implemented with very strong international consensus) it might carry relatively straight forward compliance burdens. However, it would need the highest level of international agreement and the general view of our members is that it is unlikely to attract the necessary political consensus. There have been various attempts at applying different types of formulary apportionment over the years and none have proved successful because consensus has not been forthcoming. There is no particular reason to believe that a different result would be obtained today.

Furthermore, even if consensus could be obtained formulary apportionment and the use of allocation keys is considered a blunt tool that could trigger behavioural responses. Using an approximation to allocate profits to a jurisdiction would produce results that do not reflect the economic reality of where innovation or high value activity takes place. It could encourage businesses to use third party distributors if the formulary apportionment adopted was perceived to produce an unfair result. It would also fail to acknowledge other practical issues such as differing profit margins.

The document mentions using WHT as a collection and enforcement mechanism which might be applied at a low rate but on, for example, gross sales. WHT is already applied to items such as dividends and interest and does cause significant compliance burdens and double tax concerns in global supply chains. The proposal to apply it to business expenses rather than merely to returns on capital investment would extend its use significantly and could cause disruption in supply chains.

It is also possible to have WHT filing obligations in relation to relatively small amounts which may raise concerns as to the cost benefit analysis of doing business in a particular jurisdiction.

2. **To what extent do you think that businesses are able, as a result of the digitalisation of the economy, to have an active presence or participation in that jurisdiction that is not recognised by the current profit allocation and nexus rules? In answering this question, please consider:**

   i. To what types of businesses do you think this is applicable, and how might that assessment change over time?

   ii. What are the merits of using a residual profit split method, a fractional apportionment method, or other method to allocate income in respect of such activities?

   See above comments under question 1.

3. **What would be the most important design considerations in developing new profit allocation and nexus rules consistent with the proposals described above, including with respect to scope, thresholds, the treatment of losses, and the factors to be used in connection with profit allocation methods?**

We would draw your attention to the points of principle already set out at the start of our response.

- Any solution must attract a broad consensus and consistency of approach across all aspects to minimise distortions and behavioural impacts.
- There should be a commitment to repeal unilateral measures when a solution is found. For businesses, the worst case scenario would be to have an international consensus tax and country specific unilateral measures.
- Any solution should support simplicity and certainty. This will be aided by having clear and well targeted definitions around scope.
- Any solution should be sustainable in that it is flexible enough to cater to further developments in digitisation of the economy. Any new profit allocation and nexus rules should respect the Arm's Length Standard. We believe that there will be more support for solutions that closely align with existing transfer pricing frameworks and the Arms' Length Principle. These are concepts that are well understood and are considered to track economic reality.
- At the same time the changes should not impact on business models which are already aligned with economic reality and are adequately dealt with under existing frameworks.

- Any solution should ensure that profit is taxed once and only once. In order to ensure that this happens and disputes are minimised will require a consistent implementation globally and a high degree of international consensus across a number of fundamental issues such as the calculation of the tax base.
- In order to facilitate this we think a mandatory and binding dispute resolution process should attach to the solution. The process needs to encourage taxpayers and governments alike to settle disputes reasonably and quickly.
- Compliance burdens should be minimised by ensuring that definitions and scope are clear. Where possible the solution should be capable of implementation by an MNC on a global basis (ie involving one exercise rather than multiple exercises).
- Linked to this the approach should as far as possible use existing reporting frameworks (eg be linked to audited financial statements, country by country reports etc). However they should be capable of being flexed for specific MNC approaches (for example by using management or product line information) where appropriate.
- Any timeline for introduction should allow businesses the time to implement the necessary management information system changes.

In terms of implementation matters:

- The solution needs to recognise and properly reward investment and set up costs as well as ensuring relief for losses.
- Some sectors or businesses are subject to specific tax regimes or are subject to ringfencing or specific regulatory provisions (including the extractives industry, shipping, and financial services). The interaction of any proposed solution needs to consider the potential impacts on such sectors and/or businesses with the objective of ensuring double taxation does not arise.
- The interaction with other taxes needs to be considered in particular WHT, VAT and customs duties.
- The document is silent on what happens to asset ownership as a result of these proposals and therefore whether an allocation of profit would result in a jurisdiction gaining the right to impose capital gains taxes or exit charges.

4. What could be the best approaches to reduce complexity, ensure early tax certainty and to avoid or resolve multi-jurisdictional disputes?

We believe that there are a few areas where it will be important to have consensus in order for any of the proposals to be workable.

Close international alignment within definitions and approach

Moving to forms of residual profit split (or the Significant Economic Presence approach) will require a close alignment and consensus around various points, in particular the tax base. If there is no consensus on these types of matters then we do not see a practically viable solution emerging.

We think the outcomes of this work stream should be consistent and aligned with the outcomes from the BEPS project which represents a set of principles where international consensus has already been reached and therefore would seem to be a sensible building block on which to develop these proposals. Without this there will be an increase in double taxation, an increase in disputes and therefore an increase in uncertainty for taxpayers. All of these will represent negative outcomes for global businesses and the trade they undertake.

Robust dispute resolution

Without a strong resolution framework any proposal will lack certainty for taxpayers.

There is already an uptick in international disputes arising from the existing BEPS changes and on average a dispute can take 48 months to resolve.

Any of the proposals set out in the document (under either of the Pillars) will result in additional complexity and therefore a risk of increased controversy. It is important that any solution is accompanied by a mandatory robust and binding dispute resolution process that is multilateral and not bilateral.

There should, in our view, be a formal body that is responsible for ensuring that tax authorities and taxpayers alike are adhering to the principles of any solution. This formal body should be part of a recognised and respected international organisation such as the OECD or the WTO. In order to ensure that all jurisdictions are invested in the process being as efficient as possible and not disrupting trading patterns, taxpayers should be able to stay any instances of double taxation until the dispute has been resolved. This could be done by, for example, allowing taxpayers to pay in accordance with filed returns until a formal judgement is received from the panel. This would not unduly favour taxpayers as they will still be paying tax based on a 'single taxation' principle. In many cases a finding from the panel is likely to be a reallocation of that tax cost rather than a completely new tax cost. We think there should be some form of peer review process in order to encourage the consistent application of the principles by all concerned.

Leveraging existing reporting

It would be helpful to leverage existing reporting such as audited financial statements prepared under international accounting standards and other reports such as CbyC reports.

However, the solution should also acknowledge that businesses may report in different ways. Not all MNCs report by entity, some will report by business or product lines, and therefore the ability to rely on segmental information and other forms of management information may be needed.

Questions for public comments

1. **What is your general view on this proposal? In answering this question please consider the objectives, policy rationales, and economic and behavioural implications of the proposal.**
2. **What would be the most important design considerations in developing an inclusion rule and a tax on base eroding payments? In your response please comment separately on the undertaxed payments and subject to tax proposals and also cover practical, administrative and compliance issues.**
3. **What, if any, scope limitations should be considered in connection with the proposal set out above?**
4. **How would you suggest that the rules should best be co-ordinated?**
5. **What could be the best approaches to reduce complexity, ensure early tax certainty and to avoid or resolve multi-jurisdictional disputes?**

In their responses commentators are invited to draw on experiences from the operation and design of existing rules that they consider would be helpful for this discussion.

The document acknowledges that the BEPS project has aligned tax with value creation and closed gaps in the international tax system. However, certain members of the Inclusive Framework consider that these do not go far enough and risks continue to arise from profit shifting, particularly in connection with intangibles.

BEPS is still quite new and not all of the measures have yet been fully implemented. We consider that BEPS has been very effective and that profit shifting is now very rare. The BEPS project was instrumental in ensuring that groups addressed issues of substance and ensured that tax is aligned with value creation, however in some jurisdictions the changes are ongoing and still bedding down. Whilst it is worthwhile working through the proposals on Anti-base Erosion as part of this consultation process we do think that longer should be given for the results of BEPS to become clear so that the case for these rules (which will introduce yet more complexity and compliance burdens) can be properly evidenced.

It is not clear from the document how Pillar 1 and Pillar 2 would interact and whether the OECD is considering introducing either a Pillar 1 or a Pillar 2 solution or whether it is considering both. In our view the proposals should be decoupled. If Pillar 1 and Pillar 2 proposals are introduced then this will drive complexity and uncertainty, making compliance overly onerous and double taxation highly likely.

We are concerned about both of the Anti-Base Erosion proposals in terms of the behavioural impacts they could drive. For many countries corporation tax is a powerful policy lever for inward investment which many jurisdictions, particularly smaller economies, rely on. These proposals run the risk of removing the ability of governments to exercise sovereign control over their tax policies.

Although this might be perceived as a measure that targets ‘tax haven’ jusridictions or those countries that enter into harmful tax practices it has the capacity to have a much broader and invasive impact. For example, the recent US tax reform introduced a 100% year 1 deduction for certain items of capital expenditure. This could drive the effective tax rate for a US business to below the minimum tax threshold in a year of capital spend. In a situation where the US Company is UK headquartered, the

UK would presumably record an income inclusion and pay additional taxes to compensate for the low US tax burden.

In the following years, the US business will face a higher effective tax rate because there will be no further tax write-downs (accounting write-downs would continue). Therefore in future years the US tax rate would be artificially inflated above the minimum threshold. No additional UK tax would be necessary in later years however the overall result would be that there has been an element of double taxation.

This could, in theory, be alleviated by introducing a system by which the UK would repay the additional year 1 tax over the following years, but this would seem impossibly complex to apply in practice and there would be concerns as to how willing a tax authority would be to release such tax unless these additional tax payments and refunds were supervised by an international body.

In any case, the overall result would be that the incentive introduced by the US government will have proved powerless as a policy lever and will in fact have relocated tax payments to another jurisdiction.

It is possible to see how similar results might arise in other incentive regimes adopted by G20 countries.

Essentially, therefore, the question becomes what exactly these proposals are intended to target – is it the ability of a government to use tax policy as an economic tool or is to prevent behaviour that is internationally viewed as unfairly harmful? Also, how is the difference between the two articulated both in terms of principle and practical application of proposals such as the ones in the paper?

The document states it is not intended to impact on genuine economic or business location decisions without expanding on how this will be done. But the premise of the proposals is that businesses are making location decisions based purely on tax. In our experience businesses make decisions on other factors such as availability of talent, infrastructure, political and fiscal stability, time zones etc. Tax may influence a decision but a business is more likely to look for a tax jurisdiction that provides certainty, predictability, and an administration that is efficient rather than one which offers the lowest tax rate.

These proposals need to acknowledge that governments seek to incentivise inward investment through tax policy.

International consensus may be lacking if governments perceive these measures as a threat to their own tax policies where the result is to export the tax savings in their country to one imposing a minimum tax or income inclusion rule.

Many countries will want to keep the ability to compete for investment and the point at which this becomes something that needs to be countered is not clear from the document. Implementing these measures may make governments look for alternative ways of incentivisation through non-tax measures, perhaps moving to a grant system (which, if anything, would be less transparent).

The other key concern that runs across both of the Pillar 2 proposals is the lack of detail in the paper as to definitions. For example, there is no information on whether minimum tax rates would be based on effective rates or statutory rates and whether calculations would use accounting profits, taxable profit, etc. There is also no information on how economic losses that legitimately shelter profits would be treated.

The interaction of Pillar 1 with Pillar 2 and the complexity this has the potential to cause is of particular concern to our members and our comments on Pillar 1 in relation to the need for a binding mandatory arbitration process to resolve disputes are relevant for this part also.

Both proposals need to consider whether exemptions are necessary for certain sectors or industries. We have not considered this specifically in our response.

Income inclusion rules

The effectiveness of any income inclusion rule will be driven by how many jurisdictions implement it and how they implement it (ie with a narrow or broader scope). Differences in the existence or scope of an income inclusion rule could lead to an uneven playing field for those MNCs that have their parents in a jurisdiction that implements such a rule.

The intention seems to be to draw on aspects of the GILTI regime in the US. It is hoped that the reforms in the US would also inform some improvements that could be made. For example, the GILTI regime is intended to apply a minimum tax of 13.25% however expense allocation and the foreign tax credit system means that this does not necessarily apply in practice.

It is not clear whether the income inclusion calculations would be done on an entity by entity basis (effectively country by country) or a global /consolidated basis. A country by country approach would effectively lead to a blacklist and care would be needed to ensure that legitimate flows through low tax jurisdictions (eg in investment fund situations) are not caught.

The document states that this rule would sit alongside existing CFC rules rather than replacing them which could lead to complex implementation issues and again, there may be lessons that can be learned from the US GILTI regime.

Base Erosion payments

The Base Erosion payments proposals would mean that the taxpayer either loses access to treaty benefits or loses deductions if the payee is not taxed at a minimum rate.

The proposal is based on assessing whether payments are subject to a minimum tax rate however it does not set out whether such a rate is a statutory rate or an effective tax rate. If a statutory rate approach is chosen then this will lead to a blacklisting situation where payments to certain jurisdictions are disallowed. However an effective tax rate system would be complicated to apply and could lead to MNCs having to calculate effective tax rates on an accounting period by accounting period basis (with no up-front certainty at the time of entering into a transaction). Losses, start-up costs and timing differences would need to be considered. If these proposals were implemented in conjunction with a Pillar 1 proposal then consideration would need to be given to how any Pillar 1 adjustment would impact on the minimum tax calculation.

The consultation also anticipates turning off the base erosion payment rules for payments made to MNCs based in jurisdiction with strong inclusion rules – but this will inevitably lead to a 'white list' of countries.

Any measure would also need to incorporate safeguards to ensure that legitimate payments are not mixed or confused with base erosion payments. To the extent any payment represents an expense that properly rewards costs or contributions from another jurisdiction it is not clear why the amount should be disallowed purely due to minimum tax concerns, especially as BEPS should have ensured that the payee has genuinely contributed value.

Lessons could be learnt from the BEAT rules in the recent US Tax Reform which included an exemption for costs of goods sold but did not include any exemption on services. There is no obvious policy rationale to discriminate against businesses engaged in the provision of services rather than manufacturing.

Inevitably some consideration will also need to be given to exemptions and carve outs. For example, payments made through investment fund structures will often pass through low tax jurisdictions but the purpose in doing so is to minimise tax leakage on cash or profit repatriation to the ultimate investors, the intention being that the ultimate investor is subject to tax in their home location. The rules should not disallow such payments (which could be the case where the fund is relatively widely held and therefore falls outside of related party or common control provisions). In addition where the ultimate fund investor is a legitimately exempt investor (eg a pension fund) such payments should not be disallowed.

The paper sets out that the rule should cover conduit or imported arrangements and this will involve taxpayer looking along chains of economically connected payments. This will increase the complexity of applying such a rule. Similar principles in the anti-hybrid rules introduced in the UK led to some unintended consequences.

Concluding comments

We trust the above comments are of use to you as you consider the proposals further. Please feel free to contact me at chris.oshea@100group.co.uk should you wish to discuss our comments further.

Yours faithfully

Chris O'Shea

Chairman
Tax Committee

Who we are:
The 100 Group of Finance Directors represents the view of the finance directors of FTSE100 and several large UK private companies. Our member companies represent almost 90% of the market capitalisation of the UKFTSE 100 Index. Our aim is to contribute positively to the development of UK and international policy and practice on matters that affect our business, including taxation, financial reporting, corporate governance and capital market regulation. Whilst this letter expresses the views of the 100 Group of Finance Directors as a whole, those views are not necessarily those of our individual members.