HOUTHOFF

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Re: OECD's public consultation document Secretariat Proposal for a 'Unified Approach' under Pillar One

Dear Madams, Sirs,

Thank you for the opportunity to comment on the OECD public consultation document *Secretariat Proposal for a 'Unified Approach' under Pillar One* (the 'Unified Approach').

In our view, the OECD's approach to developing a consensus-based 'Unified Approach' that reflects the commonalities of the three alternatives set out in the Programme of Work under Pillar One is the proper way to capture the strengths of the three alternatives in one single approach.

Subsequently, we would like to mention that we support:

a. applying the arm's length principle ("ALP") as the overarching principle to arrive at transfer-pricing outcomes that are in line with value creation;

b. the concept of permanent establishment ("PE") to allocate taxing rights to a jurisdiction in the absence of a legal entity to carry on business activities locally, as this concept provides a clear direction of which minimum level of business activities carried out locally results in a local taxable presence;

c. allocating profits to a market jurisdiction in all cases where a business has a sustained and significant involvement in a market jurisdiction's economy, even in the absence of a physical local presence/nexus.

In this respect, the possibilities to adapt the ALP principle and PE concept to capture profits earned in the market jurisdiction and to be allocated to the market jurisdiction have been explored in depth in the past. These efforts have resulted in concrete amendments to the relevant concepts. For instance, further guidance on applying the ALP to intangibles was agreed and included in the 2017 OECD TP Guidelines. Furthermore, the definition of PE has been broadened as a result of BEPS Action Plan 7, the outcomes of which have been integrated in the 2017 OECD Model Tax Convention and in Part IV (Articles 12 to 15) of the Multilateral Instrument ("MLI").

Considering this, the Task Force on the Digital Economy ("TFDE") deliberately adopted the 'Unified Approach', which departs from the ALP and does not include an extension, e.g. widened scope, of the PE concept. This implies that the OECD admits that it is rather difficult or even impossible to allocate profits to a market jurisdiction in the absence of a local physical presence there using a modified PE concept and a modified ALP. It is important to realise that departing from the ALP (a concept that the OECD has heavily defended in the past) could be the beginning of the end for the ALP. Without strong political support at a global level, this rather radical development could undermine the power of the imperfect but best functioning concept (i.e. ALP) which could be difficult to repair.

Below, we have detailed our views and findings on: 1. Scope, 2. New nexus, 3. Calculation of group profits for Amount A, 4. Determining Amount A, 5. Eliminating double taxation for Amount A, 6. Amount B and 7. Amount C/dispute prevention and resolution.

1. SCOPE

a. **Interaction with consumer/users:** Amount A would broadly focus on large consumer-facing businesses (including user-facing businesses). To allocate the new taxing right to the market jurisdiction for Amount A, it seems appropriate to require a certain consumer/user facing element to create a taxable presence in the market jurisdiction for a foreign enterprise. Such a consumer-facing element would also have some commonalities with the dependent agent under the PE concept since such a dependent agency PE also, although implicitly, entails a consumer/user-facing element. However, if the purpose of the new taxing right is to tax digital businesses which would not otherwise be taxed, this consumer/user-facing element should not be exclusive or at least should be very carefully defined so that it does not result in unintended consequences. There are some digital businesses which do not necessarily require direct interaction with the consumer/user but their business models are largely or fully digital. For instance, payment platforms enable consumers to buy and sell goods and services and receive a commission on the transaction's value. The other important aspect of this is in relation to B2B interactions. With the proliferation of digital apps and platforms, B2B interactions may happen more and more without any physical contact or interaction. With the current pace of change in the global economy and business models of multinationals, an approach requiring consumer/user contact may not serve the full purpose now or it may be obsolete for B2B in the near future.

b. **Defining the MNE Group:** For consistency, it would be appropriate to align with the 2017 OECD TP Guidelines, which defines an MNE Group in its glossary as "A group of associated companies with business establishments in two or more countries." In particular, a different definition for the Unified Approach Proposal could increase complexity.

c. **Covering different business models (including multi-sided business models) and sales to intermediaries:** Intermediaries often sell on their products to end consumers/users. Typically, these intermediaries have their own local taxable presence in the market jurisdiction as a result of operating their businesses through a legal entity or a permanent establishment. As such, local taxable presence in the market jurisdiction would generally already exist at the level of the intermediary, which is the party with a consumer-facing element (and not the foreign enterprise selling its products/services to an intermediary in the market jurisdiction). The profits that the foreign enterprise received when it sold to the intermediary are already taxed in its home state jurisdiction. As such, both the market jurisdiction and home state jurisdiction would be allocated taxing rights.

d. **The size of the MNE Group, taking into account fairness, administration, and compliance cost:** Aligning the threshold with the EUR 750 million consolidated revenue threshold used for Country-by-Country Reporting ("CbCr") requirements would limit administration and compliance costs for many 'medium-sized' MNE Groups. This could also result in synergies for MNE Groups in preparing financials for calculating Amount A and for CbCr. Nevertheless, from a fairness point of view, it would be appropriate that 'medium-sized' MNE Groups with consolidated revenues of, for example, EUR 250 million or more are included in the scope. In today's economy, it is possible to have more medium-sized MNE Groups selling across a few neighbouring countries without physical presence generating revenues lower than EUR 750 million. In relative terms, this could have a substantial impact on the taxes that would otherwise be collected by those jurisdictions if the threshold was lower.

e. **Carve-outs that might be formulated (e.g. for commodities):** We understand that the OECD is considering whether other sectors such as financial services should also be carved out from the definition of consumer-facing business. Firstly, we do not see a material conceptual difference between an online financial services company remotely selling online insurances, mortgages, leases to end consumers and another type of highly digitalised business selling online

subscriptions/services for – as an example – data storage or online virus protection to similar end consumers. Secondly, if the financial services industry is carved out, this may result in a different treatment for selling online services/products which only differ in terms of their industry categorisation, although the way they run their business has significant overlap. Furthermore, carving out financial services companies may result in MNE Groups potentially trying to register themselves as a financial services company, which may enable and incentivise manipulation to prevent being subject to tax over the A amount in the market jurisdiction.

While 'commodities' are mentioned as an example for carve-outs, when online commodity trading activities are being considered, attention needs to be paid to how such carve-outs could create inconsistencies with other industries. The same logic applies to platforms used for buying and selling stocks.

Another example is payment platforms used for e-commerce which may be considered financial services and thus considered to be carved out. These platforms and future variations of these platforms (e.g. possibly block chain) are at the heart of digitalising the economy. These platforms can remotely generate revenues from jurisdictions through their user base in those jurisdictions without any physical presence.

The last example is in relation to B2B. A full carve-out of B2B without sufficiently exploring the realities of how B2B dealings are shaped and concluded could result in unintended consequences. Certain business partnerships resulting in money flows between two digital businesses can take place without any physical interactions (e.g. video content businesses, online sales channels buying or selling to other businesses). Moreover, if there were full carve-outs, businesses could potentially use this to circumvent inclusion in the scope.

2. NEW NEXUS

Defining and applying a country-specific sales thresholds: Various countries, including the Netherlands, have introduced a EUR 50 million consolidated revenue threshold for the obligation to prepare a master file and a local file. This implies that the tax administrations of those countries considered this threshold significant for the impact on the taxes collected by them. In this respect, aligning the threshold to the already well-thought-out and tested existing rules could provide some level of simplification for the MNE Groups and the tax administrations. In the absence of such existing threshold for certain countries or if a completely new approach is followed, this threshold should be determined by taking into account a combination of sales and the total size of a country's economy, i.e. sales as % of the Gross Domestic Product ("GDP"). The OECD can analyse this and on the basis of that analysis introduce a few sales thresholds depending on the size of the country's economy (e.g. EUR 10, 50, 100 million). A list of countries with the relevant threshold(s) should be included in the OECD's final guidance on the Unified Approach.

Another approach would be to introduce one sufficiently low threshold. This would ensure that the countries with the smallest economies could also benefit. However, this approach would be extremely burdensome for many MNE Groups and tax administrations and the cost of compliance could outweigh the associated benefits for the relevant economy.

3. CALCULATION OF GROUP PROFITS FOR AMOUNT A

a. What would be an appropriate metric for group profit:

The definition of an MNE Group's profits under the 'Unified Approach' should be in line with the approach used in preparing financials for CbCr (consolidated figures), master file and local file obligations. More specifically, Amount A should be calculated using MNE's consolidated operating profits (EBIT) as a basis.

b. ***What, if any, standardised adjustments would need to be made to adjust for different accounting standards:***
MNE Groups should be able to follow the accounting standards (e.g. US GAAP or IFRS) they use for consolidation. Where material deviations exist between US GAAP/IFRS and different accounting standards used locally, those should be reconciled and justified. It may be worth considering introducing a materiality threshold as a simplification measure.

c. ***How can an approach to calculating group profits on the basis of operating segments based on business line best be designed? Should regional profitability also be considered?***
Calculating group profits based on operating segments based on business line should be aligned with the operating segments/business lines as included in the MNE Group's master file. The TP documentation requirements also allow to prepare a master file per business line which would then be the basis of and be aligned with the operating segments/business lines under the 'Unified Approach'. While considering regional profitability is only fair and objective, it would make the exercise far more burdensome for the MNE Groups. The MNE Groups typically do not need to calculate regional profitability for tax purposes. The regional financials prepared for management reporting purposes on the other hand may not reflect accurate figures the purpose of calculating Amount A.

4. DETERMINING AMOUNT A

In our view, Amount A should be determined based on the existing OECD guidance resulting from the *Report on BEPS Actions 8-10 Aligning Transfer Pricing Outcomes with Value Creation*. It is important to determine the MNE Groups' key value drivers, which contribute to value creation. Typically, consumer or user interaction, including reliance on data, (mostly defined as "customer relationship") is one of the MNE Groups' main value drivers. Depending on the industry sector and other facts that are specific to a particular case, these key value drivers can account for a large or small part of the MNE's value creation. Based on the specific analysis, conclusions can be drawn as to whether the value attributable to the customer relationship can be fully or partially attributed to the market jurisdictions (e.g. if carve-outs are needed to account for B2B). Then this percentage (i.e. the percentage of value creation attributable to "customer relationship" after the relevant adjustments if any) could be used as a proxy to reallocate a portion of deemed residual profit of a multinational business (on a group or business-line basis) to market jurisdictions.

If the OECD decides to implement a simplified approach relying on fixed percentages for reallocating a portion of deemed residual profit, value chain analysis would still be greatly important. In that case, the OECD should research the value chain of the relevant industries to understand how value is created through consumer-related aspects in those industries. Then, by way of empirical evidence, one or more fixed percentages can be introduced based on specific industries or sub-industries.

5. ELIMINATING DOUBLE TAXATION FOR AMOUNT A

a. Since a physical presence is no longer required, it may prove difficult, amongst other things, to identify the relevant taxpayer(s). It may be that several entities within the MNE Group fall within the scope of the overall activities of the MNE Group. In order to resolve this, the OECD could consider introducing a mechanism that would allow the MNE Group to appoint an entity within the group that is the relevant taxpayer. This would also mean that the MNE Group could appoint an entity in a jurisdiction that allows for the optimal dispute resolution mechanism.

b. Tax relief should take place in a similar way to how countries currently deal with permanent establishments.

c. The proposals would result in a reallocation of profits to user or market jurisdictions. Therefore, it is necessary that certain changes to existing treaty provisions are made to allow for this and to prevent double taxation. In addition, provisions should be included that prevent disputes or provide an efficient dispute resolution mechanism if there is a dispute. This to prevent double taxation for businesses. Binding mandatory arbitration could be an efficient solution.

If the new rules would result in a different allocation of profits over many countries and one of those countries has not yet amended its domestic rules or has not yet amended the relevant tax treaty or treaties, complex issues could arise. Agreeing upon the amendments through a multi-lateral instrument should be considered.

6. AMOUNT B

For the baseline marketing and distribution activities remunerated with Amount B, we suggest providing further guidance on the definition of these baseline distribution and marketing activities similar to how the scope has been provided for low value-adding intra-group services. It is important to note that companies performing distribution and marketing activities include fully-fledged distributors (owning marketing-related intangibles), regular distributors, limited risk distributors, commissionaires and distributors with flash titles (e.g. intermediaries). Remuneration for all these types of distributors could be different depending on the nature of their activities, being, for instance wholesale, retail or online channels. Furthermore, the remuneration could also be different depending on the country and region.

Another important matter in this respect is the fact that the transfer pricing methodologies to remunerate the various types of distributors could be different. For fully-fledged distributors, the residual profit split could be the most important transfer pricing method (combination of Transactional Net Margin Method ("TNMM") with return on sales and profit split) whereas for regular and limited risk distributors, TNMM with return on sales would be the most important method. Commissionaires and distributors with flash titles are typically remunerated using the Comparable Uncontrolled Price Method ("CUP") and TNMM with mark-up on operating expenses, respectively.

A fixed return for marketing and distributions would be welcome and would significantly simplify businesses and tax administration. However, the above-mentioned aspects need to be considered to avoid over-simplifying this matter, which may not be in line with the realities of businesses and economies. Our recommendation is to introduce fixed percentages that:

- Vary (if necessary) by industry and region;
- Consider the differences in different functional profiles (retail, wholesale, online); and
- Exclude fully-fledged distributors, commissionaires and distributors with flash titles.

Alternatively, the OECD could introduce other appropriate fixed percentages for fully-fledged distributors, commissionaires and distributors with flash titles.

All this should be justified based on sufficient research and empirical evidence. The research could suggest that alternatively, a range of fixed percentages could be introduced that account for the differences noted above.

7. AMOUNT C/DISPUTE PREVENTION AND RESOLUTION.

- (**APAs:** APAs, in particular, bilateral or multilateral APAs are an effective way of preventing disputes. However, these are voluntary procedures and can be costly for companies. The MNE Groups typically enter into bilateral or multilateral APAs with key countries only due to the time and cost aspects. Therefore, it would be unrealistic to expect global dispute prevention through APAs.
- **OECD ICAP:** The first pilot is considered rather effective. However, it is used by some countries for some companies. It may not be effective for dispute prevention in actual cases if it is not binding.
- **Mandatory binding MAP arbitration.** This is an effective way to resolve disputes. It can be lengthy and if a shorter binding timeframe (e.g. one year) for dispute resolution for Amount C was introduced, it could work very effectively.
- **Joint audits.** The Netherlands has had very positive experiences with joint audits. They provide an effective and time-efficient way of dealing with potential disputes.

On behalf of the Houthoff Tax Team

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