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Impact of Pillar I on Decentralized MNE Consumer Facing (Goods) Business Models: An Initial Assessment Through an Illustration

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1. Purpose of the blog

This contribution is a follow up to the previous contribution of the author. The objective is to address the tentative impact of the Pillar I debate on decentralized MNE business models in light of the "*ongoing work*" of the OECD with respect to the digitalization of the economy[1]. The reader should note that the proposals apply to highly digitalized as well a traditional MNE consumer facing businesses.

2. Illustration – Decentralized business model

A decentralized MNE business usually performs its activities with local entrepreneurs.
In terms of functions, the local entrepreneur usually takes key decisions associated with the purchase, manufacture as well as sale of products. In terms of risks, the local entity usually controls key risks pertaining to its value chain, that is, risks relevant to purchasing, processing and selling of the products. Moreover, in many circumstances, the local entity could also be responsible for DEMPE related activities for either trade or marketing intangibles. Thus, such entities could also own valuable intellectual property (IP).

A typical structure[2] relates to a case where an MNE (MNE Group Z hereafter), which has its ultimate parent in one jurisdiction, sets up a full fledged business in another jurisdiction. For example, consider the situation of Company R in Country R that has developed all trade and marketing intangibles with respect to certain products. Company R manufacturers and sells its products in the State R market. For its operations in Country S, Company R establishes a local entrepreneur (Company S) that is in charge of manufacturing and selling products in that territory. Company S is also responsible for selling the products in neighboring territories (for example, Country S1). Company R licenses its intangibles to Company S. Company S uses the intangibles for its manufacturing and sales related operations and derives business income. Company S pays an arm's length royalty to Company R.

From a transfer pricing perspective, Company R is usually classified as a full-fledged manufacturer (FFM) whereas Company S is usually classified as a licensed manufacturer. These said, depending on their exact functional profile, both entities could be classified as "*entrepreneurs*" from a functional analysis standpoint.

3. Application of the Unified approach

The overall objective of the Pillar I debate is to allocate additional taxing rights to market countries. In our example, sales are made into three countries. This would be Country R, Country S and Country S1 (remote sales are being made therein by Company S). However, this contribution assesses the impact of the Pillar I debate on sales made in the latter two countries.

Amount A seeks to re-allocate profits on the basis of a pre-determined formula linked to MNE Group profits. To understand the application of this approach, consider the following further facts of MNE Group Z which operates only one "*in scope*" consumer facing business such as a fast moving consumer goods business. According to its consolidated financial statements for year 2020, MNE Group X has: (1) consolidated group operating revenue = $2 billion and (2) consolidated expenses = $1500 million. Therefore, the Group profits (3) amount to $500 million. This amount (3) represents the Groups Earning or Profit Before Taxation (EBT or PBT hereafter).

Also, assume that the MNE Group generates forty percent of its global revenue from Country S ($800 million) and twenty percent of its global revenue from Country S1 ($400 million). These sales are booked by Company S in Country S. On this turnover, Company S reports a 5% taxable profit on sales (post royalties). The corporate tax rate in Country S is 20%. Thus, under the existing framework, Company S pays corporate taxes amounting to USD 12 Million on a taxable base of USD 60 million (1200*5%*20%) in Country S. As the sales in Country S1 are made on a remote basis, under the existing framework, Company S does not pay any corporate taxes in that country.

Further, let us assume that Country S applies withholding taxes authorized by domestic law and tax treaties (10%) on the arm's length royalties (5% on sales) that have been paid out. The royalties paid out from Country S by Company S amount to USD 60 Million (1200*5%) and the withholding taxes amount to USD 6 Million (60*10%).

Furthermore, let us also assume that MNE Group X generates similar revenues during the past three years from each market jurisdiction. Moreover, Company S invests heavily in Advertising, Marketing and Promotion related activities in Country S and Country S1. Accordingly, the entire MNE Group is considered to have "*significant and sustained engagement*" in both market countries and hence it satisfies the "*new nexus*" test. In order to allocate profits to market countries, assume the deemed residual profit split method would apply as follows:

- **Step 1:** The Group EBT amounts to $500 Million and EBT margin amounts to 25% (EBT / operating revenues).
- **Step 2:** The deemed routine EBT margin is fixed at 10% (through multilateral negotiations) and thus 15% will be deemed to be non-routine EBT margin.
- **Step 3**: The non-routine EBT margin of 15% is split (after multilateral negotiations) between production activities / intangibles (80%) and market activities / intangibles (20%). Essentially, 3% of the EBT margin will be allocated to market related activities.
- **Step 4:** MNE Z Group's market related profits is determined to be 3% of the overall revenues, which amounts to $60 Million ($ 2Billion*3%). The reallocation will work as follows:
    - **Country S:** As forty percent of the global sales are derived from Country S it will be

allocated USD $ 24 Million (60*400/2000 = 24) of that deemed profit.

- **Country S1**: As twenty percent of the global sales are derived from Country S1 it will be allocated USD $12 Million (60*400/2000 = 12) of that deemed profit.

As a start, the question arises as to which Country would alleviate double taxation for the taxes paid on the Amount A liability in Country S and Country S1?

The first issue pertains to identification of the relevant taxable person. As the objective of Amount A is to reallocate a part of the residual profits to the market countries, we believe that the relevant taxpayer(s) to whom the Amount A liability should be allocated is/are the entities in the MNE Group that book residual profits under the current transfer pricing rules. Therefore, at this stage, we would tend to argue that Company R and Company S should be considered to be the relevant taxable persons as they will be characterized as "*entrepreneurs*" for transfer pricing purposes (depending on their exact functional profile).

With respect to the Amount A liability in Country S1, two possibilities emerge. One possible option is to consider Company S as the taxable person since it is responsible for making sales in that market. Another option would be to regard both Company R and Company S as the relevant taxable persons. At this stage, we would tend to argue that the latter option is pursued given the fact that profits linked to Country S1 are booked directly in the hands of Company S and indirectly in the hands of Company R (as Company R also receives royalties linked to Country S1 sales). This would imply that Country R (Company R) and Country S (Company S), as 'surrender states', should provide the relief for the Amount A liability.

With respect to the Amount A liability in Country S, at the outset, it should be noted that at least one large MNE in its contribution to the public consultation has argued that Amount A should not be applicable in the jurisdiction of the licensed manufacturer as such manufacturers already report residual profits in the local jurisdiction[3]. Keeping this debate aside, at this stage, we would tend to argue that residual profits that are booked by Company S under the current framework needs to be reduced from the Amount A liability. This would among other parameters also depend on the scope of Amount C, which, at this stage, seems to be blurred.

One the one hand, it seems that Amount C is applicable to taxpayers (local PE or separate related entity) that mainly do valuable marketing or distribution activities or a combination of them. For example, this Amount would apply only to Full Fledged Distributors (FFD) that essentially buy and sell goods. On the other hand, due to lack of clarity, it also seems that Amount C could also possibly be applicable to licensed manufacturers (or a local entrepreneur). The issue has also been identified and it is stated "*The scope of Amount C is still being discussed and considered as a critical element in reaching an overall agreement on Pillar One*"[4].

Several options emerge to address the issue of an overlap between Amount A and the residual profits that are booked by the licenced manufacturer. One possibility would be to start with the taxable profit of the licenced manufacturer. The Amount A liability could then be compared to this amount. If the local entities actual taxable profit, which also includes a part of the residual profit, is higher than deemed taxable profit (Amount A) no taxes will be required to be paid on Amount A.

A more nuanced approach which could also be contemplated is to extend the scope of Amount B (in order to provide fixed returns for baseline manufacturing activities) as well as the scope of Amount C. The returns exceeding the baseline activities would be classified as residual returns.

The residual return or the tax paid on this residual return will be reduced from the Amount A tax liability. See the previous contribution.

Another question which merits consideration is with respect to the withholding taxes on the royalties. We would argue that if the royalty paid by Company S is subject to a withholding tax on a gross basis then that amount should be reduced from the Amount A allocation with respect to those countries. This is because the withholding tax captures a part of the IP profit at source. For example, the withholding tax could be credited against the Amount A tax liability[5].

In the aforementioned situations, by reducing the actual corporate tax as well as the withholding tax liability, it could well be possible that the tax liability under Amount A in Country S is not payable.

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[1] For a more recent update on this topic, see OECD/G20, *Statement by the OECD/G20 Inclusive Framework on BEPS on the Two-Pillar Approach to Address the Tax Challenges Arising from the Digitalisation of the Economy,* January 2020.

[2] See Public Comments, Unilever, p. 5.

[3] Public Comments, Unilever, p. 3.

[4] See OECD/G20, *supra* n. 1, para. 10.

[5] Public Comments, Digital Economy Group, pp. 9-10; Public Comments, Maisto E Associati, pp. 6-7.

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