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Taxing the Digitalization of the Economy: The Two Pillar Approach

Current discussions and impact on the German economy

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Oliver Nußbaum

"It must be ensured that the new taxing right and profit allocation rules are only introduced if they are implemented uniformly by all participating jurisdictions and replace all Digital Services Taxes."

Global Head of Taxes and Duties, BASF SE

Preface

The OECD is pushing one of the biggest reforms of international taxation in history. Policymakers must take the concerns of the business community seriously. Regarding the reallocation of taxing rights on corporate profits, maintaining the competitiveness of businesses must be the guiding objective of the reform. Hence, a level playing field must be created. It must be ensured that the new taxing right and profit allocation rules are only introduced if they are implemented uniformly by all participating jurisdictions.

Additionally, it is not enough to just reallocate profits to market jurisdictions, but it must be clearly and legally certain which jurisdiction forfeits the right to tax the reallocated profits. The latter is not sufficiently addressed in the current design of Pillar One. Without clear rules on the avoidance of double taxation, there is a risk of dispute among various jurisdictions over tax revenue. This would ultimately lead to double taxation and entangle businesses in chaotic dispute resolution procedures, since the current framework is not fit to deal with such an increase in multilateral disputes. Due to the complexity and increased risk of disputes, an agreement on a new tax architecture among all jurisdictions on a binding dispute avoidance and resolution procedure is a conditio sine qua non. The agreement must include a mechanism which ensures that no additional administrative burden is placed on businesses.

The proposed two-pillar approach bears numerous risks for German industry. Out of the lengthy list, the most prominent concerns of German industry are severe double taxation, excessive additional administrative burden, legal uncertainty and endless dispute resolution procedures. Since the digital economy cannot be ring-fenced, the proposals will have far-reaching consequences for German industry.

On the other hand, one must recognize that the outlook does not improve if a comprehensive international approach would fail. The political pressure to find a solution to the perceived tax challenges of the digitalization of the economy is high. Several jurisdictions have already implemented unilateral action and many other are planning to do so should the international initiative fail. Consequently, a global consensus between jurisdictions is required to avoid further fragmentation of the world tax order.

This being said, the reform must be carefully crafted in order to ensure continuity, especially because the impact of the BEPS 1.0 reforms has not yet been analysed. It is of utmost importance that the new rules are clear, modest and build on the existing principles of international taxation. Hence, scope and nexus under Pillar One must be defined delicately. The arm's length principle (ALP) should not be abandoned, formulaic apportionments should form an exception. Regarding the global minimum tax under Pillar Two, genuine economic activity should not be subject to the tax on base eroding payments. To ensure uniform implementation, a multilateral convention should be passed. Considering that the global economy is expected to return to pre-crisis GDP levels only in 2022, the agreement should ensure that net losses in tax revenue for some jurisdictions are not reconciled with tax increases.

German industry advocates for a solid, long-term framework for an international, administrable and consensus-based tax architecture. Ensuring a coherent technical architecture and an implementation of a consensus-based solution is of utmost importance. No unilateral action should be taken for the time the negotiations continue.

Dr. Monika Wünnemann

Head of Department,
Tax and Financial Policy, BDI e.V.

"German industry supports a global solution to the tax challenges of the digitalization of the economy – new rules must be easy to implement and also contain elements to avoid double taxation."

Summary

In view of the expectation that a final agreement can be reached by mid-2021, BDI would like to emphasize once again the impact of this project on German industry. For BDI it is of utmost importance that the perceived tax challenges arising from the digitalization of the economy are addressed in a responsible manner. German business **continues to support the work on the OECD project** with the aim of finding a global solution.

The remaining time until the extended deadline of mid-2021 must be used to solve the remaining political and technical differences. This extension is important as an international taxation order must provide legal certainty and coherence and since a failure of the OECD project is likely to result in further fragmentation of the international tax system through uncoordinated unilateral action. At the G20 finance ministers' meeting on April 6, 2021, the United States presented a new proposal which would provide for the redistribution of tax revenues to be based on **quantitative criteria such as turnover and profitability** and abandon the restriction to Automated Digital Services (ADS) and Consumer-Facing Businesses (CFB). Instead, the 100 largest and most profitable corporations **– regardless of industry affiliation or business model –** should be targeted.

Globally agreed proposals should include the binding abolition of any unilateral measures in place at the time of agreement such as Digital Services Taxes (DST) and a commitment for a stable and sustainable international tax system. In this context, it is important to highlight that a global consensus is required. **We call on the European Commission to refrain from own initiatives** and to urge national governments not to use the postponement at OECD level as justification for the introduction of national measures. For BDI it is important that a multilateral agreement will be reached in order to ensure uniform implementation and to minimize compliance costs.

As the current proposals would revise the foundations of the international taxation order, it is critical to make **public an economic impact assessment on a country-by-country basis**, covering the effects on national tax revenue, investment, growth, employment and business models to allow for transparent public discourse as well as informed decision making by G20/Inclusive Framework members. The impact assessment should also explore the relationship between Pillar One and Pillar Two in more detail. If the proposal is judged to increase tax revenues on a net basis, emphasis should be placed on the effect on growth and jobs since workers and consumers are the most impacted.

In the firm believe that a global consensus is preferable to unilateral action and recognizing that further work is needed to further develop the proposals and to meet the goal of finding solutions to the tax challenges arising from the digitalization of the economy, we encourage the OECD/Inclusive Framework to ensure that individual jurisdictions or their regional responsible bodies will not implement unilateral measures before a solution on OECD/Inclusive Framework level is agreed upon.

Zusammenfassung

Mit Blick auf die erwartete Einigung der Staaten Mitte 2021 möchte der BDI nochmals die Betroffenheit der deutschen Industrie, die sich aus diesem Projekt ergibt, betonen. Aus Sicht des BDI ist eine umfassende, weltweit koordinierte Lösung zur Besteuerung der Digitalisierung der Wirtschaft notwendig, um die steuerlichen Herausforderungen der Digitalisierung der Wirtschaft verantwortungsvoll zu lösen. Die deutsche Industrie **unterstützt daher weiterhin die Arbeiten am OECD-Projekt** mit dem Ziel, eine globale Einigung zu erzielen.

Nachdem sich die G20-Finanzminister darauf verständigt haben, die ehrgeizige Agenda bis Mitte 2021 zu verlängern, muss diese sechsmonatige Verlängerung genutzt werden, um die noch bestehenden politischen und technischen Differenzen zu überwinden. Diese Verlängerung war wichtig, da die neue Weltsteuerordnung sowohl Rechtssicherheit als auch Kohärenz bieten muss und ein Scheitern des OECD-Projekts anderenfalls durch unkoordinierte, unilaterale Maßnahmen zu einer weiteren Fragmentierung des internationalen Steuersystems führen dürfte. Am G20-Finanzministertreffen vom 6. April 2021 haben die USA indes einen neuen Vorschlag präsentiert. Dieser würde vorsehen, die Neuverteilung der Steuereinnahmen nach **quantitativen Kriterien wie Umsatz und Profitabilität auszurichten** und die Beschränkung des Anwendungsbereichs auf Automated Digital Services (ADS) und Consumer-Facing Businesses (CFB) aufzugeben. Vielmehr sollte auf die 100 größten und profitabelsten Konzerne – **unabhängig von Branchenzugehörigkeit oder Geschäftsmodell** – abgezielt werden.

Ein globaler Konsens muss zwingend auch die verbindliche Abschaffung aller zum Zeitpunkt des internationalen Übereinkommens bestehenden unilateralen Maßnahmen, wie etwa einzelstaatlicher Digital Services Taxes sowie das Bekenntnis zu einem stabilen, nachhaltigen internationalen Steuersystem beinhalten. Darüber braucht es einen internationalen Konsens. **Wir appellieren daher an die Europäische Kommission, von eigenen Initiativen wie der Digital Levy Abstand zu nehmen** und dahingehend auf nationale Regierungen hinzuwirken, dass der Aufschub auf OECD-Ebene nicht als Rechtfertigung für die Einführung unilateraler, nationaler Maßnahmen genutzt wird. Aus Sicht des BDI ist eine multilaterale Lösung für die steuerlichen Herausforderungen der Digitalisierung der Wirtschaft entscheidend, um einerseits eine einheitliche Umsetzung zu gewährleisten und andererseits Compliance-Kosten zu minimieren.

Da es sich bei den aktuellen Vorschlägen um eine Abkehr von tradierten Regeln des internationalen Steuerrechts handeln würde, ist die **Veröffentlichung von wirtschaftlichen Folgeabschätzungen auf einzelstaatlicher Ebene** von besonderer Bedeutung. Diese muss Auswirkungen auf die nationalen Steuereinnahmen, Investitionen, Wachstum, Beschäftigung und Geschäftsmodelle untersuchen, um einen transparenten öffentlichen Diskurs sowie eine fundierte Entscheidungsfindung der Mitglieder des OECD/G20 Inclusive Framework on BEPS zu ermöglichen. Diese Folgeabschätzung sollte auch das Verhältnis der Vorschläge von Säule 1 und Säule 2 zueinander untersuchen. Sollten die Vorschläge demnach die Steuereinnahmen auf Nettobasis erhöhen, so sollte ein besonderes Augenmerk auf die Auswirkungen auf Wachstum und Beschäftigung gelegt werden, da Arbeitnehmer und Verbraucher davon besonders betroffen wären.

Die deutsche Industrie ist zutiefst davon überzeugt, dass ein globaler Konsens unilateralen Maßnahmen vorzuziehen ist. Im Bewusstsein, dass weitere Arbeiten erforderlich sind, um die Vorschläge weiterzuentwickeln und das Ziel einer Lösung für die steuerlichen Herausforderungen der Digitalisierung der Wirtschaft zu erreichen, appelliert der BDI an die Mitglieder des OECD/G20 Inclusive Framework on BEPS, dass einzelne Jurisdiktionen keine unilateralen Maßnahmen vor einer Einigung auf globaler, OECD/G20-Ebene einführen.

01 Background

In the light of new evolving digital business models, a fundamental reform of the world tax order is currently being discussed. The debate centres on the question whether corporate profits are sufficiently taxed and whether tax revenues are distributed fairly between jurisdictions.

At OECD level, the taxation of the digital economy has been discussed since the turn of the century. In recent years, however, there has been an increased public discussion regarding the taxation of digital business models. The OECD thus addressed the issue within the framework of the OECD/G20 Base Erosion and Profit Shifting Project base erosion and profit shifting initiative (Action 1 – Adress the tax challanges of the digital economy). Since no agreement on concrete measures (Action 1) could be reached, the jurisdictions engaged in the OECD/G20 Inclusive Framework on BEPS, which to date groups 139 jurisdictions, agreed working towards a consensus-based solution by 2020 which in October 2020 has been postponed to mid-2021.

On this basis, the OECD was then mandated by the G20 to prepare an interim report, which was presented in March 2018 by the Inclusive Framework. In a policy note from January 2019, the OECD proposed a two-pillar approach and put different measures forward. The different proposals were then discussed in a public consultation in March 2019. In May 2019, the efforts culminated in the "Programme of Work to Develop a Consensus Solution to the Tax Challenges Arising from the Digitalisation of the Economy". The first Pillar concerns the allocation of taxing rights and aims to revise the profit allocation rules and nexus rules in favor of the market jurisdictions. The second Pillar seeks to develop rules which prevent low and non-taxation of corporate profits and enable a global effective minimum taxation.

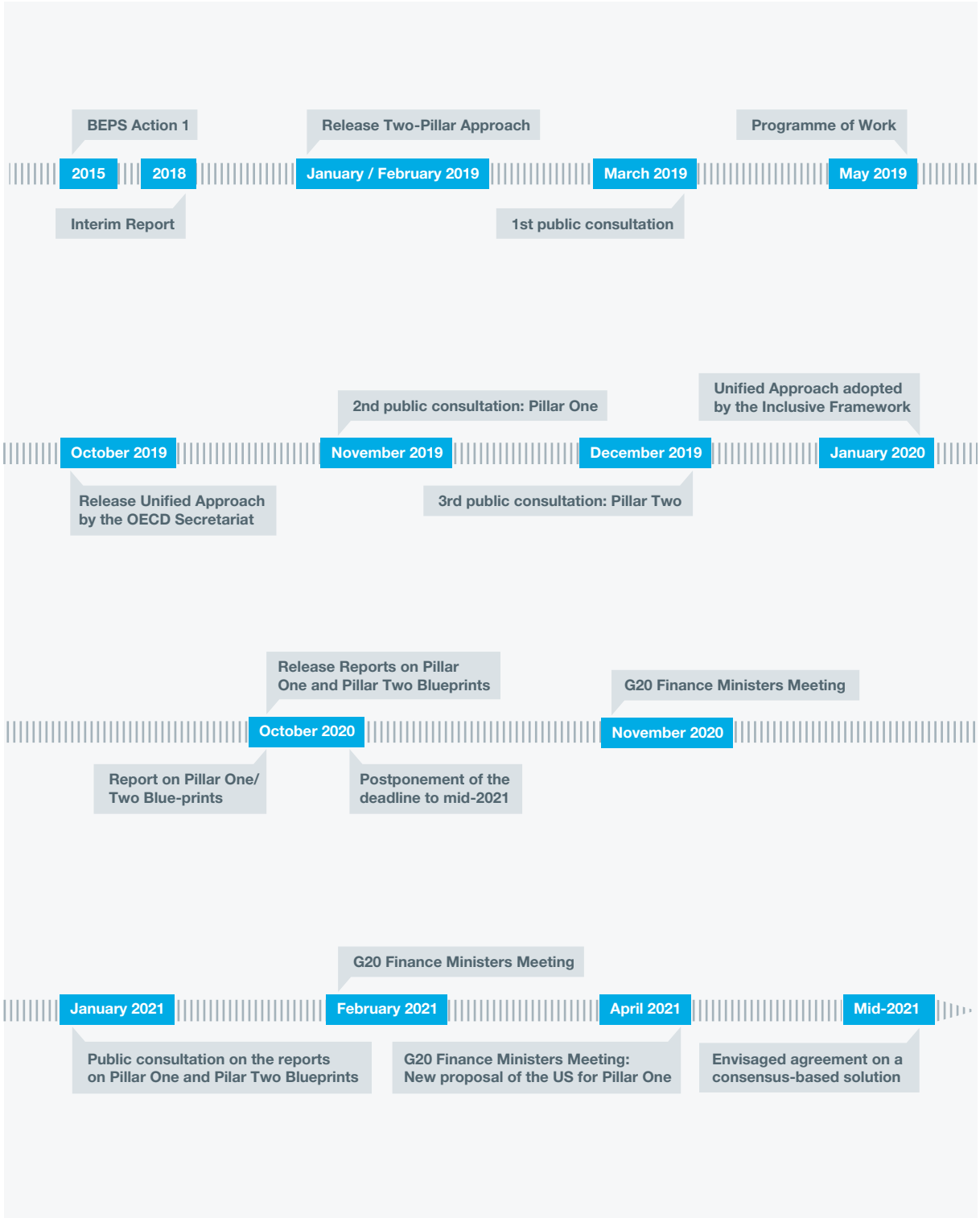
From October to December 2019, the OECD held public consultations to discuss the two pillars publicly for the second time. For the first pillar, the OECD Secretariat presented the Unified Approach as a compromise solution which is based on the commonalities of the previous alternative proposals. In January 2020, the Inclusive Framework adopted the Unified Approach as the basis for further negotiations and reaffirmed its commitment to finding a consensus-based solution by the end of 2020.

As a result of the Covid-19 pandemic, however, the Inclusive Framework meeting scheduled to take place in Berlin in July 2020, where key policy features were expected to be agreed upon, has been postponed to October 2020. On 12 October 2020, the Inclusive Framework released a package consisting of the Report on the Pillar One Blueprint and the Report on the Pillar Two Blueprint which have been discussed during the 8-9 October 2020 meeting of the Inclusive Framework on BEPS. At the same time, the OECD said it would postpone the deadline to find an agreement and keep working towards an agreement by mid-2021. Instead of the final report, a further public consultation followed in mid-December 2020 on the published Blueprints on Pillars One and Two which in parts presented more detailed proposals for implementation. This delay is due to the Covid-19 pandemic and the resulting multiple impacts on the OECD/G20 Inclusive Framework members, which has caused that the final drafting deadline by the end of 2020 could unfortunately not be met.

If no multilateral solution is found, further regulatory fragmentation could increase through uncoordinated unilateral action. The European Commission has announced at several occasions that it will advance the taxation of the digitalization of the economy at European level and propose a European digital tax, if no consensus was reached by the end of 2020. In July 2020, however, the European Commission stated that it would allow the OECD enough time to reach a global agreement and would not launch a unilateral EU proposal before 2021. Referring to the delay at OECD level and the postponed deadline to reach a global agreement, the European Commission on 13 October 2020 said it would tolerate a delay until mid-2021, mentioning that this postponed target date has to be "the final one" before continuing with its own "Plan B" to address the tax challenges arising from digitalization. At the same time, the European Commission made clear that it is already undertaking preparatory work on unilateral approaches covering Pillar One and Pillar Two in case the negotiations at OECD level should fail, or according to President von der Leyen's State of the Union Address of 16 September 2020, in case "an agreement fall(s) short of a fair tax system that provides long-term sustainable revenues." Besides, individual countries such as France or India have already introduced a digital tax or created a new nexus for digital business models through a "significant economic presence".

Timeline

Source: BDI



The Two-Pillar Approach

The OECD/G20 Inclusive Framework proposes a new taxing right and the effective minimum taxation of MNEs to address the tax challenges of the digitalization of the economy.

International Corporate Taxation

Unified Approach

Minimum Taxation

02

Pillar One: Revised nexus and profit allocation rules

The first pillar of the proposals addressing the tax challenges posed by the digitalization of the economy deals with the reallocation of taxing rights over business income. The proposal seeks to revise nexus and profit allocation rules in favor of market jurisdictions. After the first alternative proposals under Pillar One failed to provide a consensus solution, the OECD Secretariat published a compromise proposal in October 2019. The compromise proposal – the Unified Approach – has been adopted by the Inclusive Framework on BEPS as a basis for negotiation in January 2020.

Unified Approach

The Unified Approach, which is the basis of the Pillar One Blueprint, is based on the commonalities of the three alternative concepts proposed in the Programme of Work. The measures under Pillar One are intended to expand the taxing rights of market jurisdiction through the following mechanism:

- **Amount A:** Allocation of additional taxing rights to market jurisdictions via a formulaic apportionment of residual profits of a MNE group;
- **Amount B:** A fixed remuneration for certain defined marketing and distribution activities taking place physically in the market jurisdictions.

While Amount B would be embedded in the existing international tax order, Amount A would establish new nexus and profit allocation rules. Thus, the application of Amount B requires a physical presence (i.e. subsidiary or permanent establishment) while Amount A enables jurisdictions to tax in-scope MNEs irrespective of physical presence.

Amount A

Amount A constitutes the central response to the tax challenges of the digitalization by reallocating a part of the residual profit of a multinational enterprise (MNE). The new taxing right would provide for an additional allocation of taxing rights to market jurisdictions through a formulaic profit split, establishing a new nexus for in-scope MNEs in order to enable taxation in market jurisdictions where MNEs participate in the economy of a jurisdiction with significant economic activity but without physical presence. Amount A would apply to automated digital services and consumer-facing businesses.

The first category – automated digital services (ADS) – would cover business models which provide automated and standardized digital services to a large and global customer or user base such as cloud computing services, online advertising services, online search engines and online intermediation platforms such as digital marketplaces.

The second category – consumer-facing businesses (CFB) – is defined broader, covering businesses with significant and sustained engagement with consumers in a meaningful way beyond having a local physical presence. It would cover businesses which generate revenue from the sale of goods and services of a type commonly sold to consumers, including those selling indirectly through intermediaries and by way of franchising or licensing. Examples would be computing hardware and software, clothes and branded food as well as automobiles. Branded or trademarked goods and services such as franchise models would also be considered consumer-facing. Intermediate products and components that are incorporated into a finished product sold to customers would be, in principle, out of scope.

For the new nexus, the Unified Approach would define the generation of sales in a market jurisdiction over a period of years as the primary indicator for a significant economic activity. For this purpose, sales would be accounted for regardless of whether the sales are generated via direct distribution through a physical presence or via a group or third-party sales partner in the market jurisdiction. The new nexus would be designed as stand-alone treaty provision in addition to the definition of the permanent establishment (Art. 5 OECD Model Convention). For CFB, a level of sales just over the market revenue threshold may not denote the active and sustained engagement with the market beyond the mere conclusion of sales that is envisaged as the justification of the new taxing right. To demonstrate this level of engagement, the presence of additional indicators ("plus factors") is discussed and may be necessary.

Within the current system, profit is allocated to physical presence. Hence, the profit allocation rules need to be revised to enable a profit allocation regardless

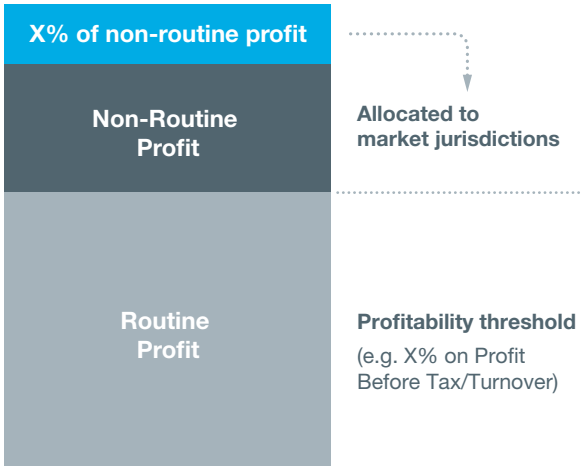
whether taxpayers maintain a marketing or sales presence (permanent establishment or subsidiary) in the market jurisdiction or conduct their business through independent parties.

Under Pillar One, MNEs would in principle apply the existing transfer pricing system (supplemented by Amount B). Amount A would apply only to MNE groups with automated digital services and consumer-facing activities which exceed a certain turnover (i.e. $750 million) and profitability and *de minimis* tests.

Given Amount A is applicable, Amount A would be determined as a combination of the profit split and formulaic apportionment method. Firstly, the total profits of the MNE group would be identified using consolidated financial accounts. Secondly, the routine profit would be identified via approximation through an agreed upon profitability level. The deemed routine profit would be excluded from reallocation to market jurisdictions. Thirdly, the non-routine profit, i.e. the profit above a certain level of profitability, would be split through the formulaic apportionment into non-routine profits attributable to market jurisdictions and non-routine profits which arise through other factors. Fourthly, the deemed non-routine profits attributable to market jurisdictions would be allocated to market jurisdictions based on sales, given the nexus test in the market jurisdiction is met.

Total profit of the MNE Group

Source: BDI



Critical design features such as the applicable thresholds and tests for scope and nexus, the profitability rate and the percentage of non-routine profit to be allocated to market jurisdictions have not yet been decided.

Amount B

Amount B would work in the existing system, i.e. require physical presence, and complement the arm's length principle. It would provide for the taxation of marketing and sales functions in the market state. With the objective of minimising disputes, this would be done by means of a fixed remuneration for so called baseline marketing and sales activities in the source state. The design is yet to be determined. The fixed remuneration could be designed as a guaranteed minimum return, a safe harbor with a rebuttable presumption, a traditional safe harbor or a risk assessment approach. The fixed remuneration could be set regionally or specific to the industry.

Example

Facts: Stream Group, a multinational group headquartered in jurisdiction A, provides streaming services to users in jurisdictions A, B and C. Marketing and distribution for jurisdiction B is conducted by a subsidiary with physical presence in jurisdiction B while users in jurisdiction C deal directly with the Stream Group parent corporation. No physical presence is maintained in jurisdiction C.

Amount B is not applicable, since the subsidiary in jurisdiction B conducts activities in excess of the defined baseline activities and is remunerated in excess of Amount B in accordance with the activities and the risks borne.

Calculation of Amount A	
Total Group Profit	**10.000 EUR**
Sales per jurisdiction	**5.000 EUR**
Total Sales	**15.000 EUR**
Profit Margin (z %)	**40 %**
Routine profit (x %)	**10 %**
Non-routine profit (z %-x %)=y %	**30 %**
Distribution of non-routine profit (w %:v %)	**20:80**
Attributable to market jurisdiction (w %)	**20 %**

Stream Group's business model is highly profitable. As an automated digital service provider which meets scope and nexus tests, Amount A is applicable. Since the intellectual property underlying the successful operation is owned exclusively by the Stream Group parent corporation, the non-routine profits are attributable to the parent corporation in jurisdiction A.

Amount A is the portion of the non-routine profit, i.e. the excess of the profit margin over the agreed upon routine profit margin, which is attributable to the market jurisdiction and allocated based on the sales.

$$\text{Amount } A_j = \text{Deemed Residual profit} * y\% * w\% * \frac{\text{sales}_j}{\text{total sales}}$$

Hence, Amount A would allocate 200 to Jurisdiction A, B and C:

$$\textit{Amount } A_c = 10.000 * 30\% * 20\% * \frac{5000_c}{15.000} = 200$$

The results for Amount A are summarised in the following table. Assuming that double taxation is avoided via the exemption method in the jurisdiction where the non-routine profit is attributed to in the existing rules, jurisdiction A would exempt the profit now allocated to jurisdiction B and C from taxation. In total, the tax base in jurisdiction A would decrease by 400 EUR while jurisdiction B and C each gain 200 EUR.

Profit allocation (per jurisdiction)	A	B	C
Profit allocation based on the ALP	**8.000 EUR**	**2.000 EUR**	**0 EUR**
Unified Approach			
Amount A		**200 EUR**	**200 EUR**
Amount B	**0 EUR**	**0 EUR**	**0 EUR**
Amount C	**0 EUR**	**0 EUR**	**0 EUR**
Prevention of Double Taxation	**-400 EUR**		
Total distribution according to new regulations	**7.600 EUR**	**2.200 EUR**	**200 EUR**
Change	**-400 EUR**	**+200 EUR**	**+200 EUR**

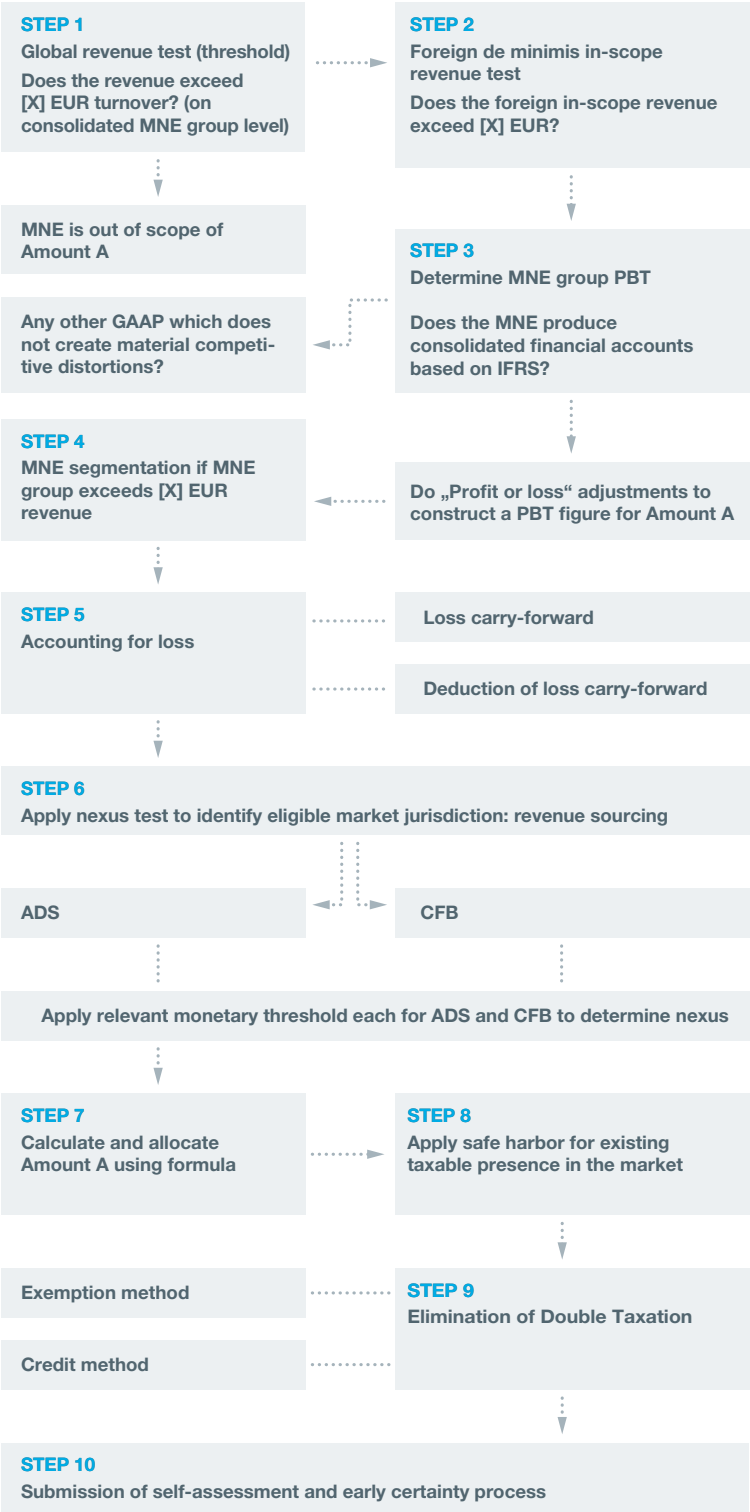
Jürgen Rieß

Vice President International Taxes & Operations, Corporate Tax, Fresenius SE & Co. KGaA

"As the economy changes so does tax law. In seeking to reallocate global taxing rights and to introduce a minimum corporate tax rate, it is important that any agreement includes provisions for international dispute settlement mechanisms."

Calculation of Amount A

Source: BDI



STEP 1

Amount A applies if MNE groups consolidated revenue exceeds [X] EUR, i.e. 750 million EUR

If not, Amount A is not applicable

STEP 2

Amount A could first apply when the relevant foreign in-scope revenue exceeds a certain threshold, i. e. 250 m. EUR

STEP 3

1. Identify and test consolidated financial accounts; if a MNE group uses IFRS or comparable GAAP it can use these as a starting point
2. Constructing a PBT figure

STEP 4: scope of segmentation

Simplified rules should apply to limit MNE groups calculating Amount A by segments, i.e. no segmentation needed if MNE group exceeds [X] EUR revenue

STEP 5: accounting of losses

Current losses can be carry-forwarded and offset against future profits

Current profits are automatically offset against past losses

STEP 6: nexus test in each market jurisdiction

1. Revenue sourcing: rules apply depending on the nature of revenue; distinction between ADS and CFB
2. Apply the relevant monetary threshold: nexus rules apply when a MNE group has significant/active and sustained engagement in a market jurisdiction, primary due threshold test

STEP 7: Formulaic allocation of Amount A

Amount A will be calculated through a formula that will apply to the tax base of a group or segment with three steps: profitability, reallocation percentage, allocation key

STEP 8: Potential marketing and distribution profits safe harbour

If a MNE group has a significant taxable presence in a market jurisdiction safe harbour rules could apply to avoid double taxation

STEP 9: Elimination of Double Taxation

Four-step approach: activity test, profitability test, market connection priority test, pro-rata allocation

STEP 10: Self assessment and early certainty process

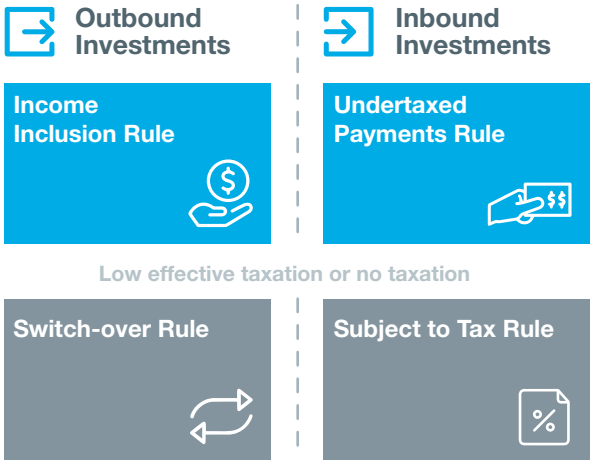
Procedural facilitation

Pillar Two: Global anti-base erosion proposal (GloBE)

The policy rationale of Pillar Two, also referred to as GloBE, is to tackle the remaining BEPS challenges and to disincentive profit shifting and tax competition by establishing a global effective minimum taxation of corporate profits. The underlying assumption is that digital business models and globalised corporate structures enable profit shifting to low-tax countries and, therefore, justify limiting tax competition to a certain minimum level. The proposal intends to preserve the sovereignty of jurisdictions to set tax rates by providing jurisdictions with tools to tax profits where other jurisdictions apply low effective taxation or do not exercise their taxing right. The GloBE proposal comprises four interrelated rules.

GloBE rules

Source: BDI



Income Inclusion Rule

The Income Inclusion Rule, which is understood as a supplement to Controlled Foreign Company (CFC) Rules regimes, would allow the taxation of a proportionate share of low-taxed profits of a foreign subsidiary in the jurisdiction where the parent corporation is headquartered. The Income Inclusion Rule would work as a top-up to a minimum rate, thereby ensuring a minimum level of taxation. Generally, this approach does not prevent jurisdictions from setting their own tax rates, but it provides for a "right to tax back" if other jurisdictions reduce their tax rates below a certain level.

The minimum tax rate would be designed as a blended[1] fixed rate. To compute the tax rate, financial accounts could serve as a basis. While many CFC regimes differentiate between types of income considering the activity of the foreign corporation, the current architecture of the Income Inclusion Rule does not include such criteria. Further critical design aspects such as ownership criteria[2] and carve-outs are, according to current information, not yet decided.

Switch-over Rule

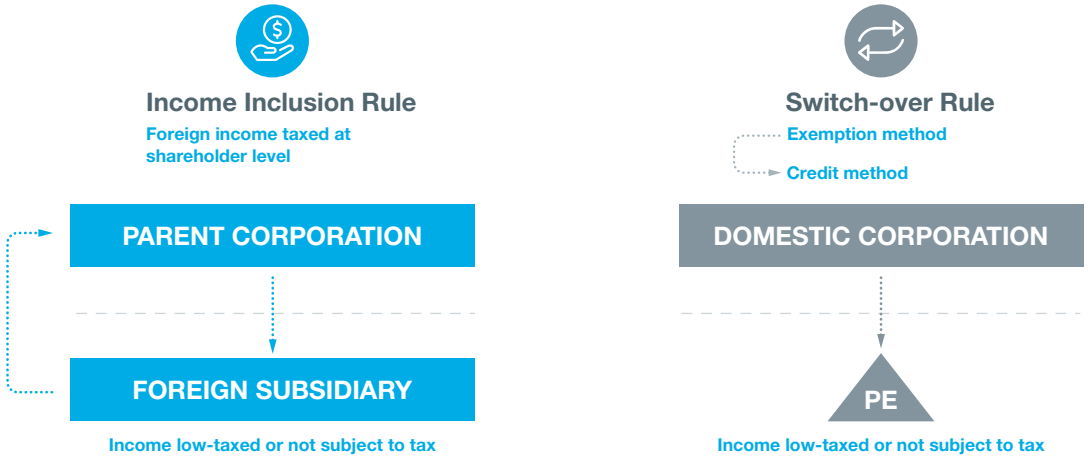
In order to ensure that the Income Inclusion Rule covers foreign branches, a Switch-over Rule would be implemented. The Switch-over Rule would apply to the income of foreign permanent establishments and would allow the jurisdiction where the corporation is domiciled to apply the credit method instead of the exemption method if the income is not subject to tax or taxed at a low rate. Consequently, the income of the foreign permanent establishment is attributed to the parent corporation and thus subject to taxation in the state of residence. The current architecture does not assess the type of income, activity or substance of the foreign permanent establishment.

[1] Blending would mix high-taxed and low-taxed income on a global, regional, jurisdictional or entity level while computing an aggregate tax rate to determine if the income is taxed above the minimum level.

[2] The Income Inclusion Rule could stipulate a significant direct or indirect ownership interest (25 per cent).

Proposed inbound measures

Source: BDI



Tax on base eroding payments

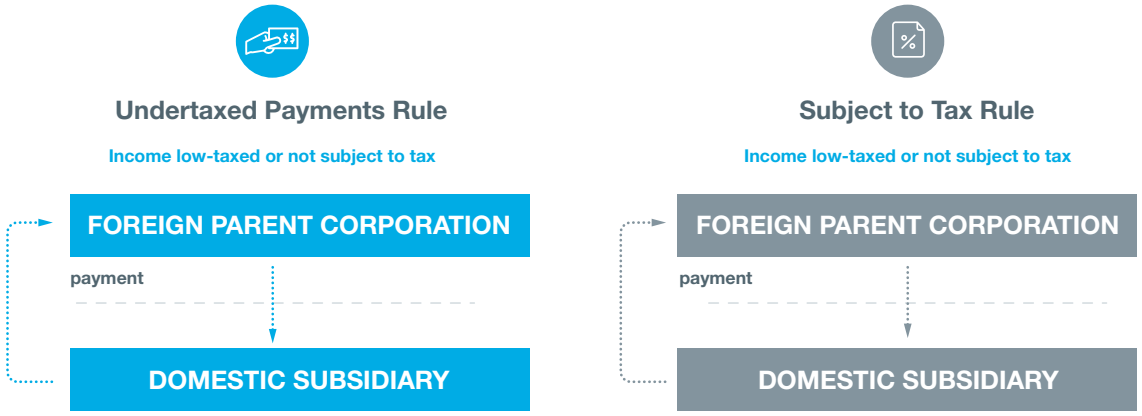
The Undertaxed Payments Rule would address payments to related foreign corporations aimed at reducing domestic tax. Under this rule, the deduction of certain types of payments would be denied if the payments have not been subject to minimum level of taxation. In such cases, the tax would thus be levied on the company's profit before the deduction of the said harmful payment.

The Undertaxed Payments Rule would be supplemented by a Subject to Tax Rule, which subjects a payment to a withholding tax and denies benefits arising from double taxation agreements for certain types of income if the payment is not taxed at a minimum rate. The Subject to Tax Rule would generally apply between related parties but could also be extended to unrelated parties for interest and royalties (Article 11 and 12 OECD Model Convention). The implementation of such a rule would entail a comprehensive amendment of the worldwide double taxation treaties.

Critical design features such as the types of payments covered, how to determine whether a payment is undertaxed and the use of carve-outs are still being discussed by the Inclusive Framework.

Proposed outbound measures

Source: BDI



Most recent US proposal of 6 April 2021

In the beginning of April 2021, the U.S. has announced its willingness to modify its national legislation and align it with the OECD proposals, in particular with Pillar Two on the global minimum tax. To this end, Base Erosion and Anti-Abuse Tax (BEAT) could be replaced with a corresponding Pillar Two regulation based on the Undertaxed Payments Rule (UTPR). In addition to the implementation of Pillar Two measures, the accompanying Pillar One measures are important. They support, stabilize and complement the Pillar Two measures and serve to achieve the objectives.

The Blueprints set a solid foundation for the Pillar One goals. Global consensus is difficult because of the far-reaching measures; work on this can and must be done. However, the U.S. has declared that they cannot agree to measures that are directed against U.S. companies. Further, the proposed measures in their view are far too complex and bureaucratic, the complexity leads to a lack of consensus. They have proposed to revise or abolish ADS and CFB definitions and stressed the need for simplification.

According to the U.S. proposal, the scope should be limited to the largest and most profitable companies. There should be no specification of particular business sectors, only size and profitability (quantitative criteria) should be taken into account (so-called comprehensive scoping). In this way, the scope can be reduced and thus become more administrable. Exceptions should only apply if they are absolutely necessary for important reasons and should be of a fundamental nature. This solves exactly the two main points of criticism of Pillar One: scoping regime and business line segmentation. For this purpose, a clearly defined revenue and profitability threshold should be defined as a starting point. Moreover, the U.S. supports a proposal that eliminates or minimizes business line segmentation and regarding tax certainty the blueprint delivers a set of good proposals where details still need to be worked out. The United States also advocates for a binding dispute resolution and prevention procedure.

03 Taxing the Digital Economy – An Academic Perspective

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"The progressing digitalization of our economy represents the greatest challenge since the industrial revolution. The OECD reform proposals show numerous shortcomings. From a scientific perspective, it is recommended to expand the concept of withholding taxes and shift the focus to VAT."

General Tax Challenges in the Era of Digitalization

The ongoing digitalization of our economy poses the largest disruption to business models since the industrial revolution.[3] In general, academics and supranational organizations are confident about the positive impact of the digital transformation on society, economic prosperity and innovative developments.[4] However, the digital revolution has created considerable challenges for the existing system of global corporate taxation. The debate on the most pressing challenges and reform proposals has started to gain momentum in response to the discussion at the level of the Organization for Economic Co-operation and Development (OECD). In its 2018 released Interim Report on "The Tax Challenges Arising from Digitalization", the OECD has affirmed three major challenges: (i) the nexus of taxation, (ii) the attribution of value to data and its usage, and (iii) the characterization of payments that are attributable to new business models.[5] The Interim Report lacks an empirical evaluation if digital businesses are more tax aggressive than less-digital corporations. Among other scholars, Olbert and Spengel (2017) have acknowledged key pressure areas for taxing digital businesses and recommended careful adjustments to the prevailing system of corporate taxation to realign the taxation of profits with value creation.[6] Early 2019, the OECD proposed a two-pillar strategy to address asserted tax challenges of the digitalized economy.[7] On the one hand, the OECD proposes the revision of the profit allocation regulation and recommends to establish new nexus requirements (Pillar One). On the other hand, a global minimum tax is proposed which goes beyond reforms that address the digitalization of the economy but presents a more fundamental change to the global system of corporate taxation (Pillar Two).

The digitalization opened opportunities to adjust the value creation of traditional businesses and created the ground for entirely new business models. Most digital businesses rely on powerful hardware, self-collected or acquired data, innovative software and a high degree of digital interconnectivity.[8]

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3 Brynjolfsson and McAfee (2016), p. 90.

4 See for example Brynjolfsson and Mitchell (2017); McAfee and Brynjolfsson (2017); OECD (2017) and OECD (2016).

5 OECD (2018a), p. 169; OECD (2015), p. 99.

6 See for an additional discussion of key challenges for taxation and reform proposals i.a. Devereux and Vella (2018); Schön (2018) and see for an update on the assessment of the recent political discussions: Olbert and Spengel (2019).

7 OECD (2019a), p. 6; OECD (2019b), p. 7; OECD (2019d) and OECD (2019e)

8 According to the OECD Interim Report 2018, the main characteristics of digital business models are scale without mass, high reliance on intellectual property and the importance of data from user participation. OECD (2018a), p. 24; Olbert and Spengel (2017), p. 6.

Understanding new business models is vital to develop recommendations on how to adjust the corporate tax system. It can be appreciated that the OECD acknowledges this need and any reform proposals should be based on insights gained in this process.[9]

Our contribution at hand adds to the insights in digital business models by sketching the process of transforming raw data into knowledge and providing guidance on the application of transfer prices to allocate taxable profits across tax jurisdictions. Further, we assess the OECD's key reform proposals and relate them to the ongoing academic debate.

Value Creation - Analyzing Business Models and Allocation of Taxable Profits

From Data to Knowledge

Data has become an important value driver for business. Today, 'Big Data' is a key asset for many digital (and traditionally non-digital) businesses and contributes to improved decision making and to value creation. Among policymakers and academics, however, it is not yet agreed upon, how to determine the value of data and how to treat it with regard to corporate income tax purposes. It is generally accepted that the value of data should be considered for taxation of corporate income. In simple terms, there are two options to take the value of data into account.[10] First, if it is seen as impossible to determine the true value of data, a fundamental tax reform towards a destination-based cash flow tax or residence-based shareholder taxation seems inevitable.[11] Second, a more promising and politically feasible approach would be the adjustment of prevailing principles to allocate profits according to the arm's length principle along the value chain. To provide clear guidance on the application of transfer prices it is necessary to understand the structural concept of how data is used to create value. The role and location of specific people functions in integrated, digital business models should be the focus for any efforts to design tax rules in response to the digital economy.

While some argue that data can be compared to valuable natural resources and draw an analogy to raw oil, this comparison is flawed.[12] Data is an important input factor for an IP intensive transformation of raw information to knowledge by discovering meaningful structures and patterns.[13] This process, which can be split across different legal entities and functions of a globally operating company, is often referred to as 'Data Mining'. For example, in a digital business model, such as a digital music platform, it is an important competitive advantage in the business to consumer market to understand the needs of customers and adapt the supplied services accordingly. The corporation can collect raw data from users in the market jurisdiction, pre-process and store the data in a data warehouse at a different location. Its employees can then apply self-developed and continuously revised and adapted algorithms (in the form of software applications) to the prepared data. Finally, the decision maker has to interpret and evaluate the gathered information and can use the knowledge to improve and sell services in foreign markets. The process of 'Data Mining' is unique for any company. Both firms that are founded in the digital sector and firms experiencing a gradual digital transformation can perform it. Central to the process of knowledge development is the involvement of specific people functions. Policymakers should refrain from any short-sighted tax legislation that intends to tax the usage of data as many firms already perform 'Data Mining' activities to various degrees.[14]

9 OECD (2019b), p. 6; OECD (2018a), pp. 24–26.

10 Olbert and Spengel (2019), p. 17.

11 The reform options are discussed by Devereux and Vella (2018) and Schön (2018).

12 Similar critical considerations of this comparison can be found in Goldfein and Nguyen (2018); Marr (2018) and Olbert and Spengel (2019).

13 See Linoff and Berry (2011) and Witten et al. (2016) for an introduction to data mining techniques.

14 Ludwig et al. (2019), chapter 2.3.2.

Guidance on Transfer Pricing

In a recent survey, conducted among corporate transfer pricing managers, tax consultants and auditors of German tax authorities, Greil, Müller and Olbert (2019), find that transfer pricing in digital business models is a pressing issue for corporations. They find that traditional transfer pricing methods (i.e. the cost-plus method) are still prevalently used despite the profit split method is recommended as the most appropriate method for digital transactions.[15] Based on their survey, the authors conclude that the resolution of uncertainties with regard to transfer pricing guidelines should be a major concern for policymakers.[16]

In light of the above discussed 'Data Mining' process, the first task of allocating profits to legal entities within an integrated company is to identify the activities performed by individual entities along the value chain of the knowledge development process. The next challenge is to determine the value of the specific activities in relation to the overall value creation by 'Data Mining' to set transfer prices in accordance with the arm's length principle. The nature of intra-firm transactions makes it – for traditional and inevitably also for digital business models – extremely difficult and almost impossible to find comparable transactions between unrelated market participants.[17] Furthermore, the individual characteristics of digital businesses' key value drivers, intellectual property and know-how add complexity to the determination of activities' value.

Nevertheless, a conceptual analysis of the functions and risks involved in the 'Data Mining' process or other digital business models, with a focus on the specific people functions, can provide benchmarks to set transfer prices in accordance with comparable market prices. Across many industries, companies have evolved that focus on separate steps of the 'Data Mining' process, such as the collection of raw data, the preparation of data or the provision of information, and sell their services on the market.[18] Besides, traditional research and development processes, which have to some extent similar characteristics as data mining activities, could serve as a blueprint for the application of transfer pricing guidelines. If the standard transfer pricing methods are not suitable to allocate profits within an integrated company, the profit split method should be considered to find consistent transfer pricing solutions. The OECD's recommendations on the residual profit split method can provide guidance for highly integrated business models.[19]

The OECD Reform Proposals

Profit Split Method – The "Unified Approach" (Pillar One)

Guidance on the application of the transactional profit split method has already been updated in June 2018 as part of the BEPS-Project: Action 10. These transfer pricing regulations are recommended to highly integrated business models whose transactions involve unique and valuable intangibles and the involved parties share the assumption of economically significant risks.[20] Digital corporations, in general, meet these characteristics. The OECD develops a new "Unified Approach" in its most recent public consultation document. In general, the proposed "Unified Approach" introduces a new profit allocation rule that should complement the arm's length principle. The proposal suggests to calculate a deemed residual profit at consolidated group level using simplified methods and to allocate a fraction of this profit – based on sales – to market jurisdictions. Routine tasks should be remunerated with arm's length principle based transfer prices.[21]

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[15] This argument has also been brought up by Hongler and Pistone (2015).

[16] Greil et al. (2019), p. 30.

[17] Keuschnigg and Devereux (2013), p. 432; Olbert and Spengel (2019), p. 21.

[18] In addition to raw data providers, such as Thomson Reuters or Bureau van Dijk, many firms provide services along the value chain of data mining such as the German Kendaxa Group that specializes in data intelligence.

[19] OECD (2019a), p. 13.

[20] OECD (2018b), p. 14 ff.

[21] OECD (2019d), p. 6.

Leading tax scholars have proposed a more systematic profit split approach and argue that this method combines traditional transfer pricing methods for routine tasks with a more flexible approach for hard to compare transactions of digital corporations.[22] They argue that this reform proposal, which recommends allocating the profits based on residual gross income, would be an improvement in comparison to the existing system on several dimensions. The idea to re-examine the formulary apportionment of residual profits and to combine this approach with traditional transfer pricing methods has been regularly discussed in the academic literature.[23] The OECD suggests sales as the allocation key to disperse taxable income across jurisdictions. A convincing feature of a more systematic profit split approach is that the determinants to allocate profits are in principle not chosen arbitrarily.[24] The combination of production based factors, such as assets and labor, and consumption based determinants, such as turnover, ensures the allocation of the tax base in accordance with the source based and the destination based principle.

In general, it is impossible to replicate the true economic value of intra-group transactions with traditional transfer pricing methods. Corporations are mostly concerned with tax compliance and avoidance of double taxation.[25] Any reform proposal, such as a profit split method, and adjustments to the transfer pricing guidelines should consider a pragmatic approach. They should minimize uncertainty for taxpayers, be relatively easy to implement into the existing system and facilitate the administration of cross-border transactions. Yet, the "Unified Approach" cannot achieve this goal convincingly.[26]

Minimum Tax and Deduction Disallowance (Pillar Two)

The second pillar of the OECD recommendations is devoted to any post-BEPS risks of profit shifting to low-tax jurisdictions. Despite its position in the report on challenges of the digitalization of the economy, the proposed coordinated introduction of both a minimum tax and a deduction disallowance are neither restricted to digital firms, nor can the specific characteristics of digital business models provide the main rationale for the introduction of this more fundamental reform option to prevent income relocation.[27]

The minimum tax proposal suggests to include the income of controlled affiliates in the domestic tax base if the foreign income is subject to a low effective tax rate.[28] According to the OECD proposal, the tax on the foreign income should be topped-up to at least a generally applicable minimum tax rate and member states should refrain from applying their statutory tax rate to foreign income.[29] This proposal would strengthen the residence principle as corporates' worldwide income would be subject to at least the minimum tax in the residence country. Companies might try to evade the minimum tax by relocating their residence to non-compliant countries. The second proposal of Pillar Two – the tax on base eroding payments – provides a counteracting force. This recommendation proposes a deduction disallowance for payments to related entities that are not subject to a minimum tax rate and suggests to tie treaty benefits to an appropriate tax level in the recipient jurisdiction.[30] This measure would prevent the tax base erosion by intra-company transactions to low-tax jurisdictions and strengthen the source based principle.

22 See Devereux et al. (2019) for an intensive discussion on the potential design of a residual profit split method.

23 Avi-Yonah and Benshalom (2011) have already promoted the formulary apportionment system.

24 Jacobs et al. (2016), p. 238.

25 Greil et al. (2019), p. 21.

26 See our comment on the public consultation document to Pillar One of November 2019.

27 Grubert and Altshuler (2013) have analyzed the potential effects of a minimum tax in a model demonstration and Englisch and Becker (2019) provide a recent overview of policy rationales to introduce a minimum tax.

28 OECD (2019b), p. 25.

29 OECD (2019a), p. 27 and OECD (2019e).

30 OECD (2019b), p. 27.

The proposed coexistence and reinforcement of the residence and source based taxation principle might lower the attractiveness to relocate income to low-taxed jurisdictions and to relocate the residence of companies. Nevertheless, the new measures could also increase tax competition between OECD member states with the coordinated minimum tax level being the lower bound. Furthermore, the risk of double taxation increases if all jurisdictions try to expand their access to the tax base of multinational enterprises. The design of far-reaching reform proposals should be considered carefully and provides the opportunity to replace existing unilateral and diverse BEPS countermeasures.

Assessment of Reform Proposals and Alternative Recommendations

So far, all OECD initiatives to adjust the system of corporate taxation, including the well-known BEPS Action Plan, exclusively aim at protecting tax revenues of member states at the expense of improving conditions for investment and, thus, employment including underlying revenues from taxes and social security contributions. The proposed reforms step in the same direction. The OECD's two-fold strategy intends to ensure market countries a fair share of taxation right (Pillar One). Simultaneously, the proposed global minimum taxation and deduction disallowance regulations aim to restrict tax competition and to strengthen both the residence and the source principle (Pillar Two).

With regard to Pillar Two, a global minimum tax likely distorts ownership structures if not all countries adopt worldwide taxation and credit foreign taxes. In addition, the location of real investment will be distorted if some countries refrain from adopting the deduction disallowance regulation. Severe economic distortions can only be prevented if corporate taxation is fully harmonized on a global basis including tax rates. This has been known and recognized for decades now.[31]

Furthermore, minimum taxation measures already exist around the globe in the form of controlled foreign corporation legislation (CFC legislation) and interest and royalty deduction limitations rules. The EU Anti-Tax Avoidance Directive has already put forward a harmonized approach for both CFC and interest deduction limitation rules within the EU member states until the end of 2019.[32] An extension of these concepts, as proposed by the OECD, thus, increases tax complexity, administrative costs and the risk of double taxation.

As an alternative, referring to minimum taxation, we first recommend to rely on existing CFC legislation for outbound investment. Regarding inbound investment, we recommend to levy withholding taxes at source comprehensively and consistent on all cross-border transactions. Extending withholding taxes in an internationally coordinated way ensures source taxation and thus the allocation of taxing rights.[33] In line with the existing system, double taxation can be avoided by crediting withholding taxes in the residence country, the proposal would dry out tax havens.

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[31] Tanzi (1995).

[32] Anti-Tax Avoidance Directive (ATAD): Council Directive (EU) 2016/1164 of 12 July 2016 laying down rules against tax avoidance practices that directly affect the functioning of the internal market, OJ L 193/1 (19 July 2016), at 1–14.

[33] Fuest et al. (2013), p. 319.

Second, referring to the allocation of taxing rights to market countries according to Pillar One, we recommend to concentrate on indirect taxes to generate tax revenues at the location of user participation. The role of value added taxes (VAT), as an already existing mean to tax consumption in market countries, is surprisingly not at all considered in the current political discussion.[34] Yet, billions of tax revenue are at stake if consumption taxes are not collected appropriately.[35] Enforcing VAT on digital services thoroughly is a crucial step to generate and protect tax revenue in market jurisdictions.[36] Furthermore, the increasing relevance of the sharing economy contributes to a defragmentation of the economy and the appropriateness of small-business VAT exemption regulations is debatable for highly digitalized interactions between market participants with systematic and complete knowledge of transactional data.

Platform providers could be integrated in the process of consequent VAT collection.[37] Moreover, enforcing VAT on non-monetary transactions, i.e. the exchange of user data for services such as Google or Facebook, could be a viable solution to ensure tax revenues at the market jurisdiction and is in line with existing tax principles.[38]

Overall, we highlight the potential disadvantages of the recent OECD reform proposals if they are not harmonized globally and our briefly sketched recommendations – to expand the concept of withholding taxes and to shift the focus on VATs – could provide pragmatic short-term solutions to some of the most pressing tax issues in the era of digitalization.

[34] The OECD has recently presented a recommendation on the collection of VAT: OECD (2019c).

[35] The VAT gap is estimated to exceed EUR 150 billion in the European Union in 2015. CASE and IHS (2017), p. 8; Olbert and Spengel (2019), p. 3.

[36] An assessment by the ZEW for the German Ministry of Finance estimates that the total revenue of digital services exceeds 5.7 billion Euro in Germany in 2016. ZEW (2017), p. 20.

[37] See also Bräutigam et al. (2019) for a discussion of reform proposals.

[38] It has been admitted among legal scholars that such non-monetary transactions are subject to VAT. See Pfeiffer (2016), p. 161.

04 BDI Position

BDI advocates for a solid, long-term framework for a consensus-based and easily administrable international tax architecture

Avoidance of Double Taxation

Dispute Resolution Mechanisms

Legal Certainty

Pillar One

The **scope and the nexus** of Pillar One should not be validated every year but in **agreed-upon periods** (e.g. every five years). The introduction of administrative simplification mechanisms would be vital for both tax administrations and businesses to ensure compliance.

While the final details of the new nexus still need to be developed, the creation of a new nexus is likely to come with significant administrative challenges. If MNEs without physical presence in market jurisdictions are required to file additional tax returns, this will represent a significant additional compliance burden and could give rise to treasury issues in terms of cash-flow. This is further aggravated when this requires the establishment of a financial representation in the market jurisdiction.

The documentation requirements should be limited for those companies under Pillar One that are predominantly out of scope. In addition, multinationals need clarity and certainty of in-scope and out of scope businesses. Generally speaking, we believe that **administrative simplification** is a far more important objective than seeking to set monetary or activity-based thresholds.

A "SPOC" ("single point of contact")-Approach should be implemented as it would promote the headquarters' responsible national tax authority to lead the tax administration of the "Unified Approach". Such a "competent authority" would be responsible for verification of the applicability of the "Unified Approach", compliance, declaration, enforcement, collection of payment, onward distribution of payments and issues binding decisions which cannot be challenged by market jurisdiction's tax authorities. A uniform electric form would further simplify the administration.

We take the position that in case segmentation reports (business line, region) which have been certified by professionals such as tax consultants or chartered accountants before submission to the "competent authority", these certificates must be binding for the "competent authority".

The **"competent authority" of the headquarter** should be entitled to decide whether an MNE would fall under the scope of Pillar One. Also, it should have reporting obligations to all other "competent authorities". In this regard, there must be **clarity about parent companies domiciled in two jurisdictions ("dual-resident companies").** It should be determined in a bilateral (cf. with Art. 4 OECD-MC) procedure which jurisdiction is the country of domicile for purposes of the "AB"-Approach to assess in which country the "SPOC" is determined.

Scope

The scope for the application of Amount A should be based on an activity test. The definition of the in-scope activities does not attempt to ring-fence the digital economy and targets ADS and CFB. At the moment, the concepts of ADS and CFB are defined rather broadly and leaving room for uncertainty, ambigous interpretations and complexity. In order to be manageable for businesses, further clarification and sharpening of the scope is needed.

Automated Digital Services

The first category – Automated Digital Services (ADS) – would cover business models which provide automated and standardized digital services to a large and global customer or user base such as cloud computing services, online advertising services, online search engines and online intermediation platforms such as digital marketplaces. It is important that the concept of ADS is further sharpened and oriented towards the underlying policy rationale to specific challenges created by the digital economy and digital business models.

Consumer-Facing Businesses

The scope of Pillar One does not attempt to ring-fence the digital economy, it also targets "broadly consumer-facing business" (especially via "Amount A"). One of the key challenges of the scope lies in defining "consumer-facing". The Pillar One Blueprint suggests that Consumer-Facing Businesses (CFBs) would include businesses that generate revenue from the sale of goods and services of a type commonly sold to consumers. Nevertheless, there is **high uncertainty** as to which business models, industries and segments might be considered within scope. After all, **at the end of each value chain, there is always a consumer**. If the concept of a consumer-facing business cannot be well-defined, we are concerned that the scope of Pillar One may generally increase tax liabilities in market jurisdictions, leading to an outcome which is neither focused nor appropriate. While the Blueprint has further narrowed the scope and includes partial sector exceptions, such as for financial services, it otherwise remains indeterminate. In addition, it is currently also discussed whether a phased implementation with ADS coming first and CFB following later should be taken into consideration.

Generally speaking, situations, where the applicability of the "AB"-approach instead of the ALP is not clear cut for an MNE at the beginning of a taxable periods should be avoided. We believe, that a possible definition should **consider at least the following aspects**:

1. As a **starting point for the discussion**: Consumer-facing businesses offer their products or services to a **multitude amount of (potential) customers or users** to generate revenue. Their sales approach is orientated on a high number of addressees with the aim to generate a high product or brand awareness. Non-consumer-facing businesses instead have less customers, a more individual and a closer client relationship.

2. For a **clearer definition**, only products that are readily usable for consumption (e.g. without any significant modification prior to be consumed) should be considered. A catalogue based on the internationally **Harmonized six-digit Code System** could be considered.

3. For a negative demarcation of "consumer facing", any **look through provision** that requires tracing direct sales through third-party distributors to end users or consumers stands to introduce significant complexity for both taxpayers and tax authorities and should thus be excluded from the scope. Pillar One should shift to the new nexus rules only as far as it is required by the digitalization of the economy. Sales through low-risk distributors are likely to take place through a taxable presence within the market jurisdiction and, hence, to be captured by that market jurisdiction's tax regime.

Attempts to argue if a business is "consumer-facing" or not would lead to discussions that are neither helpful for companies nor for tax administrations and make the solution impossible to administer.

Only remote sales ("B2C") should be targeted, which is in line with the Pillar One policy objective. Sales to third party distributors/intermediaries, who themselves sell further to third party consumers in different jurisdictions, are a challenge for MNEs as the final sales destination cannot be identified. If sales through third party distributors/intermediaries are considered, taxpayers could simply side-step the new rules by using alternative forms of a physical in-country presence (whether a local branch or related entity), **making the new taxing right elective**.

Therefore, **clear, proportionate and aligned rules should exclude "B2B"-activities from the scope of the proposal**. This is essential to achieve the policy goals of Pillar One. Where companies do not use in-house distribution but rather third parties, it is impossible for them to determine in which country the end consumer is located, since they would only be able to track the sales to the third-party distributor. Companies also have no knowledge about the end consumer if contracts are concluded "local-to-local" and the contracting party may, for example, grant rights of use within the group. If the political will deviates from this approach, it would be helpful to **define an exhaustive list of "B2B"-operations which are in the scope of Pillar One**. The in-scope carve-outs mentioned in the Pillar One Blueprint regarding sectors that mainly provide "B2B" services, i.e. natural resources, international aviation and shipping services or financial services are welcome, but remain unspecific, especially with regard to re-exceptions. Challenges associated with the determination of the location of sales would remain.

Definition MNE

For MNEs within the scope limiting the new rules to "Consumer-Facing Businesses" is meaningful, as in a production chain the country where the final product is consumed is not necessarily the country of production.

First, it needs to be determined **what constitutes the MNE**. Evidently, this could be determined by the same rules as for purposes of **Country-by-Country Reporting (CbCR)**, i.e. the same definition as used for the consolidated financial reporting of the group.

Segmentation requirements

Business segmentation is a dynamic process. Hence, using **segmentation** as a reference **would increase the overall complexity**. Nonetheless, business **segmentation** could instead be **relevant for "mixed" MNEs** with multiple business lines, but also for MNEs with business models where different entrepreneurs operate in different regions. Applying segmentation might likely be difficult in several cases, since:

1. The organization of the business units follows internal guidelines, that are generally not based on the separation of consumer-facing and non-consumer-facing and

2. Figures for the relevant consumer-facing areas are often not available in external accounting but only within the framework of management accounting. We want to emphasize, that although in this case the segmentation would follow management accounts, there is no reasonable economic incentive for MNEs to manipulate these accounts, since they serve as base for calculating operational ratios. The segmentation can be verified and certified by a chartered accountant. In line with the "SPOC"-Approach, the home-jurisdiction tax authority could audit and approve this segmentation.

It should be at the discretion of the group to form **reasonable business segments** for allocating the profits. If these are not in line with CFB or ADS, **detailed and harmonized OECD-guidelines** for segmentation are required. However, we advise against integrating the guidelines into financial standards (e.g. IFRS). In case a segmentation beyond the segments in the annual financial statements is required, businesses would be confronted with significant administrative burden. Therefore, any segmentation required should be practicable and seen to meet the objective of Amount A only.

A way to minimize the burdensome calculation of profits for segments would be to stick to MNE segments according to their financial statements. At the same time, any further segmentation requirements should be ruled out. Should this not be politically feasible, it should be considered to establish alternative materiality thresholds which should apply at the level of operative segments according to the annual report.

Threshold

Once the group is defined, it must be determined which size of group should be in-scope. Considering the background of administration and compliance costs it seems to be fair to define and implement a threshold which captures large MNEs only. The OECD Secretariat has suggested a consolidated group revenue threshold of EUR 750 million consistent with the CbCR rules to ensure that smaller companies are not burdened with additional administrative efforts. At the same time, according to the *de minimis* foreign in-scope revenue test, a second threshold should apply to MNEs that exceed the EUR 750 million revenue threshold, but only have a small amount of foreign source in-scope revenue. **Any threshold should be empirically validated in a transparent manner**, which means higher thresholds should be considered if they prove capture the policy objective of Pillar One more accurately.

Past and current losses should be considered by application of the threshold. For instance, this could be done by applying the threshold on the average revenue of the last five years.

We support the suggestion that the market revenue thresholds will apply to the in-scope revenue of a group (or segment of a group where relevant) generated in a market jurisdiction. It is important to apply the EUR 750 million threshold per country and **to only such revenues which are in-scope**. Otherwise, a MNE with insignificant in-scope revenue but significant out-of-scope revenues with a total which exceeds the threshold would become fully liable to the overwhelming new compliance requirements.

We feel the need to underline, that **hard cut-off thresholds** (both for scope and nexus) **increase complexity**, especially when revenues cycle around the threshold: MNEs would cycle in and out of the new rules from year to year. This situation could be avoided, if an average "Multi-Period"-Approach would be applied. In this context the effects of **inflation and exchange rate risks** should be analysed in depth. The local currency of the headquarter (decisive currency for the consolidated financial statements) should be used as the currency for the sales threshold.

Carve-outs

A scope which is limited to specific business models would be prone for dispute and avoidance strategies. On the one hand, it can be assumed that the exclusion of individual sectors will reduce the number of companies in total, which could increase the re-allocated profit of the remaining MNEs. On the other hand, a wider scope would include more companies, the allocated amounts per company could be lower, minimising the effects this would have on a jurisdiction's financial position. This proposal should also be considered against the background of equal taxation.

A distinction must be made between carve-outs from within scope MNEs and systematic and principle-based exclusion, such as:

1. **MNEs with almost exclusively domestic activities** (e.g. above 80 %). Therefore, the proposal in the Blueprint for Pillar One to introduce a revenue threshold related to significant foreign sales is to be welcomed. Regarding the revenue threshold, a transparent and empirical way has to be determined. The de minimis foreign in-scope revenue test is intended to exclude MNEs that have a small amount of foreign in-scope revenue (using a threshold of of EUR 250 million), which would result in a low amount of total profits to be reallocated under Amount A.

2. **MNEs with high entrance barriers in market jurisdictions**. In this context the interaction between "Amount A" and customs duties and withholding taxes should be explored deeper. It must not give rise to additional filing or tax requirements for other taxes (income or non-income tax), as well as non-tax areas (such as environmental, labour, customs etc.). Therefore, it is positive that the Blueprint reaffirms that the new nexus rules will be considered a standalone provision.

3. **Profits connected with physical presence according to Article 6, 8 and 13 of the OECD model convention**. This new nexus would be introduced through a standalone treaty provision of the OECD model tax convention, e.g., Article 6a or 7a OECD model tax convention as a further exception to transfer pricing under ALP and permanent establishment allocation under of Article 5, 7 and 9 OECD model tax convention. The new rule should not affect existing exceptions but should have equal status.

Nexus

New nexus rule

Independent of the MNE's business structure and the number of group entities earning a residual profit by doing business in a market jurisdiction, **only one "digital PE" (nexus) per market jurisdiction** should be established. Only one taxpayer should file one single tax return per market jurisdiction even in cases where multiple entities earn residual profits. Considering that the digitization of the economy is a very dynamic process, the **new PE definition must withstand the dynamic element** or else will become obsolete in a short span of time, triggering hurdles for taxpayers and administrators.

Implementing a new nexus may require modifications to domestic tax law (e.g. § 49 German income tax law). Any reform would need to be **compatible and implementable within every IF jurisdiction**. Parallel to the introduction of a new standalone article in the OECD model tax convention for the new nexus, the articles 23a to 27 of the OECD model tax convention should be modified.

Threshold

The new nexus needs to go beyond physical presence but should **mirror some form of significant economic presence** in the market jurisdiction. The significant economic presence nexus is not very principled in its economic foundation and does not have an obvious link to concepts of value creation. It has the advantage that its scope can be determined flexibly by setting appropriate parameters such as revenue thresholds.

It should be clarified that any new nexus (and associated profit allocation) is **only applicable for purposes of direct taxation** (as discussed in the Pillar One Blueprint) and will not give rise to additional filing or tax requirements for other taxes (e.g. VAT) or custom duties. The stated intent to avoid spill-over effects from a new nexus rule should be clearly supported with wording that limits the ability of jurisdictions to use this rule for anything other than "Amount A" purposes. A strong interplay of the revised profit allocation rules with the new nexus proposal is essential to ensure that not only market countries but also origin countries get their fair share of the profit.

While we agree with the revenue threshold of EUR 750 million, it must be ensured that there is in any case significant economic activity, initiated and sustained by the MNE, in the market jurisdiction to trigger a nexus. A **sales threshold** can be a primary indicator for this purpose, but others should be explored as well. Even though ring-fencing is impossible, **country specific thresholds** would capture policy objective, i.e., large digital MNEs but exclude minor in-scope sales to minimise administrative burden.

The **calibration of jurisdictions** to ensure that smaller economies can benefit too shall be designed to ensure that "Amount A" is sufficiently large to meet the policy objectives while excluding minor amounts. To ensure that small jurisdictions benefit from the "Unified Approach" in the same way as large jurisdictions do, a **multitier threshold** should be considered which categorises countries in accordance with economic indicators such as GDP and defines a sales threshold for each category.

New profit allocation rules

General remarks on the new "AB"-Approach

We note that the Pillar One Blueprint is rather unspecific when it comes to the crucial question on "how much" should be redistributed to market countries. Nearly all the required input parameters for "Amount A" and "Amount B" are still to be determined. A formulaic **redistribution of residual profits** to market countries should be **limited to a modest fixed amount**.

Against this background it needs to be **clarified** whether **international accounting standards** could be taken as a starting point for the market redistribution, and if so, whether the receiving market jurisdictions would have the legal sovereignty to define own rules to reconcile IFRS/US-GAAP revenues/profits to the taxable profit. While this approach referring to the respective standard of the consolidated financial statements seems to be reasonable from a practical point of view, there might be **challenges**:

1. In Germany (and many other countries), not all taxpayers prepare their financial statements consistently based on IFRS/US-GAAP, but also on German or **other local GAAP**. If any accounting standard is applicable to calculate "Amount A", this might result in an **unequal taxation** (thus contradicting e.g., the principle

of tax equality pursuant to Art. 3 par. 1 German Constitution). The most prominent example is certainly the fair value accounting according to IFRS, whereas German GAAP usually refer to historical cost to evaluate assets/liabilities in accordance with the principle of prudence. This mismatch would result in significant uncertainties not only for the taxpayers but also for the tax authorities.

2. Furthermore, e.g. the German Federal Fiscal Court has stated that IFRS may not be used to determine the taxable profit (Decision as of 25.08.2010, ref. I R 103/09, Federal Tax Gazette, Part II 2011, p. 215). Accordingly, the **IFRS-based profit** could **not** be directly taken as the **taxable profit** to be reallocated to market countries.

Hence, we suggest that the **accounting standards applicable in the jurisdiction of the headquarter** (relevant for group accounting) should be considered as it is discussed in the Blueprint. This would provide tax certainty and minimize administrative burden. If, despite all concerns, IFRS would be defined as the only allowed standard to determine "Amount A", there should be specific rules to ensure the correct taxation in the transition phase (e.g. from German GAAP to IFRS).

Legal and procedural issues

There must be a clear legal basis for the two-tier mechanism ("Amount A" and "Amount B") to ensure its consistent application worldwide.

A strong emphasis on **dispute prevention and resolution** should be integral **to each of the two types of profit**. Otherwise jurisdictions could "cherry-pick" the elements of the mechanism which they consider favorable while not applying other elements. This would aggravate the risk of double taxation even further.

Regarding dispute prevention, calculations, declarations and enforcement of the "AB"-Approach should be handled by only one "competent authority" **("SPOC"-Approach)**. To ensure standardized procedures and based on availability of information the following system could be reasonable:

"Amount A": The "competent authority" in the headquarter jurisdiction is responsible for providing binding information to tax authorities of the market jurisdictions.

"Amount B": The "competent authority" of the physical presence is responsible for providing binding information to tax authority of the headquarter jurisdictions.

"Amount A"

Calculation of group profits for "Amount A"

The calculation of "Amount A" should be designed **considering data availability and practicality**. Generally, data can be derived from the group financial statements in accordance with local or international reporting standards as well as CbCR data for fully consolidated companies.

If **consolidated financial standards** of the parent company apply, it should be considered that the standards applied may differ according to the size of a group and the fact whether the group is publicly listed or not. Determining the profit for tax reasons based on the most complex standard, i.e., large groups which are publicly listed, is not helpful, as this de facto would lead to new reporting standards and add a significant administrative burden to smaller groups.

Financial accounts are meant to give a financial picture to investors, **not** data to **tax authorities**. Similarly, businesses are partitioned into segments for internal control purposes rather than to provide an accurate view of profitability for fiscal purposes. Given there should be no base erosion concerns at a group consolidated level, adjustments to a group's financial statements should be limited. The **IF should engage with financial accounting and tax experts** to best construct a reporting framework that minimises disruption and complexity.

For example, it could be reasonable to allow for **adjustments** of consolidated financial statements for **material book-tax differences** (e.g. more than EUR 5 million). **Capital-intensive industry** invests significant capital in fixed assets, which is why differences in the recovery period for book and tax purposes will cause distortions if book profit is used without adjustments. Some special items could be excluded too. **At equity consolidations, proportional consolidations and minority joint venture stakes must be excluded** to avoid the inclusion of profits without real sales. Adjustments might also need to be performed to level out effects of items that could drive a difference between residual profits derived on the group level and taxable profits earned by residual profit

earners. Nevertheless, considering data availability and practicality considerations, **crude approximations** computation might be the only viable solution that can be applied by all MNEs.

However, many companies only **segment at the gross margin level**, so it will be necessary to decide how to allocate common expenses. Group expenses and overhead costs should be allocated among the entity's business line or regional grouping. Consolidated profits per market jurisdiction and/or business line are most likely not available in most MNEs since this does not necessarily reflect the organisation of current business models and regulatory requirements do not necessitate such calculation.

Losses must be considered appropriately, even **over several years** as losses might arise in multiple years while profits only in a certain year. A **fair and simple solution** to deal with loss situations needs to be implemented. Although the Blueprint confirms the introduction of an "earn-out" mechanism, no political consensus has yet been reached on its scope. So far, only a loss carry-forward in the context of a single account pooling of losses for Amount A is considered. The IF should also consider loss carry-backs as a possibility for appropriate loss accounting. Moreover, an **average "Multi-Period"-Approach** for the calculation of "Amount A" would help to partly solve his challenge from a conceptual and operational perspective. However, it must be avoided that by segmenting Amount A is distributed and taxed without an actual relief in the country of the paying entity. Since time limitations for loss-carry forwards are discussed in the Blueprint, a limitation of the time period of – for example – five years should be introduced.

Determination of "Amount A"

As a substitute for unilateral digital taxation, "Amount A" is an entirely arbitrary measure and there **is no conceptual link to an arm's length reasoning** based on the OECD Guidelines.

Only market jurisdictions where new nexus exists should be considered. German industry strongly believes that market jurisdictions should only receive allocated "Amount A" profits if the jurisdiction has signed up to the legally binding Pillar One framework and utilises the centralized dispute resolution mechanisms contemplated.

The splitting of profits into "normal" and "above normal" can cause many legal disputes unless very clear guidelines are in place. Therefore, the adopted rules should **not provide any leeway for different (legal) interpretations** in the participating jurisdictions.

Hence, a **simplified approach should apply**. That is, re-allocation of a portion of non-routine excess returns ("above normal profit") to market jurisdictions **via formula**, which could be calculated for the **group, per business-line and/or region**. It is important to highlight that determining profit at product level, segment level or country or region based on financial consolidated accounts would be extremely challenging as the way revenue and costs are segmented and allocated to different sectors depends on the individual company and its structure.

The deemed residual profit used for "Amount A" should be the result of simplifying conventions agreed on a consensual basis. This means that "Amount A" would only **seek to approximate, without precisely quantifying**, the amount of residual profit of an MNE.

The **deemed routine profit** (x per cent) should be set at a "high enough" level (minimum 10 per cent (proportion of profits to revenues) or higher for specific industries) on an MNE level.

On the other hand, we take the position that the **profit re-allocation share** (w per cent) to market jurisdictions should be set considerably low, considering that residual is in general driven by many factors which are not related to markets.

The value of "w" could indeed **vary by industry**. However, one of the key purposes of the "Unified Approach" is to ensure simplicity, certainty and consistency. Hence, this differentiation would run contrary to that purpose.

Elimination of double taxation

There are several substantive and procedural issues (through either difference in law or interpretation between tax administrations) regarding "Amount A" which should be elaborated with care and in close exchange with the industry. The Pillar One Blueprint discusses a mechanism which is based on two components: First, the identification of the paying entity (or entities) within an MNE group (or segment, where relevant),

based on a four-step process; and second, the methods to eliminate double taxation.

From an industry point of view, **provisions should be established to guarantee a relief for Amount A in paying entities**. In view of obtaining such a relief at the paying entity, income tax-credit (allocated Amount A * national tax) could be immediately paid out irrespective of the overall tax situation or the paying entity. Such a system is preferable to other options (such as a credit system or an exemption method) because these options involve risks of temporary or long-term double taxation. This applies, for instance, if the paying entity is in overall running losses while having profitable ADS/CFB business. The same holds true in case the paying entity has loss carry-forwards or is part of a loss-making fiscal unity. These examples clearly demonstrate that the avoidance of double taxation as one of the aims of Pillar One laid down in the published Cover Statement on the Reports on the Blueprints of Pillar One and Pillar Two cannot be realized.

Substantive issues

Allocating amounts to market jurisdictions under "Amount A" and "Amount B" will require close coordination to ensure that double counting is avoided. It is more challenging to identify where the profits which are to be reallocated come "from" than identifying where they should be allocated "to". This issue is particularly evident when IP and the functions generating more than routine return are not centralized in one entity but owned by various group entities in various jurisdictions. **When residual profits are de-centrally allocated, for each "residual profit-taker" an amount would have to be determined that logically corresponds to "Amount A"**. The measurement of how much profit each "residual profit-taker" should surrender might pose new challenges and **give room for dispute**.

Under "Amount A", **double taxation** would arise when a **withholding tax is levied on license payments/royalty payments**. Moreover, countries may have implemented rules that cap the **tax deductibility of certain costs** at thresholds that depend on Earnings Before Interest and Taxes (EBIT) or Earnings Before Interest, Taxes, Depreciation, and Amortization (EBITDA) (e.g. tax deductibility of interest expense in Germany, tax deductibility of inter-company service charges in Poland). Further clarification is needed on how such a cap is influenced by "Amount A", as this might increase the overall tax burden.

The proposed safe harbour rules on "Amount A", according to which a jurisdiction's claim to "Amount A" ceases to apply if it already has an excess taxing right under the existing transfer pricing rules, will also not change the need for effective dispute resolution measures. A positive aspect is that MNEs can request a binding pre-assessment from authorities concerned to achieve tax certainty which is supposed to be binding for all tax authorities involved.

Problems may arise as "Amount A" is calculated at the consolidated accounts level while the tax relief of entrepreneurs would be implemented per legal entity and could impact the individual financial account (differences in e.g., amortisation, hedging). It should be clarified how situations will be handled if the relevant profit falls short of the deemed routine share, especially if this happens only in specific years. If a nexus is only established in a subset of market jurisdictions (because for some market jurisdictions, sales are below the revenue thresholds), will the "market share" (sum of market jurisdictions' "Amounts A") be fully spread across the markets for which the nexus is established? Or will the portion of the market share that relates to those markets for which no nexus is established not be distributed?

As the company filing the tax returns might not be the (only) company that earns residual profits (entrepreneur), jurisdictions where the other entities which earn residual profits reside must surrender part of their taxable profits. **Tax credits will not work in instances with a territorial concept of taxation, low profit margin entrepreneurs or periodic loss-making entrepreneurs**. Hence, a **tax neutral tax relief** (from the tax base of worldwide entrepreneurs) might become a big challenge. Carry forward and carry back should be provided for loss-making entrepreneurs, irrespective of whether the "AB"-Approach or the ALP applies.

Procedural issues

We are deeply concerned that at present, the attempt to eliminate double taxation under the Pillar One may neither provide tax certainty nor minimise administrative burden. Moreover, we see high risk that **neither accepted credit nor exemption methods or treaty-based solutions** would effectively work to avoid double taxation with respect to "Amount A". Even in situations in which

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It is not advisable to implement new special tax regulations with the aim of supposedly taxing the digital economy more fairly, especially when it comes to unilateral action. Similarly, broader concepts (such as "Pillar One, Two") are not effective if these concepts will not have a uniform global application. Such proposals threaten the digitization efforts of European and, in particular German industry, by creating significant legal uncertainties and competitive disadvantages. The principles of international tax law applied at present also offer an appropriate and balanced set of instruments for the taxation of the digital economy and should therefore not be hastily discarded."

a complete string of bilateral tax treaties exists, satisfactory results appear to be highly unlikely. Reallocation of such profits will therefore require a **clear and objective multilateral treaty** that covers all jurisdictions impacted to address an increasing number of double taxation-occurrences.

To minimize the compliance efforts for the preparation of the whole financial analysis of the MNE and the risk of disputes a **"centralized tax audit process"** needs to be implemented. The obligation to file the tax returns for "digital PEs" could be levied on the entity that prepares the group financial statement (e.g. headquarter) under the "SPOC"-Approach to ensure administrative simplicity. Under no circumstances should the declaration be made in a jurisdiction without any physical presence.

It should be considered whether the determination of the **tax relief amounts could be audited by a chartered accountant** as part of the consolidated financial statements. It should also be considered, for example, that the determination of the tax relief amounts would then, like the declaration of the "Amount A", be reported by the headquarter to the responsible "competent authority" which would then use an automatic exchange of information to transfer these to the other jurisdictions. In a next step, the jurisdictions could determine the corresponding tax based on this file. **Information sharing agreements** can facilitate sharing audit information, and jurisdictions could request redeterminations for material errors.

Further pending issues

In addition to the above-mentioned points, we would like to address further open issues:

1. We would welcome clarity on the term non-routine (="profit above normal").
2. Further clarification is needed on the situation, where the consolidated group **profitability is occasionally "below normal" or even negative.**
3. The consultation paper does not mention a mechanism for re-allocation of "Amount A" to market **jurisdictions**, which **do not participate** in the current project.
4. This should be accompanied by clarification that "Amount A" has **no impact on customs duties**. Are year-end adjustments on global level supposed to be made? A baseline profit should be so flexible that annual year-end adjustments to a hard value are not necessary and the margin around this value can float over a multi-year average.

"Amount B"

Calculation of routine profits for "Amount B"

In respect to "Amount B", the question is **whether post-BEPS ALP rules** (including the concept of Development, Enhancement, Maintenance, Protection and Exploitation (DEMPE)) should apply further **or a "new" definition** (understanding) of value creation should be introduced. We take the position that the rules must clearly mandate which transfer pricing method is to be applied. Taxpayers should be able to understand which functions are included (e.g. buy/sale of products, after-sales services) and which differentiations between distribution related business models (e.g., limited risk distributors, agents/commissionaires, marketing service providers) apply.

The application of "Amount B" – as a safe harbor – for distribution activities to minimize compliance efforts and the risk of double taxation (including Advance Pricing Agreement (APA)/Mutual Agreement Procedure (MAP) cost) is mandatory. It should be impossible for countries to unilaterally change "Amount B".

The introduction of **fixed remuneration would lead to administrative simplification** with planning security and cost savings for companies. **Nevertheless**, a unified fixed remuneration for the assumed baseline activities **cannot** be considered the **most proportionate approach** as this would not reflect the diverse reality and might adversely impact a company's decision making. More varied percentage rates (**by industry or region**) would be preferred. To determine "Amount B", **APAs** (at least for limited risk/routine distribution activities) and average regional rates (**benchmarks**) agreed-upon periods could be used as a basis.

Further pending issues

As with other aspects of the Pillar One "Unified Approach", there is a lack of clarity regarding how "Amount B" will be implemented in practice:

1. **Customs duties, indirect taxes and withholding taxes** are on transaction level. Are **year-end adjustments** on global level supposed to be made? A baseline profit should be so flexible that annual year-end adjustments to a hard value are not necessary and the margin around this value can float over a multi-year average. Customs valuation should be aligned without triggering additional complexity (e.g. two parallel transactional pricing systems, one for customs purposes and one for CIT purposes).

2. How will the **activities** that shall be remunerated with "Amount B" **be ascertained**? Based on a function and risk analysis in the local transfer pricing documentation, which – as in Germany – may not be prepared contemporaneously?

3. Within a business that generally qualifies for the "AB"-Approach, will "Amount B" be **only applicable in market jurisdictions for which a nexus has been established**? Generally, two parallel transfer pricing systems should be avoided. Flexibility should be provided to MNEs not in scope of the new rules (e.g., "B2B") to **fully or partly opt in**. We take the position that checks for whether "Amount B" is applicable should be performed based on a globally consistent logic (same P&L segmentation logic, same accounting standard); this implies that also the analysis of other functions' realized outcomes under the arm's length test should be made in a globally consistent way to prevent distortions.

Hence, **a binding review and extension of the guidance in Chapter VI of the OECD Guidelines** would be highly welcomed.

Tax Certainty: Dispute prevention and resolution

Dispute prevention and resolution

Tax authorities might have different opinions on the value of the appropriate routine remuneration for routine functions. Disputes on transfer pricing could thus translate into the new taxing right and thus have a multilateral dimension.

In general, we take the position that **APAs** are an effective means to avoid dispute. However, the practical reality of a **lengthy negotiation process** limits the utility of such an instrument, particularly as multilateral APAs would be necessary under the "Unified Approach". While **joint audits and ICAP** have shown some success in their limited pilot phases, **neither is yet sufficiently scalable** to allow for effective resolution of disputes over profit allocation.

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"The unified approach constitutes a profound modification of well-established international taxation principles. This can only work without harm to the taxpayer if all states recognise the system without exception and the approach is mandatorily flanked by robust dispute prevention mechanisms."

A robust, transparent, mandatory and binding dispute resolution is crucial, when it comes to "new" taxation rights. This issue should not be taken lightly. Not only may double taxation lead to reduced foreign investment and tax uncertainty, but it can also lead to reduced employment and lower economic growth in the long-run. We therefore urge the OECD/IF to include both appropriate dispute resolution and dispute avoidance mechanisms in any consensus, with significant ambition in terms of scope, enforcement, effectiveness and timeliness.

Existing dispute resolution mechanisms for transfer pricing cases are **time consuming and expensive** and lead to high uncertainty.

An effective dispute resolution would therefore have a **short time frame** of only few months to resolve cases, including all interest payments and penalties related to the adjustments. Because disagreement over any "Amount A" allocation will inevitably affect more than just two jurisdictions, a **multilateral solution** is needed. There should be low thresholds and no domestic barriers for MNEs to access to procedures. Unfortunately, even binding agreements are often not applied correctly by the states that signed the agreements. For a dispute resolution to be effective, the right for taxpayers to challenges cases in an **international arbitration body** (arbitral tribunal for the adequate settlement of dispute) is therefore necessary.

Tax Certainty under Amount A

The existing and anticipated problems in dispute prevention and resolution have been identified by the OECD and shall be addressed by three new measures:

1 Standardized Amount A self-assessment

In a first step, the "paying entity" (usually the ultimate parent entity) would submit a self-assessment on behalf of the entire MNE group containing the most important information/documents for the determination of Amount A. The ultimate parent entity will regularly file this with its lead tax authority, which will usually be the tax administration of its jurisdiction of residence. This means that an MNE group only has to document once according to a harmonized form and does not have to address different tax administrations in the respective jurisdictions. Furthermore, this considerably reduces the documentation effort through, which is a desirable measure.

This self-assessment form is planned as a mandatory and binding form for both, the tax authorities and taxpayers. This binds all parties involved and is intended to prevent unadministratable individual provisions.

2 Early Tax Certainty Request

MNE groups that wish to have certainty in their evaluation of whether they are subject to Amount A or the MNEs determination and allocation is in line with the provisions will be given the opportunity to obtain "binding information" in advance from the leading tax authority.

3 Representative panel mechanism – multilateral review

The IF considers it essential to resolve tax disputes regarding Amount A in a binding process, quickly and transparently. Although the design is still under political discussion, an initial review / "final review" panel of the involved jurisdictions is envisaged. The main responsible jurisdiction would be the jurisdiction of the ultimate parent entity. The dispute resolution mechanism is to be available for various disagreements, probably essential with regard to the question of the existence of a sufficient nexus in a jurisdiction and the elimination of double taxation by a jurisdiction through the credit or exemption method. Given the importance of an administrable and timely process, the IF's proposal to tie the duration of this process to the fiscal year and to resolve dispute resolution within 15 months of the fiscal year is welcome compared to the current duration of MAP.

Most recent US proposal to abandon the restriction to ADS and CFB

The most recent proposal of the U.S. Treasury Department unveiled in April 2021 seems like a significant simplification by reducing the scope of Pillar One. However, a global consensus would have to be reached on this proposal as well and it does not achieve a significant simplification of revenue sourcing as the problem to determine the generation of revenues in each market jurisdiction would still not be solved.

Pillar Two

The GloBE proposal bears the potential to set an overarching standard in international taxation. However, many fundamental questions have not yet been answered. Under the current design, an increase in complexity, double taxation and tax disputes would inevitably arise.

To address the concerns, the GloBE proposal should be focused by clarifying the underlying principles. If the objective of GloBE is to disincentive profit shifting by imposing a minimum tax, the rules should differentiate between genuine commercial transactions and wholly artificial arrangements.

Additionally, the previous BEPS measures should be reviewed prior to the implementation of a new layer of rules in order to reduce complexity and to allow for continuity under the new rules.

Careful attention must be paid to the design of the rules. The following sections address some critical design aspects for Pillar Two from an industry perspective.

Income Inclusion Rule

Tax Base Determination via Financial Accounts

Since the Income Inclusion Rule would tax a portion of the low-taxed income of a foreign subsidiary on shareholder level, the question how to determine the tax base has a fundamental nature.

The preferable solution, calculating profit based on ultimate parent tax law for every subsidiary, would prove excessively costly. Therefore, the **tax base should be determined according to the financial accounting standards applicable at ultimate parent level** such as IFRS/US-GAAP.

However, no uniform accounting standard which could be used for the purposes of GloBE exists since many MNEs use different accounting standards in parallel. Therefore, the use of financial accounts **can only serve as a proxy** and **adjustments must be made** to provide an approximation of taxable profit and taxes paid and to ensure fair and equal taxation.

Adjustments for differences in financial accounting standards

Reflecting material differences between financial accounting and tax accounting as well as between the different accounting standards in adjustments requires a **multilateral and harmonized view** on the treatment of permanent and temporary differences through as many as possible simplifications to limit the administrative burden

and legal uncertainty for businesses. Any approach that is adopted to cure timing differences should apply to excess taxes and tax attributes on a global level.

Some important **permanent differences** common to many tax accounting rules are the exclusions of dividends received, step-ups, business combinations, discontinued operations, extraordinary items, or impairments not recognised in a territory. These differences should be excluded to eliminate double taxation. Capital gains and losses need to be considered carefully, as there is no common view to whether they are subject to taxation or not.

Overall, it must be ensured that exemption systems are not discriminated as compared to credit systems. There are several jurisdictions which apply corporate taxation not until distribution (e.g. Estonia, Latvia). If not covered by differed taxes under the domestic law of that jurisdictions, the "suspended" taxation should be treated like the "normal" case for the purposes of the Income Inclusion Rule.

By their nature, **temporary differences** relate solely to the timing of taxation rather than whether the item will be subject to tax. The temporary differences can be addressed by applying cumulatively deferred tax accounting and a multi-year average effective tax rate.

Deferred tax accounting is a relatively simple approach from the viewpoint of using financial accounting as a starting point and simplification. However, careful consideration is required with regard to the valuation allowance for deferred tax assets and equity in earnings of affiliated companies.

Effective Minimum Tax Rate

Setting the minimum tax rate as a percentage of the parent jurisdiction's CIT rate would disadvantage groups headquartered in relatively high tax jurisdictions. Therefore, the effective minimum tax rate should be designed as **a uniform fixed top-up rate at ultimate parent level.**

The Income Inclusion Rule might punish projects which carry significant level of taxation through their entire project duration but might not incur high effective taxation during every project phase (i.e. infrastructure project with a long term cost lead). To address such timing differences the effective tax rate should be computed on a multi-year average.

The minimum tax rate should not require an effective tax charge. Hence, the use of deferred tax assets, tax credits and the exemption of income to avoid double taxation should not trigger the application of the Income Inclusion Rule.

Often, a company's **total direct tax contribution to a government** consist of more than simply corporate income taxes paid, but also other taxes such as sector specific levies, withholding taxes and other taxes such as the German trade tax. The definition of types of taxes covered in the Pillar Two Blueprint is a positive step, as it recognises that income taxes consist of several components and includes them in the calculation of the ETR. A clear list of taxes covered would be a significant administrative relief. Therefore, a **list of relevant corporate taxes** for each jurisdiction should be included in the final agreement.

Blending

The scope of blending should be as wide as possible to make the proposal practicable, to mitigate complexity and to reduce the risk of double taxation. **Global blending at the ultimate parent level on a multi-year basis** meets the policy objectives of Pillar Two as an effective minimum taxation on a MNEs global profits would be established. Systematically, domestic subsidiaries should be included in the global blending.

Due to the double taxation risk, jurisdictional blending should not be implemented. Double taxation can arise when a parent corporation must incorporate foreign income that is effectively low taxed but cannot credit the foreign tax as domestic tax is not due because of negative domestic income or specifics of the jurisdiction. This would create enormous compliance costs and would require the introduction of a tax credit carry forward or a **deduction scheme for foreign tax**. However, the latter option is feasible only when the jurisdiction recognizes loss carry forwards.

Carve-Outs

An exclusion ("white-listing") of certain domestic regimes appears challenging. It could be complex to keep a "White List" up to date. However, the OECD/IF should find the right balance in addressing countries' concerns on artificial arrangements and countries' right to initiate an incentive-driven tax framework, which attracts FDI,

R&D, employment, etc. through transparent and fair tax competition. Any possible "White List" should not be subject to alteration without unanimous and globally coordinated consent.

In order to not burden smaller businesses with significantly complex rules, we would advocate for a fixed threshold, under which the "GloBE"-proposal would not apply. The proposal of the current document to put this in line with the CbCR revenue threshold of 750 million Euro for the whole MNE group seems appropriate.

The Income Inclusion Rule should not punish activities which are not subject to profit shifting. Therefore, **a standardized escape rule for testing for abusive practices should be implemented**. This would focus the proposed measure and ensure that there is no taxation where there is no economic profit, no double taxation and have a favorable effect on the compatibility with EU law.

Furthermore, we advocate for a carve-out of those incentive schemes which have shown to be fully compliant with **BEPS Action 5** ("Unharmful Tax Regimes") and the **EU Code of Conduct**.

We would also like the OECD/IF to consider simple gateway tests for those **businesses with a modestly higher consolidated Effective Tax Rate** of an MNE group (that usually coincide with non-mobile activities), e.g. higher that a certain percentage point above the fixed absolute minimum Effective Tax Rate to be determined for the Income Inclusion Rule (e.g. 20 per cent above the minimum Effective Tax Rate). In these instances, companies should not be obliged to calculate the applicable tax rate in order to minimize the additional administrative burden.

An MNE with a consolidated Effective Tax Rate more than the identified minimum tax rate is not running afoul of the policy objective which is to minimum tax MNEs that have an average low-income tax rate due to shifting income to low-tax jurisdictions. In addition to accomplishing the policy goals of the Income Inclusion Rule, this carve-out is **administratively simple** for all parties. The carve-out is also **reliable**, given the data used to qualify for the carve-out is audited by an independent accounting firm.

Moreover, an MNE should be permitted to **carry forward any "excess tax rate"** for next period carve-out judgments. This would, in addition to adjustments of temporary differences, acknowledge that an MNEs Effective Tax Rate may vary from year-to-year (e.g. exchange rate P&L) based solely on timing differences between financial accounting and tax or market conditions, and not based on shifting profits to low-tax jurisdictions.

Switch-Over Rule

The Switch-over Rule covers **foreign branches as well as immovable property** and allows the state of residence to apply the **credit method instead of the exemption method** where the profits attributable to a permanent

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"Unilateral actions by certain countries to introduce so-called digital levies should be avoided, which is why a harmonized approach under the guidance of the OECD is to be welcomed. The minimum taxation of Pillar Two is seen by many countries as an essential supplement to Pillar One, although this has nothing in common with the intention of fair taxation of so-called digital enterprises. In addition to the many unanswered questions regarding the implementation and administration of Pillar One, Pillar Two must also take into account interactions with existing systems and find regulations that are manageable in practice"

establishment or derived from immovable property are subject to tax at an effective rate below the minimum rate.

Switching from exemption to credit method incorporates the income of a branch into the corporation's domestic taxation. Insofar, further clarification on the **avoidance of double taxation** is required. Given the parents domestic income is negative and remains so after the income of the foreign branch is incorporated, the **foreign tax credit** should be subject to a carry forward or be deductible from the domestic income. The latter option is feasible only when the jurisdiction allows loss-carry forwards.

The introduction of a switch-over rule in accordance with Pillar Two would require **changes in every major tax treaty**. Insofar, the implementation of the Switch-over Rule would require a multi-lateral instrument (**MLI**) or a similar legal instrument.

Moreover, a globally **uniform definition of permanent establishment** is needed. Taxation of a permanent establishment below required minimum effective level may occur because of qualification conflicts (e.g. **service permanent establishments**). This would lead to double taxation. Hence, the OECD/IF should provide clear rules on definition of permanent establishments, which would be applicable uniformly.

Undertaxed Payments Rule

The Undertaxed Payments Rule would **deny a deduction or impose source-based taxation** for a payment to a related party if that payment was not subject to tax at a minimum rate.

The scope of the Undertaxed Payments Rule and the Subject to Tax Rule should be limited to payments related to "mobile" income (e.g. **interest and royalties**). It would be appropriate to apply a substance-based carve-out reflecting the principles stated in the BEPS Action 5 final report. **Other payments** (e.g. by distributors to acquire inventory which they on-sell) should be **out of scope**.

Although the Undertaxed Payments Rule is limited to payments to related parties, there is no such restriction in the Subject to Tax Rule. It should be clarified that the **scope is limited to payments to related parties** only. It is not practical for companies to be required to determine the Effective Tax Rate applied to payments received by third parties.

Again, we would like to stress the point that **German Industry is very critical** towards the proposed Undertaxed Payments Rule. Due to **lack of any economic reasoning** the Undertaxed Payments Rule should under no circumstances apply to under treaty **benefits beyond interests and royalties** or to unrelated parties. Not only would such an extensive application increase the administrative and compliance cost massively but would often **reach its limits** due to the lack of information. **Double taxation** would arise when the Undertaxed Payments Rule is applied in multiple jurisdictions due to multi-tier group structures.

The Undertaxed Payments Rule would require the receiving corporation to share sensible tax information with foreign tax authorities such as tax declarations and tax returns. This possess significant challenges and could violate the German fiscal secrecy rules. Therefore, the receiving company should to able provide proof of being taxed at a sufficient level by a certified chartered accountant who verifies the Effective Tax Rate of the receiving corporation. Alternatively, and in line with the "SPOC"-approach, the home jurisdiction tax authority of the receiving corporation should audit and provide proof of sufficient effective taxation to the relevant foreign tax authorities.

The Interaction of the "GloBE"-Proposal with other International and Domestic Tax Rules

Coordination between Pillar One and Pillar Two

There will be significant interaction between Pillar One and Pillar Two for countries adopting both proposals, with a high **likelihood of double taxation risks without proper coordination**. Therefore, it is crucial that further work is taken to understand the interaction between these two pillars.

Clarification is required regarding the **timing of the test** for effective low taxation with regards to Pillar One. For instance, a profit allocation which was not subject to low taxation could be subsequently reallocated under Pillar One, creating a situation in which the income of the foreign company is effectively low taxed. This would trigger the Income Inclusion Rule and would not reflect the policy rationale of Pillar Two. We believe that **profit reallocation under Pillar One must be considered by calculating the Effective Tax Rate for Pillar Two**.

At the current stage we cannot make proper comments on administrative burden and coordination challenges between jurisdictions. The OECD/IF, however, should provide clear rules upon **overlapping substantive and procedural elements** of both pillars.

The OECD/IF should include considerations, to be determined, prior to any agreement on the "GloBE", whether the forthcoming Pillar One would not already address countries' concerns to a reasonable extend.

Coordination between Elements of "GloBE"

First, we feel the need to stress that **globally unanimous rule coordination within the Pillar Two** proposal is essential as a lack of rule coordination can easily lead to instances of double or multiple taxation.

A rule of precedence, whereby the **Income Inclusion Rule would take priority**, would prevent double taxation that results from the simultaneous application of both the Income Inclusion Rule and Undertaxed Payments Rule. Insofar, further clarification on the **communication between the national tax authorities** should be explored. For example, in case, the Income Inclusion Rule is applied, this should trigger a notification process for other tax authorities to avoid an application of the Undertaxed Payments Rule. The use of **binding cross-border administrative acts** should be explored.

The current proposal does not contain explanations on how globally uniform and coordinated implementation could be achieved to avoid massive legal uncertainty and instances of double taxation due to overlapping rules between two or more states. **Triangular cases** (and cases where more than one jurisdiction sought to apply "GloBE"-rules to the same structure or arrangement) should be analysed with care and in exchange with tax experts to avoid uncoordinated actions and double taxation.

If the Undertaxed Payments Rule applies to a series of payments of which the first ones are taxed at a sufficient level, but the consequent payments are considered being undertaxed, this could trigger a denial of deductions of such payments in more than one jurisdiction, further aggravating the double taxation which might already arise from the combined effects of the Income Inclusion Rule and the Undertaxed Payment Rule. Situations in which double taxation could arise due to the combination of the profit-oriented and expenditure-oriented approach are foreseeable. For instance, considering a proportion of foreign low-taxed income in the parent's taxation (profit-oriented) while at the same time denying the parent to deduct expenses related to the foreign subsidiary (expenditure-oriented) would inevitably lead to severe double taxation. In extreme uncoordinated cases the **Effective Tax Rate** can **exceed 100 per cent**[39] which is not acceptable.

If such a rule of precedence cannot be agreed upon, the Undertaxed Payments Rule could alternatively be **limited to those payments made to a company whose ultimate parent is not subject to an effective minimum tax** in accordance with the Income Inclusion Rule of Pillar Two. To allow countries to operate the Undertaxed Payments Rule as a primary rule will dramatically increase complexity as well as disputes and double taxation and dramatically decrease tax certainty.

Hence, **it is highly questionable whether the simultaneous introduction of both rules is advisable**. In our understanding, the combined effects of the rules would **result in gross taxation** which does not allow for deduction and would disregard the "Ability-to-Pay"-Principle. Furthermore, the simultaneous application of both rules under Pillar Two would punish certain behaviour twofold without introducing incentives for preferable behaviour contrary to similar policy initiatives (e.g. US Tax Reform, **"Carrots and Sticks"-Approach**). Therefore, **we advocate for the implementation of an Income Inclusion Rule only** which focuses on abusive practices.

Coordination between "GloBE" and BEPS Actions

The elements of the **"GloBE"-proposal overlap** with existing and already implemented tax regimes with similar objectives on national level as well as with measures implemented in the context of the **BEPS project (e.g. Action Points 2 to 5)**. Therefore, the OECD/IF should clarify the relation of the "GloBE" to national and other similar regimes as a simultaneous application could result in **severe double taxation and high administrative and bureaucratic burdens.**

The legal consequences of the Income Inclusion Rule resemble so-called **Controlled Foreign Corporation (CFC) regimes.** While a parent corporation is generally

[39] Calculation can be provided upon request.

not taxed for a subsidiary's income, under certain circumstances CFC regimes apply to apportion income of a subsidiary to the parent company and subject the subsidiary's income to taxation on parent level without profit distribution. Generally, CFC regimes intend to thwart practices which have no purpose other than to escape the tax due on the profits generated by certain harmful activities in the state of residence of the parent but artificially moved to a low taxed subsidiary. In this context, CFC regimes commonly stipulate a low tax rate threshold, consider the nature of the activities, contain a significant or controlling ownership criteria and contain some sort of carve-outs that include substance and motive tests as well as *de minimis* exemptions.

The parallel existence of measures with similar objectives would result in **double taxation, high administrative costs and bind human as well as financial resources** to comply with the parallel measures. Such ramifications become even more severe in multi-tier structures and in triangular cases when multiple CFC regimes apply. The same is true with Undertaxed Payments Rule and comparable national rules (e.g. Section 4j German Income Tax Act).

In our view, once the "GloBE" is introduced, existing **national anti-abuse rules** would need **to be abolished and repealed** rather than be supplemented by the new rules to avoid conflicting tax computations and double taxation. Since the mentioned national anti-abuse rules result from EU Directives and initially from the BEPS project, **changes** should first be made **to EU Directives**.

Compatibility with EU law

Special emphasis should be placed on the compatibility with EU law. Regarding the implementation of the proposal, we are concerned, that the implementation via a Directive (Art. 288 TFEU) would not be feasible due to the limits set by Art. 115 TFEU and the principles of subsidiarity and proportionality. Given the proposals are implemented on national level, either implementing an EU Directive or without a secondary EU law basis, the measures must be in line with primary and secondary EU law and the relevant CJEU case law.

Income Inclusion Rule

From a primary law perspective, the **Freedom of Establishment** (Art. 49 TFEU) and the **Free Movement of Capital** (Art. 63 TFEU) are particularly relevant. The fundamental freedoms **prohibit discriminatory legislation** by mandating equal treatment of residents and non-residents in cross-border cases. While the Freedom of Establishment is limited in its geographical scope to EU cases, the Free Movement of Capital can apply to intra-EU as well as non-EU cases. In this regard, the applicable fundamental freedom, and thereby the limitations set by it, can be influenced by an **ownership criterion**. In case the Income Inclusion Rule requires a significant or controlling ownership, it is settled CJEU case law that the Freedom of Establishment would take precedence over the Free Movement of Capital,[40] limiting the EU law implications to intra-EU/EEA cases.[41]

Generally, the imposition of a fixed top up rate in accordance with the **Income Inclusion Rule could constitute a restriction of the mentioned fundamental freedoms** as a difference in treatment is established between cross-border and domestic cases, creating a tax disadvantage for the cross-border cases. A restriction is permissible only if it is justified by overriding reasons of public interest and the legislation is proportionate. Therefore, it is important to ensure that the **Income Inclusion Rule is justifiable and proportionate**.

As previously argued, the legal consequences of the Income Inclusion Rule resemble CFC regimes. In this context, possible justifications of a restriction could be **the need to prevent tax evasion and the balanced allocation of taxing rights** between EU Member States. According to CJEU case law, the specific objective of a restricting measure must be to **prevent conduct involving the creation of wholly artificial arrangements** which do not reflect economic reality, with a view to escaping the tax normally due on the profits generated by activities carried in the parent's resident state.[42] A restriction by a parent company Member State **cannot be justified by** the intention to offset a tax advantage gained through low taxation in a source Members State or the intention to prevent a reduction of tax revenues.[43] It

[40] See Case C-35/11 (Test Claimants), paragraphs 90 et seq.; case C-685/16 (EV), paragraphs 31 et seq.

[41] In case a significant or controlling ownership threshold is not included in the Income Inclusion Rule, the following would generally also apply vis-à-vis so called third countries, see case C-135/17 (X), paragraphs 57 et seq.

[42] Case C-196/04 (Cadbury Schweppes), paragraph 55.

[43] Case C-196/04 (Cadbury Schweppes), paragraph 49; case C-294/97 (Eurowings), paragraph 44.

must be stressed that the establishment of a subsidiary or a permanent establishment in another Member State does not constitute tax evasion or allow for a general presumption of such activities.[44]

According to our understanding, a fixed top up rate in accordance with the Income Inclusion Rule could be triggered exclusively by low effective taxation, lacking concrete criteria relating to practices of tax evasion. Since this could constitute an unjustifiable restriction of the fundamental freedoms, the Income Inclusion Rule should include **further criteria such as significant or controlling ownership, certain activities as well as *de minimis* thresholds** to determine not only if income has been subject to tax at a minimum effective rate but also if the low taxation is the result of conduct involving the creation of wholly artificial arrangements which do not reflect economic reality.

It must further be determined whether the legislation is proportionate. **A measure is not proportionate when it goes beyond what is necessary to achieve its purpose.** The introduction of a standardized escape possibility/carve-out can align the Income Inclusion Rule with the standards set by CJEU case-law. The parent company should be given an opportunity to **produce evidence that the subsidiary is actually established and that its activities are genuine.**[45] The definition of such substance, activity and/or motive requirements could be based on a combination of various criteria (e.g. capital investments, education level of employees, etc.) as such activities are less likely to be part of profit shifting activities.

In light of this, it might appear tempting to **design the Income Inclusion Rule in a non-discriminatory way**. Would the Income Inclusion Rule apply to all domestic and foreign subsidiaries, it would likely not capture domestic German cases due to the high effective domestic tax rate. Even though treated legally equal, low taxed cross-border cases would be treated factually different to domestic cases, which would not be in line with the fundamental freedoms. We take the position that this approach **does not establish compatibility with EU law** because discrimination is assessed based on factual (and not legal) equal treatment.

Furthermore, we are convinced that the problems arising from EU law cannot be minimised by setting the **minimum Effective Tax Rate at below the lowest EU Members State corporate tax rate.** Although the Income Inclusion Rule would not apply to intra-EU/EEA cases, this would **infringe the Members States' tax sovereignty** as their ability to set their tax rates would be severely limited and would not address discriminatory issues regarding the Free Movement of Capital.

Additionally, **secondary EU law** such as the Interest and Royalty Directive (2003/49/EC), Merger Directive (2009/133/EC), the Parent-Subsidiary Directive (2011/96/EU) or the Anti-Tax Avoidance Directive (2016/1164/EU and 2017/952/EU) should be considered for the evaluation of the Income Inclusion Rule from a EU law perspective. In recent judgements, the CJEU assessed the compatibility of a national measure on the basis of the anti-abuse definition included in the Anti-Tax Avoidance Directive,[46] further highlighting the need to analyse the compatibility of the Income Inclusion Rule with secondary EU law.

Undertaxed Payments Rule

From a **primary law perspective**, the above outlined arguments also hold true for the Undertaxed Payments Rule as it creates a difference in treatment for residents and non-residents in cross-border cases. A similar **expenditure-oriented regime** which denies deduction of payments to foreign companies if they are not subject to a fixed minimum tax is **submitted to the CJEU for a preliminary ruling** in light of the Freedom of Establishment (Art. 49 TFEU).[47] From a **secondary EU law** perspective (for a list of EU Directives see above), the issue concerning **beneficial owners and payment recipients** with regards to interest and royalties should be considered.

[44] Case C-164/96 (ICI), paragraph 26; case C-478/98 (Commission/Belgium), paragraph 45; case C-334/02 (Commission/France), paragraph 27.

[45] Case C-196/04 (Cadbury Schweppes), paragraphs 61 et seq.

[46] Case C-116/16 (T Danmark); case C-117/16 (Y Denmark Aps).

[47] Case C-484/19 (Lexel AB).

05 EY – Specification of the implementation process of the Two Pillar Approach

A successful implementation process is pivotal for ensuring tax certainty. But at any rate to be recommended: a continuous review to address necessary refinements.

On 12 October 2020, the Organisation for Economic Co-operation and Development (OECD) released a series of major documents in connection with the ongoing G20/OECD project titled "Addressing the Tax Challenges of the Digitalization of the Economy" (the BEPS 2.0 project). These documents include the reports on the Pillar One and the Pillar Two Blueprints. The aim of Pillar One is to adapt the international income tax system to new business models through changes to the profit allocation and nexus rules applicable to business profits and by that to expand the taxing rights of market jurisdictions. Pillar Two of the BEPS 2.0 project addresses the development of global minimum tax rules with the objective of ensuring that global business income is subject to at least an agreed minimum rate of tax.

As the OECD documents make clear, the Blueprints do not reflect agreements by the member jurisdictions of the Inclusive Framework on Base Erosion and Profit Shifting (BEPS) because there are political and technical issues that still need to be resolved. However, the cover statement of the Inclusive Framework refers to the Blueprints as a "solid basis for future agreement" and states that the member jurisdictions have agreed to keep working "to swiftly address the remaining issues with a view to bringing the process to a successful conclusion by mid-2021."

The proposals under Pillar One and Pillar Two represent a substantial change to the tax architecture and go well beyond digital businesses or digital business models. These proposals could lead to significant changes to the overall international tax rules under which businesses operate. It is already clear that the changes under discussion for the German national tax system on the one hand, and for an "internationally compatible global tax system" on the other, would be extremely complex and multi-layered.

Therefore, it is necessary to keep an eye on the revenue effects, the steering and guidance effects as well as the administrative burden for the companies and tax authorities concerned. Not even less complex will be the implementation process of the two pillars. Some remarks on its possible specifications are made in the following:

Procedural issues regarding Pillar One

Tax certainty

The Blueprint for Pillar One proposes two sets of tax certainty rules – dispute prevention and resolution for Amount A and dispute prevention and resolution for amounts beyond Amount A.

Regarding Amount A, the Blueprint proposes a mandatory binding dispute prevention process that aims to address in advance potentially controversial issues regarding Amount A – such as the correct delineation of business lines and calculation of its profits, the existence of nexus, or the identification of paying entities. The process would be based on a multinational entity's (MNE's) self-assessment that would be reviewed by a representative review panel in first instance and, if no agreement can be reached at that stage, by a determination panel in second instance. The agreement reached in this process would be binding on all relevant tax administrations and on the MNE.

The Blueprint also contemplates additional procedures for certainty to determine:

1. whether an MNE falls within the scope of Amount A;
2. whether a jurisdiction is a market jurisdiction – to be started upon the initiative of tax administrations;
3. whether the self-assessment of an MNE is correct when there's no request for tax certainty – upon the initiative of tax administrations or
4. whether the MNE can seek dispute resolution when it did not submit a request for early certainty.

An enhanced dispute resolution process is suggested for cases where an MNE does not opt into the certainty process, however, it is expected that most MNEs in scope would make use of the prevention mechanism.

The tax certainty approach beyond amount A includes a number of steps, including dispute prevention, use of the existing mutual agreement procedure (MAP), as well as a new mandatory binding dispute resolution mechanism. For developing countries, elective binding dispute resolution is contemplated. In designing these tax certainty approaches, lessons learned from the existing tax certainty initiatives are taken into account, including strengthening the BEPS Action 14 minimum standard based on the work of the Forum on Tax Administration MAP Forum and Working Party 1.

Finally, the Inclusive Framework is exploring a mandatory binding dispute resolution for MAP cases that remain unresolved after an agreed period. The Inclusive Framework would agree on the defined period after which the dispute resolution mechanism would be triggered, and the mutual agreement would be submitted to a panel of experts (a determination panel) who would reach a decision. Ongoing technical work is addressing the potential structure and authority of the determination panel, as well as its potential interaction with existing mandatory binding dispute resolution mechanisms.

Implementation and administration

Tax certainty is the result of a combination of two things: clear legislation tailored to the particular policy objectives that comprehensively addresses all relevant issues and reliable implementation of that legislation, including a reliable dispute prevention and resolution process. To some extent, subjectivity or lack of clarity in the legislation itself can be compensated for by having a reliable dispute prevention and resolution process, but it is necessary to have clear underlying principles that can guide how to resolve any interpretation issues.

Therefore, it might be essential for the ambitious tax certainty process described in the Blueprint to be in place before any Amount A rules are implemented. If agreement cannot be reached on the tax certainty rules, the proposed Amount A rules should be re-considered with a view to replacing them with rules that are clearer and more closely tailored to the stated policy objectives of Pillar One.

In particular, a mandatory binding dispute prevention process requires a clear set of rules implemented on a global scale in a consistent manner. In the end, this process means that a few tax administrations determine the amount of income to be taxed on a global scale. We support this proposal as it is the only practical solution to avoid Amount A controversy. However, proper implementation into public international and domestic tax laws needs to be ensured by also establishing some sort of a "review" or "monitoring" body that oversees the implementation process. In the given set-up such roles could only be assumed by the OECD and/or the UN.

The Blueprint indicates that the implementation framework for Pillar One is yet to be developed. This will require action across three different aspects: domestic law, public international law and guidance to supplement these two elements.

The translation into domestic law is aimed at achieving:

1. a domestic taxing right consistent with the design of Amount A;
2. relief of double taxation;
3. incorporation of procedures to administer the new rules and
4. processes to improve dispute resolution.

As existing tax treaties contain provisions that would generally prevent the application of Amount A, even after it has been implemented in domestic legislation, changes to public international law are also needed, likely through the development of a multilateral convention. A multilateral convention would need to contain the following elements:

1. removal of treaty barriers to determine a new Amount A tax;
2. elimination of double taxation;
3. procedure for tax certainty regarding amount A and
4. other tax-certainty processes beyond Amount A.

Finally, in addition to the domestic and the public international law changes, guidance will be developed to secure coordinated implementation.

Procedural issues regarding Pillar Two

Focus on a consensus based and consistent solution

As the Inclusive Framework continues to work toward consensus agreement on Pillar Two, it is important to be clear what form that consensus will take. The expectation is that, in contrast to Pillar One, consensus on Pillar Two will not require a commitment by each country to fully implement the Pillar Two rules. Is Pillar Two to be done in the form of minimum standard? Alternatively, is it to be a recommendation or will it take some other form?

Further on it is important to ensure that countries that choose to implement the Pillar Two rules do so in a manner that is consistent with the parameters of Pillar Two. Such consistency is essential to ensuring that the rules interlock in the intended manner and that the result of Pillar Two is not taxation in excess of the agreed minimum rate due to the imposition of multiple top-up taxes. The exigence of a harmonized approach stresses the tremendous amount of coordination that would be required both among entities in an MNE group and among tax authorities.

For Pillar Two the development of model legislation, standard documentation and guidance, designing a multilateral review process if necessary and exploring the use of a multilateral convention, which could include the key aspects of Pillar Two are conceived as crucial for the implementation. A Public Consultation Document on the Pillar Two Blueprint specifically requests stakeholder input on co-ordination mechanisms or other features of the GloBE that are worth exploring to ensure more tax certainty in applying the Pillar Two rules. It also recognizes the risk of double taxation and controversy resulting from the application the GloBE rules and, in the context of dispute prevention and resolution, requests stakeholder input on additional options to mitigate these risks.

Meaning of tax treaties

The Blueprint concludes that tax treaties should not present any obstacle to jurisdictions implementing an IIR and UTPR along the lines envisaged under the GloBE. It includes a number of references to the OECD Model Tax Convention and its commentaries, noting that, with limited exceptions, tax treaties are not intended to restrict a jurisdiction's right to tax its own residents. For the IIR, reference is made to paragraph 81 of the Commentary to Article 1 of the OECD Model Tax Convention that states that "(…) controlled foreign company legislation structured in this way is not contrary to the provisions of the Convention." The Blueprint regards the IIR as "similarly compatible with the provisions of tax treaties." For the UTPR, the Blueprint

includes an analysis of OECD Model provisions and Commentary and comes to the conclusion that there is no conflict with the provisions on business profits (Article 7) and non-discrimination (Article 24).

In our view, the suggestion in the Blueprint that both the IIR and the UTPR do not conflict with existing tax treaties raises legal, policy and certainty concerns. In general, the analysis in the Blueprint seems to be based on the premise that 'tax treaties are not intended to restrict a jurisdiction's right to tax its own residents.' However, as the OECD Model Commentary also acknowledges, the objective of most treaty provisions is to restrict the right of a state to tax residents of another state. The GloBE rules present an approach for domestic legislation that effectively taxes income from non-resident entities. This represents a shift in the allocation of taxing rights reflected in the treaty. It is also noted that the saving clause, included in the OECD Model Tax Convention in 2017, has not been widely adopted.

The analysis for the UTPR is particularly concerning as it is at odds with the current Commentary and undermines the arm's length principle embodied in the existing treaty network. The points made in this regard in the Blueprint seem to be self-serving rather than analytical. The specific category of entertainment expenses is not comparable to the general scope of intra-group payments to which the UTPR will be linked. Deduction limits for entertainment expenses are generally used as a way to distinguish between commercial costs (deductible) and expenses that have a personal element (non-deductible). For that reason, entertainment expenses are non-deductible whether paid to an associated enterprise or a third-party. More fundamentally, the deductibility of expenses is "subject to the provisions of the Convention," as specifically confirmed in the Commentary to Article 7 of OECD Model. We urge that the discussion in the Blueprint be reconsidered, particularly in light of an already emerging trend of undermining treaty obligations and denying access to MAP.

Implementation process

According to the blueprint outcome, the IIR and the UTPR do not require changes to bilateral treaties and can be implemented by way of changes to domestic law. Having mentioned the concerns above there are some doubts about this statement. On the contrary, the STTR and the SOR can only be implemented through changes to existing bilateral tax treaties. Their implementation could be fulfilled through bilateral negotiations and amendments to individual treaties or as part of multilateral convention. The MLI (Multilateral Convention to Implement Tax Treaty Related Measures to Prevent Base Erosion and Profit Shifting, BEPS Action 15) is conceived to offer a model for a coordinated and efficient approach to introducing these changes.

Even though the question of a required unitary implementation of the GLoBE rules is not fully answered, an orderly implementation process for Pillar Two should in any case be important. The Inclusive Framework should be involved in overseeing and monitoring all aspects of the implementation.

As in the case of Pillar One, the work of the Inclusive Framework also should continue beyond implementation in order to ensure that the new rules are being applied appropriately in practice and the dispute resolution processes are working effectively. This should include a peer review process, with a workable procedure for stakeholder input so that taxpayers can provide information on how the new rules are being applied in practice without fear of reprisal and with the expectation that any practices that are not consistent with the consensus agreement will be called out and addressed promptly and effectively. Finally, a schedule should be laid out for periodic review of the operation of the new rules together with a process for making any adjustments to the rules that are found to be needed during such review.

We recommend the development and adoption of a public international law instrument to facilitate consistent implementation of the proposed Pillar Two measures, address the interaction of the GloBE rules with existing tax treaty obligations, and provide a legal basis for effective dispute prevention and resolution mechanisms.

Therefore, we believe that it is essential that the implementation of Pillar Two specifically addresses the interaction of the GloBE rules with tax treaties to provide the certainty and stability that is needed. This could be done by amending existing treaty provisions or by concluding a new public law instrument that supersedes the relevant tax treaty provisions.

As noted in the Blueprint, a new public international law instrument can also support the consistent implementation of the Pillar Two rules by jurisdictions that choose to adopt them and thus increase certainty for taxpayers. In addition to defining common terms and codifying key design elements of the rules, the instrument should also include dispute resolution mechanisms that ensure the consistent interpretation of its provisions.

In addition, implementation must include the adoption of effective mechanisms for the elimination of double taxation. The risk of double taxation and controversy with respect to the Pillar Two rules and their potentially inconsistent implementation is significant. The statement in the Blueprint that the Convention on Mutual Administrative Assistance in Tax Matters is a tool that mitigates the risk of double taxation is not convincing. While that agreement allows for the exchange of tax information, it does not require tax administrations to align their interpretation of either facts or tax rules. It is this potential misalignment that will be a major source of controversy and dispute.

Specifications of a multilateral convention

For both Pillars a new multilateral convention is conceived as the most efficient way of implementing them given the need to coordinate results among multiple jurisdictions.

The Blueprint on Pillar One points out that the implementation of rules for the determination of Amount A in an international public law instrument on tax would only strictly be necessary for those jurisdictions that have these restrictive bilateral tax treaties in force. On the other side, where there is no treaty, the rules could, at least in theory, be implemented purely under domestic legislation. However, the Blueprint recommends including in the multilateral convention implementation rules for the determination of all aspects of Amount A for all jurisdictions irrespective of tax treaties. This is just to ensure consistent coherent implementation of Amount A among jurisdictions. Content of the implementation should be all the essential elements of a new taxing right, consistent with the design of Amount A and domestic legislation. In this context consistency regarding the implementation is key. In contrast to the MLI concluded in scope of Action 15 of the first BEPS project it is therefore of utmost importance that a multilateral convention for Pillar One does not allow for any reservations by countries. Rather, the finally agreed set of rules need to be adopted by all jurisdictions in a consistent manner. As an overarching goal any controversy about Amount A and its allocation is to be avoided from the beginning. This is because such controversy would not be manageable for both tax administrations and taxpayers.

Bilateral tax treaties would remain in force and continue to govern cross-border taxation outside Amount A. Therefore, the new multilateral convention will not be designed to change existing bilateral treaties but will coexist side by side. Its provisions would generally supersede only certain provisions of existing bilateral tax treaties where there was a potential conflict. Amending bilateral treaties alone would not be sufficient, as

multilateral mechanisms are necessary to implement the multilateral dispute prevention and resolution mechanisms foreseen by Pillar One. Further, it needs to be considered that Amount A allocations will also be made to non-treaty countries and taxpayers need to be certain that in these cases double taxation risk is avoided as well. Therefore, the multilateral convention needs to be a standalone document to cover also relationships between non-treaty countries and it needs to become binding law in all countries signing it. Signing the multilateral convention should also be mandatory for all IF countries. The multilateral convention would not seek to modify the wording of existing treaty provisions (unlike the MLI, BEPS action 15). Rather, standalone treaty provisions would be developed to govern the new taxing rights and the GLoBE rules. A focus in the multilateral convention should be on those rules being relevant for all jurisdictions, regardless of the existence of bilateral tax treaties. This would ensure both, relief from double taxation and the effective operation of the dispute prevention and resolution process. All in all, the Blueprints summarize the requirements on a multilateral convention by ensuring coordination, consistency and certainty, and operating in a speedy manner. Further on, it may be also possible to include the GLoBE provisions in the new multilateral instrument considered under Pillar One, which could also have the benefit of setting out the interaction between Pillar One and Pillar Two.

The Multilateral Convention to Implement Tax Treaty Related Measures to Prevent Base Erosion and Profit Shifting ("MLI") is considered to be a blueprint for the implementation of the Two Pillar Approach. However, it requires some amendments and enhancements to be adopted in the BEPS 2.0 process. Although the MLI still has not yet been ratified by all signatories, allowing us to evaluate only preliminary experiences, we should recognize some caveats in the MLI:

The MLI is a multilateral instrument to consistently implement tax treaty related BEPS measures, an enablement facing the challenge of an existing network of more than 3,000 bilateral tax treaties. The main benefit is a significant efficiency gain compared to the alternative of multiple pairs of bilateral negotiations. The multilateral treaty MLI applies alongside existing bilateral treaties, but with the aim to change their application and modify the wording of existing treaty provisions. This means that the closed concept of the MLI does not work for provisions with no connection to tax treaties or in cases where no bilateral DTT exist at all.

Upon completion of the negotiation, its implementation requires that national governments ratify the treaty, including a domestic legislative process. In some countries (e.g. Germany), the implementation of the MLI additionally requires amending the respective domestic DTT implementation

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"The current OECD proposal on Pillar One does not eliminate the risk of double taxation. As an internationally operating business, we expect the new taxation approach to create legal certainty by applying an appropriate multilateral convention."

acts and those countries may furthermore consult with each affected treaty partner in order to establish a joint understanding of the induced treaty modifications. The aim is to render the implementation process of the respective BEPS action points more efficient than bilateral negotiations could do, respecting the enormous number of DTTs worldwide. A disadvantage of the MLI regarding a speedy and coherent implementation of the two pillars might be, that the timeline for signing and ratifying the MLI is flexible. Even though the MLI was signed in 2017, a significant number of participating jurisdictions has yet to ratify it, while some countries rejected the MLI altogether (e.g. the United States). Especially in Germany, where ratification requires, in effect, two steps, the timeline for first-time application is long. After the ratification, jurisdictions can adopt more (but not less) provisions than initially declared. This ensures that states cannot "back out" of the MLI. However, a more comprehensive application of the MLI comes with regulatory changes that might be more difficult to anticipate when not all changes are planned at the same time. Besides, the MLI explicitly allows to be overwritten by later changes in a DTT.

An important feature of the MLI is the optionality approach, letting each country choose which treaties and, to some extent, which provisions would be modified. The MLI allows for flexibility with respect to the geographical coverage, as well. Participating jurisdictions can choose which double taxation treaties to amend through the MLI process and which ones to renegotiate bilaterally, leading to opacity and uncertainty. Germany even explicitly prefers bilateral negotiations where they (supposedly) lead to a faster implementation of the respective BEPS measures. At the current state, only 14 of 96 existing DTTs Germany signed, are intended to be part of the MLI revision. In this context it might ease the willingness to quickly implement a new convention and apply it on a large number of partner jurisdictions if the multilateral convention was shaped in a way (unlike the MLI) not only to modify the wording of existing treaty provisions, but in addition to develop new standalone treaty provisions to govern the new taxing rights. Lastly, the MLI allows for flexibility in the scope of the new regulations. Aside from the four minimum standards, the participating jurisdictions can choose which provisions of the MLI to apply and which ones to ignore. Note that a double tax agreement can only be modified if both countries intend to apply the respective provision of the MLI. Where there are mismatches in the application of the MLI provision, bilateral negotiations are necessary, or else, generally, no change will be made.

The flexibilities contained in the MLI are likely unsuitable for the implementation of both pillars without seriously undercutting its effectiveness. The new approach requires the subscription of a "critical mass" of tax jurisdictions at the same period. Thus, considering the lessons learned from the MLI and the distinct nature of the Two Pillar Approach process, a new multilateral agreement is feasible only if the timelines for implementation across the participating jurisdictions are congruent. Moreover, optionality with respect to applying provisions should be under strict review and best be excluded right away. As shown above, the assumption that both the IIR and the UTPR do not conflict with existing tax treaties, is not necessarily true. And even though the Blueprint states that the MLI approach would not require all countries to adopt the STTR and SOR, the interaction of the single GLoBE rules should not be underestimated. Participating jurisdictions should make unequivocal commitments to applying the new rules with all other partner jurisdictions as to avoid legal uncertainty resulting from lacking transparency.

The OECD will likely have to take a central role in ensuring the coherent roll-out of the new approach. For the MLI, the OECD coordinates the member jurisdictions' responses to the application of provisions, "matches" the respective double taxation agreement, and tracks the implementation in each participating country. Information on the status of ratifications and implementations in all participating jurisdictions, made publicly available by the OECD, helps to clarify which new regulations apply in which country and when. Yet, as the MLI has shown, in the confusion arising from different processes and different applications (due to

optional reservations) in all participating jurisdictions, a central authority is crucial.

Recommendations

There are good reasons for a reform of international tax law. However, it is crucial for practice, taxpayers and tax authorities – whether in Germany or another jurisdiction – that tax law is practicable and takes legal certainty and the avoidance of double taxation as an imperative.

Ultimately, any solution must be measured by the practicability of its implementation. The total burden of settlement costs, legal and double taxation risks must not be lost sight of. Since it is almost impossible to design such a complex approach in a way that will be "bullet-proof" from the outset, the recommendation would be to plan a thorough review after several years of experience with the new rules to determine what refinements should be made to address any problem areas that may have arisen.

The work of the Inclusive Framework should continue beyond implementation in order to ensure that the new rules are being applied appropriately in practice so that the intended results are achieved. This should include a peer review process, with a workable procedure for stakeholder input so that taxpayers can provide information on how the new rules are being applied in practice without fear of reprisal and with the expectation that any practices that are not consistent with the commitment to the consensus agreement will be called out and addressed promptly and effectively. Finally, a schedule should be laid out for periodic review of the operation of the new rules together with a process for making any adjustments to the rules that are found to be needed during such review.

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