6. Winners and Losers under BEPS Action 1

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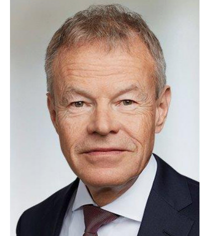

1. Background

Whether large Multinational Enterprises "may pay their fair share of tax or not" has been debated in the public domain for quite some time. In June 2012, the G20 group mandated the Organization for Economic Development ("OECD") to develop an action plan to counter "Base Erosion and Profit Shifting (BEPS)". The OECD defines BEPS as tax avoidance strategies aiming at exploiting gaps and mismatches in tax rules to "artificially" shift profits to low or no-tax locations. According to the OECD the idea behind the BEPS project is to create a level playing field by bridging the gap between the local laws and the fact that businesses operate on a global scale. The OECD addressed 15 Action Points in order to counter BEPS.

2. Action 1: What is it all about?

Action 1 is the most controversial topic since it addresses solutions for international taxation created by the spread of the digital economy. Through an iterative process, the OECD developed a method that should also address the special challenges posed by the digital economy. It is acknowledged that because the digital economy is increasingly becoming the economy itself, it would not be feasible to ring-fence the digital economy from the rest of the economy for tax purposes. However, the opinion of the representatives of the OECD is that certain business models and key features of the digital economy could exacerbate BEPS risks. In the OECD's February 13, 2019, consultation document[1)] a two pillared approach to the issues is outlined.

The first pillar addresses the rules of how to determine the connection between a business and a tax jurisdiction (nexus) and how much profit should be allocated to the business conducted there.

The second pillar of the OECD's approach would address remaining BEPS challenges. Minimum tax and a tax on base-erosion payments. In other words, Pillar 2 should safeguard that a minimum level of taxation remains.

3. Pillar 1: How to Tackle the Issue? OECD/G20 Inclusive Framework Statement on January 29-30, 2020[2)]

In order to accelerate the process of finding a solution for the digital economy, the Secretariat of the OECD summarized the outcome of the above-mentioned consultation process, in what is referred to as the Unified Approach. It "is designed to adapt taxing rights by considering new business models and thereby expand the taxing rights of market jurisdictions which, for some business models, is the jurisdiction where the user is located."[3)] Pillar 1 is now comprising 3 elements:

a. *Amount A: The Magic Wand?*

The aim is to address the issue that profit should also be allocated to marketing jurisdictions, even if the MNE does not have a physical presence there. It is intended to use a formulaic approach applied to a MNE at group or business line level to allocate a share of residual profit to market jurisdiction. This approach should be taken by MNE that meet a certain revenue threshold, which currently is anticipated to be EUR 750 million. The new taxing right should reflect profits associated with the "active and sustained participation" of a business in the respective economy of a market jurisdiction. Accordingly, it reflects the primary response of the unified approach to the tax challenges of the digitalization of the economy.

According to the secretariat of the OECD the following MNE groups are in scope: Obviously, automated digital services, whereby services that involve a high degree of human intervention and judgement such as legal, accounting, architectural and consulting, should be exempt. Also "Consumer-Facing businesses" are mentioned. The term is new to the tax world and created some confusion. Consumer-Facing businesses are enterprises that generate revenue from the sale of goods and services of a type that is commonly sold to consumers. It is expected that Consumer-Facing businesses should comprise amongst others, those businesses that sell consumer products indirectly through third-party resellers or intermediaries that perform routine tasks such as minor assembly and packaging. But also, businesses that generate revenue from licensing rights over trademarked consumer products and businesses that generate revenue through licensing a consumer brand and commercial know-how such as under a franchise model. To add some color, the following business could be mentioned:

- Enterprises distributing personal computing products e.g. software, home appliances, mobile phones
- Enterprises distributing clothes, toiletries, cosmetics, luxury goods
- Enterprises distributing branded foods and refreshments
- Business operating under franchise models, such as licensing arrangements comprising the restaurant and hotel sector
- Automobiles

The term Consumer-Facing business is not intended to comprise certain industries such as the extractive industries, sellers of raw materials and other commodities. The reason being that extractives, agricultural and forestry products are generic goods which are then sold. The price is determined based on their inherent characteristics. Generally, out of scope should also be industries that are subject to a high degree of regulation, such as the financing and insurance business. Another business segment that has a high degree of regulation is obviously the Pharmaceutical Industry, in the segment of prescription drugs. Accordingly, it was suggested to make a distinction between "Over the Counter" and "Prescription" Drugs. The underlying assumption was, given the high level of regulation, the business of distributing prescription drugs should be carved out. Albeit a carve out appears to be well founded, it seems that the US delegation is strongly against such carve out for the Pharmaceutical industry distributing prescription drugs. If one analyses the flow of prescription drugs, one may assume the underlying rationale for the position of the US team is to carve out of a larger piece of the pie from the Pharma business exporting to the US market.

Where does that leave us? Currently at the level of the OECD the following is discussed: The threshold for Amount A seems

to be the profit that is above 10% of turnover. It is assumed that thereof 20% should be attributable to marketing IP and should be shared amongst the marketing jurisdictions. Accordingly, if income is 15% of turnover then 1% will go into amount A.

b. Amount B: The Good old Tradition?

Pillar One also comprises Amount B, which reflects a fixed remuneration based on the arm's length profit (ALP) for defined baseline distribution and marketing functions that take place in the market jurisdiction. It is contemplated that a different threshold will be defined depending on the Region and the Industry.

c. Amount C: Last but not Least

Lastly, Pillar One also comprises Amount C reflecting additional profit where in-country functions exceed the baseline activity compensated under Amount B.

Amounts allocable under B and C are based on the existing profit allocation rules including reliance on physical presence to improve the practical application of the ALP.

4. Pillar 2: The other side of the coin

Pillar Two aims at safeguarding that a minimum level of taxation is achieved. Based on the current discussions, it seems that the threshold for the level of the minimum taxation is below the lowest rates under the revised Swiss tax laws. However, depending on the final proposal, Swiss entities taking advantage of the transitional rules under the TRAF[4], such as step-up and two tax rate model, might have an effective tax rate that could be below the minimum tax rate as per Pillar Two. Over the past few years there have been discussions at the OECD level regarding IP-Boxes. The OECD then finally agreed that IP-Boxes are compliant with the general rules and do not constitute harmful tax practices. In the context with TRAF, Switzerland introduced IP-Boxes. The Swiss delegation therefore has favored that such a tool should be carved out from the minim tax rate regime. However, it seems that such carve-out may not be considered in the final proposal.

5. Next Steps: The Gordian Knot

The OECD is currently discussing how to shape the final proposal with the representatives of the countries. Pascal Saint-Amans made numerous statements that the final agreement on Pillar One should be reached in July 2020. However, due to coronavirus crisis the physical meeting has been replaced by a video conference[5]. A physical meeting is expected to take place in October 2020. A further uncertainty was created by United States (US) Treasury Secretary Steven Mnuchin's letter on December 3, 2019 to the OECD. He mentioned that the US has "serious concerns" about aspects of the project of Pillar One which could be "substantially achieved" by making it a safe-harbor regime. To what extent the OECD is willing to accept such compromise in order to get the support of the US remains to be seen.

6. Winners and losers: On which Side is Switzerland?

On February 13, 2020[6], the OECD presented an economic analysis that the two-pillar approach should have a significant impact on global tax revenues. It does not present results on country-specific basis. The preliminary analysis distinguishes between high-income, middle-income, and low-income jurisdictions and investment hubs. In the analysis it is estimated that revenues may increase up to 4% of the global corporate income tax (CIT), or USD 100 billion on an annual basis, depending on the design of the reform. Not surprising Pillar One would lead to only a slight increase in global tax revenues as taxing rights would shift from low tax to higher tax jurisdictions. Or in other words, the way how jurisdictions carve up the "tax pie" is changing. Most economies would experience slight CIT revenue gains, with low-income and middle-income economies gaining relatively more CIT revenue than high-income economies. Investment hubs would experience a CIT revenue loss. Given the above, it does not come as a surprise that the influence that taxes have on investment location decision-making may decrease. However, it may contribute to more investments being driven by other factors, such as infrastructure and labor costs, leading to global growth.

And where does this leave Switzerland? Before all the parameters of the final proposal are known, it may be difficult to assess to what extent Switzerland may be losing tax revenue. Or to put it in the words of our Federal Councilor Ueli Maurer: "we may expect a loss in tax revenue ranging between CHF 0.5 and 5 billons or even above"[7]. Applying to Switzerland the analysis made by the OECD, one may come to the following conclusions: Switzerland is home for numerous centralized structures in high margin business selling via Limited Risk distributors. Therefore, if under the current set up of the centralized structure amount B is below the threshold of the final proposal, one must expect a loss of tax revenue. This may even be exacerbated if currently the centralized structure operates without having taxable presences in the marketing jurisdictions and the profit exceeds the threshold that qualifies for an allocation to Amount A. In addition, we may find ourselves in an economy that qualifies as a high-income economy and an investment hub, both according to the OECD are expected to lose tax revenues. In short, Switzerland may expect a loss in tax revenue. The extent depends on the parameters laid down in the final proposal. So, to stay on the wish list of MNE as the place to invest it may become even more important that Switzerland provides attractive tax regimes coupled with its superb infrastructure.

1) OECD February 13, 2019, OECD invites public input on the possible solutions to the tax challenges of digitalization; http://www.oecd.org/tax/oecd-invites-public-input-on-the-possible-solutions-to-the-tax-challenges-of-digitalisation.htm; visited on May 2, 2020
2) OECD (2020), Statement by the OECD/G20 Inclusive Framework on BEPS on the Two-Pillar Approach to Address the Tax Challenges Arising from the Digitalization of the Economy – January 2020, OECD/G20 Inclusive Framework on BEPS, www.oecd.org/tax/beps/statement-by-the-oecd-g20-inclusive-framework-on-beps-january-2020.pdf., visited on April 17, 2020
3) loc.cit. above N. 10
4) Tax Reform and AHV Financing, Federal Law dated September 28, 2018 regarding Tax Reform and AHV Financing, effective as of January 1, 2020 (AS 2019 2395 2413; BBl 2018 2527)
5) Webcast Slide; Tax Talks on May 4, 2020 Slide 48: https://www.oecd.org/tax/oecd-tax-talks-presentation-may-2020.pdf visited on May 5, 2020
6) OECD presents analysis showing significant impact of proposed international tax reforms 13/02/2020 https://www.oecd.org/tax/beps/oecd-presents-analysis-showing-significant-impact-of-proposed-international-tax-reforms.htm, visited on May 6, 2020
7) Ueli Maurer in «Die Schweiz fürchtet wegen Steuerplänen von G-20 und OECD um einen grossen Teil ihrer Steuereinkünfte" NZZ am Sonntag; https://nzzas.nzz.ch/schweiz/steuer-plaene-von-g-20-und-oecd-operation-schadensbegrenzung-ld.1497281?reduced=true vistited on May 9, 2020

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This article reflects the personal view of the author.