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Global Transfer Pricing | 10 October 2019

OECD proposes “unified approach” to Pillar 1 of project to address tax challenges from digitalization of the economy

Global Transfer Pricing Alert 2019-032

The OECD on October 9 released a public consultation document on the Secretariat’s proposal for a “unified approach” under Pillar 1 of the Inclusive Framework’s project to address international taxation in the digitalized economy. Pillar 1 focuses on revising the allocation of taxing rights among countries, potentially including new approaches to nexus (permanent establishment) issues and the arm’s length principle.

Stakeholders are invited to provide comments on the document by Nov. 12. A public consultation will take place in Paris on Nov. 21-22.

The document attempts to narrow the field of options, drawing largely on aspects of the modified residual profit

split (MRPS) method and the distribution-based approaches laid out in the *Programme of Work to Develop a Consensus Solution to the Tax Challenges Arising from the Digitalisation of the Economy* issued in May 2019, and less so on the fractional apportionment method. The document lays out a three-tier profit allocation mechanism as the foundation of Pillar 1.

The document also suggests that the new approach may go beyond highly digital business models by focusing on "large consumer-facing businesses," while proposing to exempt certain extractive industries and commodities-related enterprises, as well as perhaps financial services. The proposal indicates a desire to have a threshold over which the new provisions would apply, suggesting EUR 750 million in revenue as an option (similar to that adopted for the country-by-country reporting requirements). This and other provisions will be subject to further discussion and negotiation. It is also possible that there will be a per country dollar threshold that would vary depending on the size of the relevant market jurisdiction.

The document emphasizes that "consumer-facing businesses" will not necessarily be limited to "business to consumer" (B2C) business models only. Rather, factors such as customer engagement and interaction, data collection and exploitation, and marketing and branding will be considered in determining whether the new approach may be appropriate. For example, highly digitalized businesses that interact remotely with users, who may or may not be their primary customers, would likely be in scope. Significant technical work will be needed to distinguish precisely between consumer-facing businesses and other businesses. The proposal also envisions a new nexus (permanent establishment) rule that is dependent not on physical presence in the user/market jurisdiction but on sales – a commonality among the various tax solutions discussed this year.

The work will be guided by the goal of expanding the reach of taxing authority in market jurisdictions in a way that is simple, avoids double taxation, and significantly improves tax certainty relative to the current practice. The document also notes that the goal of the new rules is that they should apply to situations involving not only positive taxable income but also to those involving tax losses. In addition,

consideration will be given to prevent the new rules from creating distortions.

Approach to profit allocation

According to the document, the proposed three-tier mechanism would:

1. Use a formulaic approach to allocate to market jurisdictions a share of a multinational business' non-routine return attributable to market intangibles (vs. that attributable to other factors, such as trade intangibles), irrespective of the business' residence or locations **(Amount A).** This approach allows jurisdictions to maintain taxing rights over income generated through *routine* activities in that jurisdiction. It is contemplated that the determination of both (i) the routine return, and (ii) the portion of the excess (non-routine) return attributable to marketing would be determined by agreed formulas.
2. Provide a fixed return for baseline marketing and distribution functions taking place in a market jurisdiction **(Amount B).** This return is based on the arm's length principle, but fixed amounts of return will be explored to minimize disputes.
3. Tax an additional return **(Amount C)** in accordance with existing transfer pricing rules when a market jurisdiction can successfully establish – subject to robust and binding dispute resolution mechanisms – that there are more functions in the market jurisdictions than have been accounted for and included in Amount B.

The proposed starting point for calculating Amount A is determining a group's profits, which could be derived from the group's consolidated financial statement. The document suggests that profits may need to be determined on a business line and/or regional/market basis to avoid distortions that may arise from groups with both high- and low-margin businesses.

The second step would be to determine the group's "routine" profit; the proposal suggests that a simplified approach would be to use a fixed percentage of sales, potentially with variation by industry. The routine return is then subtracted from the overall profit to produce the non-routine return of

the multinational enterprise (MNE) (or the relevant business line). This non-routine return must be further split between the portion of the non-routine return attributable to the market intangibles (as opposed to arising due to trade intangibles and other factors such as risk and capital). The proposal explains that this amount, too, could be determined through the use of a simplifying convention, such as non-routine profit multiplied by an internationally agreed fixed percentage. Finally, once the amount that is attributed to marketing intangibles on a group basis is determined, this amount would be allocated among the jurisdictions based on an agreed allocation key, using variables such as sales.

Practicalities

In several places, the proposed unified approach emphasizes the desire for simplification as changes are contemplated, and it notes that "an administrable solution is essential, especially for emerging and developing countries." Those countries will broadly need to sign on to any solution that emerges from the Inclusive Framework if there is to be an implementable international consensus.

The devil, of course, will be in the details, and many such details would need to be worked through if stakeholders were to agree to this general architecture – from how a deemed routine return is determined and what percentage of the residual should be reallocated, to the treatment of losses and how to avoid double counting.

The document acknowledges the implementation challenges that lie ahead, including the need for a new nexus rule as a "self-standing treaty provision," the development of a common withholding tax mechanism for those countries that chose to use one for collection of Amount A, and ensuring simultaneous implementation by all jurisdictions.

Next steps

Separately, the document mentions that a consultation paper on Pillar 2 will be released in November, to be followed by a public consultation in December. Pillar 2 is concerned with the potential creation of a global anti-base erosion proposal, or "GloBe," to ensure all multinational businesses pay some minimum level of tax. The outline consists of an income inclusion rule, modeled on the US GILTI regime, although with some countries proposing that

the minimum tax apply on a country-by-country basis. Policymakers are also considering a tax on base-eroding payments that would be coordinated with the income inclusion rule.

The OECD said during a webcast on October 10 that they hope for greater consensus in 2020, looking in particular to the June 2020 meeting planned for Inclusive Framework participants. When – and if – a general consensus is reached, significant technical work would then follow, and that is expected to take 18 months or more before changes would be ready for implementation.

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