SQUIRE PATTON BOGGS

Pillar of Salt?
OECD Unveils a Proposed Unified Approach to Profit Allocation

In May 2019, the OECD/G20 Inclusive Framework on BEPS (the Inclusive Framework) published its Programme of Work to Develop a Consensus Solution to the Tax Challenges Arising from the Digitalisation of the Economy (the Programme of Work). The Programme of Work focused on two pillars:

- Pillar One – The allocation of taxing rights, involving changes to profit allocation and nexus rules
- Pillar Two – A new global minimum tax regime for multinational businesses

On October 9, 2019, the OECD Secretariat published a proposal for a "Unified Approach" (the Proposed Unified Approach) under Pillar One. Although it may be important in helping to move the Programme of Work forward, the Proposed Unified Approach *does not* represent a consensus view of the Inclusive Framework.

The OECD hopes that the Proposed Unified Approach will help expedite international negotiations by providing what is still a very high-level set of general parameters for such negotiations. Therefore, although enormously ambitious, the Proposed Unified Approach is little more than a "stepping-stone" towards finding a political agreement during 2020 on changing the existing international tax rules regarding profit allocation and nexus.

The OECD recognizes that the Proposed Unified Approach is merely an unfinished blueprint, but hopes it forms the basis for something capable of multilateral acceptance and practical implementation. Nonetheless, it has also re-emphasized that political ambition, engagement, pragmatism and endorsement are critical to reaching a consensus-based solution.

This note summarizes the Proposed Unified Approach and comments on a number of issues that such an approach raises.

The Proposed Unified Approach Under Pillar One

The Proposed Unified Approach attempts to:

- Give more taxing rights to countries where the buyers or users of a multinational's products or services reside
- Create a new tax nexus rule that is not dependent on physical presence
- Depart from the separate entity approach to taxing the profits of a multinational group
- Simplify and stabilize the rules, providing increased tax certainty (recognising that current transfer pricing rules are complex, result in rising administrative and compliance costs, and cause growing numbers of tax disputes)

The four key principles underpinning the Proposed Unified Approach are:

- Simplicity and administrability
- Retention of current rules where they function well, but making changes where needed
- Elimination of double taxation
- Enhancement of tax certainty through effective and binding dispute prevention and resolution mechanisms

The Proposed Unified Approach would operate as an "overlay" on existing rules that addresses specific issues arising from the digitalization of the economy; it is not intended to overhaul the entire international tax framework.

The Proposed Unified Approach has three main elements:

- Scope Limitations
- New Nexus Standard
- New Profit Allocation Rules

Scope Limitations

The Proposed Unified Approach will (potentially) apply to *any* consumer-facing business, defined as one involving interaction with final consumers of a product or service. It is not limited only to highly digitalized businesses.

More work needs to be done to define "consumer-facing businesses" and how the new rules would apply to supply chains involving intermediaries and franchises. In addition, the OECD will carry out further work on defining the scope, including, for example:

- A possible revenue threshold, to ensure so that only "large" businesses are covered (e.g. those with global revenues in excess of a stated threshold, e.g. €750 million)
- Carve-outs for particular types of business, such as the extractive industries and (possibly) financial services

New Nexus Standard

The Proposed Unified Approach would create a new test for taxable presence, separate from the existing concept of a permanent establishment.

The new nexus rule would apply in all cases where a business has a *sustained and significant involvement* in the economy of a market jurisdiction, irrespective of any physical presence there. Consumer interaction and engagement would be evidence of involvement in an economy, with significance triggered by exceeding a market-specific revenue threshold.

The detailed indicators, mechanisms, calculations and thresholds for this are yet to be determined.

New Profit Allocation Rules

New formulaic rules would allocate a portion of the profits of in-scope multinational entities to the countries where their customers are – i.e. market jurisdictions – regardless of whether the entity has a physical marketing or distribution presence in that jurisdiction.

Under this proposal, a share of the *deemed* above-normal profit of the business would be taxable in the market jurisdictions. The new rule would operate according to a three-tier profit allocation mechanism:

- **Amount A** – Using a set formula, a share of *deemed residual profit* (i.e. a new taxing right). Amount A is calculated in four steps:
  - **Step 1:** Determine the total relevant profit, as identified in the global consolidated group financial accounts (or business line calculations).
  - **Step 2:** Exclude *deemed routine profits*. The excess is the *deemed residual profit* of the business. Although there is currently no detail, the calculation is likely to involve the application of fixed profit margins considered normal in particular industries.
  - **Step 3:** Allocate a share of the *deemed residual profit* to the market jurisdiction(s). Again, no detailed mechanism has been set out, but this will involve the application of a simple set formula or percentage (i.e. not a detailed, case-by-case, analysis of specific circumstances).
  - **Step 4:** In a case involving multiple market jurisdictions, allocate the relevant share of the *deemed residual profit* among the various market jurisdictions, based on a set (so far unspecified) allocation key (e.g. in-country sales revenue).
- **Amount B** – The normal return on an assumed level of marketing activities and distribution functions taking place in a market jurisdiction. The proposal does not specify what the appropriate level of return on these functions would be. Coordination rules will be necessary to avoid double taxation in cases where a business has both Amount A and Amount B in a given country.
- **Amount C** – An additional amount (calculated using normal transfer pricing principles) reflecting any additional profit arising from in-country activities exceeding the "baseline" marketing and distribution activity (already allocated as Amount B). The aim is to ensure that market jurisdictions retain the entitlement to tax profits from all in-country activities.

Outstanding Issues

As illustrated already, a number of key issues remain outstanding. All of these issues fundamentally affect the design and implications of the Proposed Unified Approach. Each issue will have to be addressed, and political agreement reached, before the Proposed Unified Approach could become a consensus-based solution.

These issues include:

- Should the Proposed Unified Approach apply to global groups, business lines or regional business segments?
- How should losses be allocated?
- How should the location of sales be determined?
- Should different rules be applied to different business models based on the level of digitalization?
- How should key concepts be defined (e.g. "consumer-facing business", "marketing activities" and "sustained and significant involvement" in an economy)?
- In any given case, what are the appropriate thresholds, percentages, proportions and formulae, and should these be universal or adapted to particular businesses, sectors or jurisdictions?
- How should double taxation be prevented from arising as a result of introducing these new rules?
- How should the practical aspects of enforcement and collection, as well as dispute prevention and binding dispute resolution mechanisms, be addressed?
- How should an agreed unified approach be implemented simultaneously in all of the Inclusive Framework countries?

The Impact Assessment – Preliminary Findings

Based on the work done so far, the OECD unsurprisingly expects that the effect of the Proposed Unified Approach (especially when combined with the global minimum tax regime of Pillar Two) would result in both:

- A significant redistribution of taxing rights to market jurisdictions
- An increase in global business income tax revenues

Again unsurprisingly, the preliminary findings suggest Pillar One would most significantly affect MNEs operating in the digital and intangible-intensive sectors.

Countries with low and middle-income economies are expected to gain most (i.e. they will experience the highest rate of increase in revenues) from the Proposed Unified Approach under Pillar One. Even so, the OECD also currently expects high-income, large-market economies to benefit more in absolute terms. Jurisdictions hosting offshore financial and investment centres should expect to experience a significant loss of tax base because the new rules are likely to identify high levels of residual profit in such places.

Next Steps

The OECD is seeking comments on policy issues and technical aspects arising from the Proposed Unified Approach. Comments must be sent by email (to TFDE@oecd.org), in Word format, addressed to the Tax Policy and Statistics Division, Centre for Tax Policy and Administration, no later than Tuesday, November 12, 2019.

A public consultation meeting on the Proposed Unified Approach under Pillar One is scheduled for November 21-22, 2019. The Inclusive Framework will consider all comments received in developing a consensus solution to be included in its final report to the G20 in 2020.

A separate public consultation document on Pillar Two is expected to be published in early November 2019, with a consultation meeting in December 2019.

The next meeting of the G20/OECD Inclusive Framework will take place in January 2020.

Final Observations

The OECD's proposal appears to be an attempt to find a middle ground between the current international tax framework, which is based on separate-entity taxation using arm's length pricing rules, and global formulary apportionment of the profits of a multinational group, which is touted by some as a better approach. Like all compromises, the proposal runs the risk of failing to attract wholehearted support from anyone. Despite this, the OECD is hoping that the fear of uncoordinated unilateral tax measures proliferating in the absence of a multilateral agreement on new rules will lead the Inclusive Framework countries to agree to a compromise agreement.

Clearly, a lot more work remains to be done in order to fill in the gaps in the Proposed Unified Approach. The multinational business community has the opportunity, through the public consultation exercise and other means of engagement with policymakers, to help design new rules that are (at least) tolerable to the many different stakeholders.

We Can Help

We have a dedicated team of leading tax experts to help you with issues arising in the taxation of the digital economy. Jeff VanderWolk, who has extensive experience in private practice and government and agency work, leads our digital tax team. Most recently, Jeff was head of the Tax Treaty, Transfer Pricing and Financial Transactions Division at the Centre for Tax Policy at the OECD. He has also served as International Tax Counsel to the US Senate Committee on Finance and as a Special Counsel in the Office of the Chief Counsel at the Internal Revenue Service.

We can strategise and support your engagement with the OECD's Inclusive Framework on BEPS. We can help you understand the possible business and technical tax impacts of the proposals set out in the Proposed Unified Approach. We are also ready to assist with the implementation of strategies to ensure you are positioned to respond efficiently and effectively when change comes.

As a full-service global law firm, we are connected both locally and globally on the tax challenges arising from digitalization. We can provide unique insight at the point where law, business and government meet. We place our clients at the core of everything we do, giving them a voice, supporting their ambitions and achieving successful outcomes.

We look forward to engaging with you as your trusted adviser, as national and international tax law continue to evolve and respond to the digitalization of the economy.

Contacts

Jeff VanderWolk
Partner, Washington DC
T +1 202 457 6081
E jefferson.vanderwolk@squirepb.com

Robert O'Hare
Senior Tax Policy Advisor, London
T +44 20 7655 1157
E robert.ohare@squirepb.com