On the OECD's 'Unified Approach' as Frankenstein's Monster and a Dented Shape Sorter

I INTRODUCTION

We all know the story of Frankenstein from the English novelist Mary Shelley's 1818 novel featuring the scientist Victor Frankenstein who created a monster.¹ It was this story that immediately came to mind when this author read the OECD Secretariat's recent proposals for a 'Unified Approach' under Pillar One. To be quite honest, these thoughts of Frankenstein had to compete with a toddler stubbornly trying to forcefully push a square shape into a triangular hole in a dented shape sorter. Meanwhile, in the background, this author could hear The Animals playing their 1965 hit '*We gotta get out of this place*'. Things did not work out well for Frankenstein and his monster in the novel. This author does not imagine they will with the shape sorter either and, as far as this author is concerned, that is exactly what should happen to the OECD's creation as explained below.

2 OECD'S REFORM TRAIN CONTINUES THUNDERING AHEAD

On 9 October 2019, the OECD Secretariat published a discussion document on how countries could – or, perhaps, should – seek to apportion multinational business profits among market jurisdictions.² This document has been published prior to a public consultation on the subject that will be held at the OECD conference centre in Paris on 21–22 November 2019. Interested parties can submit input until 12 November 2019.

The recently published document is one of the boxcars of a train that has been continuing to thunder ahead that is loaded down with proposals for reforming the way the tax base is allocated to tax jurisdictions and is determined to reach its final destination – a worldwide solution for the problem of taxing multinational business profits – by the end of 2020. Pressure is building, and the interests at stake are substantial. It is certainly becoming increasingly

difficult in our globalizing and digitalizing world that is shackled with an outdated international tax framework to tax multinationals' investment returns in a way that can be regarded as both fair and effective. However, although the problem is now fairly widely recognized, countries still fundamentally disagree on the most suitable policies for apportioning the profit tax base among the various jurisdictions.

The OECD document appears to be intended as a crowbar for wrenching the discussions out of their current logjam and also preventing the reform train from derailing. The latter, however, is now a distinct possibility considering the range of countries that have already switched to unilaterally introducing all types of disruptive turnover-related taxes on services, including certain digital services, outside the confines of the existing tax framework. While the OECD document requests input on certain practical aspects, the lack of agreement on the underlying policy lines makes this an unusual question to put to public consultation.

3 ARE MARKET JURISDICTIONS ALSO ENTITLED TO A SLICE OF THE TAX PIE?

The central question in this context is whether market jurisdictions – or also market jurisdictions – should be entitled to a slice of the tax pie. How big that slice of pie should be is something on which countries still need to agree. As yet, some countries are not actually getting any of it because the current transfer pricing rules allocate the tax base entirely to the supply side and, therefore, to the origin jurisdictions where the assets (capital and labour) are located that businesses use to perform functions. Under the transfer pricing model, none of the corporate tax base is allocated to the market jurisdictions where businesses sell their goods and services. Whether this approach is fair is difficult to ascertain. As there are no objective reference points for determining the formula,

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¹ M. Shelley, *Frankenstein, or The Modern Prometheus* (Wisehouse Classics 1818).

² OECD, *Secretariat Proposal for a 'Unified Approach' Under Pillar One*, Public consultation document 9 Oct. 2019–12 Nov. 2019 (OECD Publishing Oct. 2019).

the question of apportionment is ultimately a subjective matter. This consequently gives countries plenty of scope in political discussions to adopt the stances that are most reflective of their own interests and negotiating positions and that, of course, is precisely what they do in practice.

The problem that is faced in this context is systemic and ultimately requires a systemic solution. In response to the previous round of consultations, Wisman and this author wrote approximately six months ago in an article in the International Bureau of Fiscal Documentation (IBFD) book, *Taxing the Digital Economy*, that '[f]or that, we need to go back to the heart of the problem. And that is the fact that the rules have become outdated and no longer reflect the current economic reality. We are facing a fundamental and worldwide problem. And that means (...) that there is little option but to come up with a fundamental and worldwide solution, given that any "half-way house" solution will irrevocably and systematically lead to new problems and complications. This holds, even if these result from OECD consultations on how to go about with corporate taxation with a 3-week period for submitting input.'³ In seeking to identify a systemic solution, this author has arrived in research at a unitary system that taxes multinationals' worldwide economic profits while using a destination-based sales only formula to apportion the tax base to the various jurisdictions as a replacement for the current model⁴; otherwise stated, a 'clean-slate approach'.

4 THE OECD HAS COME UP WITH A TRAILER; A HEAD-ON COLLISION RATHER THAN A SYNTHESISED APPORTIONMENT MODEL

Rather than moving towards a systemic solution and new tax architecture, the OECD's proposed reforms intend to provide a 'solution' – designed to allocate taxable profits to market jurisdictions – by, in effect, adding a 'trailer' or 'overlay' to the existing international tax framework. The challenges that globalization and digitalization are creating for company taxation are thus being addressed by proposals that add yet another layer of regulation to the existing and already very complex system. As explained below, the OECD describes this trailer as 'Amount A'. In contrast to the anti-abuse measures that have been seen as being introduced by countries, including the EU Member States, following the outcomes of the OECD/G20 countries' BEPS project, the post-BEPS reforms now being proposed encroach on the very foundations of our crumbling tax system. The fear of this author is that this is being conducted in a way that could conceivably cause the collapse of the world's already somewhat fragile tax architecture – the 'international tax

framework' in the metaphorical dented shape sorter referred to in the introduction.

The Unified Approach outlined by the OECD Secretariat appears to suggest a synthesis of various apportionment models. The OECD gives the impression of harmoniously blending a newly developed destination-based formulary apportionment-type model (which this author refers to as 'System II') into the existing origin state-based transfer pricing model in a slightly amended form (which this writer refers to as 'System I'). This, at least, is the suggestion it seems; the reality, however, is different. Actually, what the OECD is proposing will trigger a confrontation or head-on collision between two mutually incompatible apportionment systems ('System I' *v.* 'System II'). Proceeding along the lines that are now being laid down would result in a series of alignment problems in all of the areas in which these various apportionment models would, in practice, interact. The impact of these alignment problems will be felt both when ascertaining the taxable entity and taxable base and when determining how to allocate the taxable base to tax jurisdictions; in other words, in the personal ('who to tax'), substantive ('what to tax'), and geographical ('where to tax') spheres of application of the international company tax architecture and, therefore, throughout the entire tax framework. These alignment problems will create all types of problems of both substantive (e.g. multiple taxation) and administrative natures (e.g. disputes); on top of that, they will occur on a worldwide scale. Returning to the shape sorter metaphor, it could be stated, 'The OECD is attempting to jam a square peg into a round hole.'

5 'JAMMING A SQUARE PEG INTO A ROUND HOLE'

The current transfer pricing model – which the OECD continuously returns to in its Unified Approach – is based on the concept of entities having an independent, subjective liability for tax ('separate accounting') even if they are part of a functionally integrated group. Entities are taxed on their taxable profits (i.e. the object) based on their nominal returns on equity. When determining the tax base, the extent to which liquid assets are available to pay the tax are also considered. When allocating the tax base to countries, it is assumed that legal transactions between group members to be priced at 'arm's length' (i.e. at prices that would be agreed upon between non-related entities in normal market conditions). Businesses' tax presences are determined by reference points of a legal nature (i.e. where they were established) or a physical and

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³ M.F. de Wilde & C. Wisman, *OECD Consultations on the Digital Economy: 'Tax Base Reallocation' and 'I'll Tax If You Don't'?*, in *Taxing the Digital Economy: The EU Proposals and Other Insights* (P. Pistone & D. Weber eds, IBFD 2019), at Sec. 1.10.

⁴ M.F. de Wilde, *Sharing the Pie: Taxing Multinationals in a Global Market*, IBFD, Amsterdam, 2017, Ch. 7.

geographical nature (i.e. where their fixed assets are located and/or key management functions are performed). These are the foundations underpinning the entire international company taxation architecture both with regard to the way that taxation rights are determined in national legislation and regulations and also in the manner in which the powers to levy tax are attributed and arrangements for eliminating double taxation are incorporated into countries' tax treaty networks. The current model could, in effect, be considered as the triangular hole in the metaphorical shape sorter.

The alternative formulary model – also in the variant applied by the OECD in its Unified Approach – is constructed on the idea of determining the tax that is subject by reference to the economic entity (the functionally integrated group) in its entirety or perhaps to its individual business lines ('unitary business approach'). The starting point for determining the tax base from a formulary perspective is usually the consolidated or combined investment returns; in theory, this starting point can align with a classical definition of profit (e.g. the nominal return on equity) determined independently or can be based on a group's commercial accounting profits or, alternatively, on a different concept of profit such as an economic concept of profit. For determining the tax subject, the OECD seeks reference to multinational groups or business lines and then only to those multinationals of sufficient size (i.e. with revenues exceeding EUR 750 million) and that operate 'consumer-facing' business models (whatever that may mean), i.e. a ring fence. For determining the taxable base, the OECD bases its proposals on standards that are used to determine commercial accounting profit in, for example, financial statements (Generally Accepted Accounting Principles (GAAP) and the International Financial Reporting Standards (IFRS)), and that are more likely to align with value (i.e. 'fair value' instead of available liquidity) than in tax-oriented concepts of profit. For allocating the tax base to countries, formulary systems – including that in the OECD proposal – seek reference to exogenous formulae based, for example, on labour, assets, and/or sales ('formulary apportionment'). The OECD has decided to refer to sales, that is, for 'Amount A tax base division purposes'. Proponents of a formulary approach to determining taxpayers' geographical location base their ideas on quantitative factors ('factor presence tests' in formulary terms). This can also be seen in the consultative document as the OECD's destination state-based proposal uses a quantitative sales formula; in effect, a type of 'sales factor presence test'. It should be pointed out here that the international profit tax architecture is absolutely *not* based on these principles. This applies both regarding how taxation rights are determined in national legislation and regulations and also how powers to levy tax are apportioned and arrangements for eliminating double taxation are incorporated into countries' tax treaties. The alternative model can, in

effect, be considered as the square peg in the metaphorical shape sorter.

The OECD document uses somewhat veiled terms ('Amounts') to describe the seemingly harmonious apportionment model synthesis at which it has arrived. These 'Amounts' are then classified into 'Amount A', 'Amount B', and 'Amount C'. Amounts B and C represent, in slightly amended forms, the origin state-based transfer pricing model (referred to 'System I' by this author) while Amount A is the destination-based formulary system (which this author calls 'System II') or the overlay. In the document, these two apportionment systems collide head-on. The fact that all of this remains implicit is the explanation for the confusion that arises – for this author, in any event – when reading the document. It took a while to recognize that what the OECD Secretariat is actually presenting is, in effect, the toddler in the introduction who is stubbornly trying with all his might to push a square peg into a triangular hole in a dented shape sorter whereas the dented shape sorter can be considered as the international tax framework, the square peg as 'System II' (unitary business approach/formulary apportionment; 'Amount A') and the triangular hole as 'System I' (separate accounting, arm's length pricing; 'Amounts B & C').

The way in which Amounts B and C ('System I') are determined can, in effect, be seen as a slightly modified variant of the traditional transfer pricing model. The adaptation, at least that is how it appears, applies only if and insofar as the businesses in question are multinationals (revenues exceeding EUR 750 million) with consumer-facing business models. The only thing that actually happens in this aspect is that the profit that is allocated to the jurisdictions on a transfer pricing basis is divided into two parts referred to as 'Amount B' and 'Amount C' with Amount B comprising little more below the line than the presumed level of remuneration for certain functions. The sum of Amounts B and C is the total profit of the relevant group companies ($B+C=1$). Amount B is then the routine remuneration for certain functions, more specifically, the 'baseline marketing and distribution functions' and is determined using a proxy ('fixed remuneration'). This is, at least, the basic assumption. However, it would also be acceptable if the relevant jurisdictions were to make a case for and apply a higher remuneration. This will require an effective system for resolving disputes. In this way, Amount B simply becomes the presumed amount referred to above. Any remuneration exceeding that for the routine or baseline activity would subsequently be included in Amount C along with other remuneration for the functions performed by the taxpayer, both of a routine and non-routine nature. The OECD document leaves scope for Amount C to be limited to the functions performed by group members in market jurisdictions. In that case, there would also have to be an 'Amount X' for functions performed by group members in production jurisdictions ($B+C+X=1$). This author's perception on System I is that, by adopting

a proxy approach, the OECD is seeking to address the discussions that are ongoing in certain countries regarding allocating profits from marketing and distribution functions.

The primary issue in the OECD document is how to calculate Amount A (i.e. the boxcar on the metaphorical train) in order to apportion tax base to market jurisdictions. In effect, the OECD has devised a new system for apportioning the tax base (System II) which, in the way that this author is attempting to view it in combination with the 'System I apportionment', would have to be applied as a sort of two-stage rocket ('Stage I: Apply tax base division system I; Stage II: Apply tax base division system II'). The new system would apply to the large multinationals, as referred to earlier, with consumer-facing business models. Just as with the current company tax system, System II would have a subject, an object, and an allocation mechanism, albeit all somewhat implicit. The taxable entity would be the multinational enterprise (not defined in any further detail in the document), possibly divided into its different business lines (unitary business approach). The taxable base would be the consolidated profit (also not defined in any further detail) that is ascertained by applying the standards that are used to determine commercial profit (GAAP, IFRS). The tax base would be apportioned in two stages: 'nexus' (i.e. deciding the tax jurisdiction) and 'apportionment' (i.e. establishing the tax base). Nexus would be determined by applying a quantitative sales threshold (factor presence test) while the tax base would be allocated using a sales factor test ('sales apportionment').

The process of determining Amount A (the sales apportionment formula) is a four-step process. First (Step 1), the multinational's worldwide consolidated commercial accounting profit, referred to in the OECD document as $z\%$, where $z = 100$ and where $z \neq B+C(+X)$, is calculated. This is because the System I and System II calculations each assume different quantities with the result that, contrary to what appears to be suggested, two separate apportionment models must be addressed. This immediately explains why the synthesized apportionment model cannot be accommodated in a single pie chart. From the amount calculated for z , Step 2 derives the 'deemed routine profits' that are determined on the basis of a fixed percentage. The amount ascertained in this manner ($x\%$) is subsequently deducted from the above $z\%$ to arrive at the 'deemed non-routine profits' ($y\%$) where $y = z - x$, and $x + y = z = 100$. Then (Step 3), this amount of 'deemed non-routine profits' ($y\%$) is divided into two amounts ($w\%$ and $v\%$) where $y = w + v$, and $x + w + v = z = 100$. The first amount ($w\%$) represents the 'profits attributable to market jurisdictions' and is determined using a fixed percentage (possibly with industry-specific variants). The second

amount ($v\%$) represents the 'profits attributable to other factors such as trade intangibles'. Ultimately, Amount A is equal to the above $w\%$. That amount of the profit is then apportioned (Step 4) to countries on the basis of the reference points used for determining nexus and allocating the tax base. The percentages must still be established.

6 ALIGNMENT PROBLEMS: 'RISK OF DOUBLE COUNTING OR DUPLICATIONS'

Although the OECD suggests differently, the synthesized apportionment model depicted in the document is anything but a harmonious synthesis. Implementing the plans would create problems in every building block on which countries' tax systems are constructed (taxable entity, taxable base, and tax base allocation), and this would be on a worldwide scale. This will occur whenever System I and System II come up against each other in practice. System I refers to taxpayers, taxable profits, and the arm's length principle ('the triangle in the shape sorter') whereas System II refers to multinationals/business lines, commercial profits, and formulary apportionment ('the square peg'). Successfully incorporating Amount A into the current international tax framework would require incorporating a full business income tax apportionment system into national legislation and regulations as well as the tax treaty networks of every country around the world; otherwise stated, tax harmonization on a global scale.

Alignment problems will arise at those points where the trailer established as Amount A is incorporated into the current international tax framework. The OECD refers – in the context of possible (and otherwise unspecified) obligations – to eliminate double taxation – when Amount A is intended to be levered into the current framework – that 'the implementation of the proposed approach would require the identification of the member(s) of an Multinational Enterprise (MNE) group that should be treated as owning the taxable profit in such market jurisdictions under Amount A (e.g. entity(ies) with high profitability, entity(ies) owning certain intellectual property (IP)).'⁵ Identifying and geographically pinning down these 'owning companies' and allocating the tax base to them will create enormous pressure. For 'Amount A taxation purposes', these companies are the sluice gates in the international tax framework. Market jurisdictions will be keen to regard these companies as non-resident taxpayers while resident States will have to renounce their jurisdiction for that share of the tax pie and put arrangements in place to eliminate double taxation. This is because the two apportionment systems, in the synthesis as outlined, must not be allowed to result in double taxation but to arrive at a single taxation of business income ($A+B+C$

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⁵ OECD, *supra* n. 2, at 10.

(+X)=1). In order to achieve single taxation and prevent mismatches at a tax entity, tax base, and tax base allocation level, therefore, the countries that are affected will also have to reach agreements with each other on all of the reference points, both in policy terms and in a more legal and technical sense.

Interventions in countries' legislation and regulations as well as tax treaty networks will be needed on a global scale in order to find compatibility solutions for all of the dangers that are present in the synthesis of the 'Unitary System II Model' and the 'Separate Accounting System I Model'. An *à la carte* MLI 2.0 will not be sufficient and neither will an EU directive, ATAD 3, or the like. What is needed goes far beyond simply supplementing the definition of the permanent establishment and adjusting the profit allocation and transfer pricing rules. All of the 'tax shape sorters' of countries around the world will need to be 'sanded down' in a mutually consistent manner if the different shapes are to be put through the triangular holes. The effects of implementing the Unitary System II model as it is proposed will be felt in every fibre of countries' international profit tax systems around the world.

The OECD's states that 'approaches to address any risk of double counting or duplications between the three possible types of taxable profit (Amounts A, B and C) that may be allocated to a market jurisdiction would need to be considered, in particular interactions between the new taxing right under Amount A and current profit allocation rules.'⁶ This, to state it mildly, is an understatement. Considering that countries currently experience significant problems agreeing on the underlying directions of their policies for apportioning the tax base, this author can certainly imagine that any subsequent alignment issues of a more legal or technical nature will initiate all sorts of legal disputes. Even if consensus could be achieved on incorporating System II into national legislation and tax treaties on a worldwide scale, single taxation in the absence of effective worldwide opportunities for dispute resolution could not always be ensured. This would be irrespective of the possible need, in due course, to add yet another layer of regulation – that would subsequently prompt further calls for apportioning the tax base – specifically the OECD's Global Anti-Base Erosion (GloBE) proposals for an 'income inclusion measures' and a 'tax on base erosion payments'. A document on these subjects is also expected from the OECD.

7 CLOSING COMMENTS

One year ago, this author wrote in the *Intertax* article 'Comparing Tax Policy Responses for the Digitalizing Economy: Fold or All-in' that '[F]irst, the policy should be set and then reflected in legislation; it should not be the other – dangerous – way around'.⁷ Approximately six months ago, Wisman and this author wrote in the previously mentioned article in *Taxing the Digital Economy* that '[a]dopting the suggestions set out in the consultation document without any adjustments would result in an uncontrollable and unmanageable drifting of the tax base across production jurisdictions and market jurisdictions'.⁸ Returning to *Intertax*: 'Such a move would seem to be bringing little else to the table other than market distortions, inequities, arbitrary taxation, tax cascading, legal uncertainties, and red tape.'⁹ If the Unified Approach is adopted, that is precisely what would happen. In this way, and just like Frankenstein, the OECD is creating a monster all of its own. Quite frankly, the persistence with which the OECD is allowing its reform train to continue thundering along without any evidence of even the slightest pause for thought is rather shocking. Although this author has no idea what the pedagogically most appropriate response is to the toddler and his dented shape sorter, what is certain is that 'when it comes to fixing the broken international tax framework, there seems to be no such thing as a readily available "quick fix"'. Perhaps, therefore, it should be reconsidered that, in that respect, it may be worth considering breaking away from status quos in company taxation and instead proceed to explore genuine and fundamental corporate tax reform.'¹⁰ Meanwhile, in the background, The Animals are singing, 'We gotta get out of this place'.

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⁶ *Ibid.*

⁷ M.F. de Wilde, *Comparing Tax Policy Responses for the Digitalizing Economy: Fold or All-in*, 46(6/7) *Intertax* 472 (2018).

⁸ De Wilde & Wisman, *supra* n. 3, at Sec. 1.1.

⁹ De Wilde, *supra* n. 7, at 475.

¹⁰ *Ibid.*