Tax Alert: OECD releases proposal for 'unified approach' under Pillar One for public comments

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Summary

The Organisation for Economic Cooperation and Development (OECD) has released a public consultation document proposing a new **'unified approach'** for digital economy taxation. The document proposes that nexus rule needs to be based on sales and not on the physical presence of an enterprise. It has however been clarified that the new rule would not only apply to highly digitalised businesses but also to consumer facing businesses, subject to certain carve-outs.

The document also proposes new profit allocation rules which goes beyond the traditional arm's length principle. The new profit allocation would be as follows:

- **Amount A** represents profit percentage of residual profit to the market or user jurisdictions
- **Amount B** is return allocation to routine marketing or distribution functions
- **Amount C** is allocating additional return to market jurisdictions beyond the baseline activity as per traditional arm's length principle

The OECD has sought public comments by **12 November 2019**

Introduction

- The OECD inclusive framework laid down a programme of work for developing a consensus-based solution on tax challenges arising from digital economy.
- The roadmap for digital economy taxation was based on following two broad pillars:

Pillar 1	Revised nexus and profit allocation rules
Pillar 2	Development of a global anti-base erosion proposal[1]

- With regards to Pillar 1, while the programme of work intended to explore three proposals (user participation, marketing intangibles, significant economic presence), it recognised that in order to reach a solution, an outline for a **"unified approach"** would need to be agreed upon.
- In this regard, the secretariat has now issued a public consultation document on the "unified approach".

Development of a new framework to be based on commonalities of the three approaches

The document highlights significant commonalities of the three proposals (user participation, marketing intangibles, significant economic presence) viz:

- All proposals would reallocate taxing rights in favour of the user/market jurisdiction
- All proposals envisage a new nexus rule that would not depend on physical presence in the user/market jurisdiction
- All proposals go beyond the arm's length principle and depart from the separate entity principle
- All proposals search for simplicity, stabilisation of the tax system, and increased tax certainty in implementation

[1] popularly known as 'GloBE', seeks to develop rules providing jurisdictions with a right to 'tax back' where other jurisdictions have not exercised their primary taxing rights or the payment is otherwise subject to low levels of effective taxation.

Scope of the proposals

The proposals are designed to ensure that multi-national enterprises (MNEs) conducting significant business without having a physical presence are appropriately taxed in such jurisdictions.

- Nexus rule
- Profit allocation rules

The proposals not only cover highly digital business models, but also focus on consumer-facing businesses subject to certain carve-outs.

New Nexus rule: to be based on sales and not on physical presence

- The rule proposes defining a revenue threshold in the market as the primary indicator of a sustained and significant involvement in that jurisdiction.
- The intention of setting up a revenue threshold is that it would not only create nexus for business models involving remote selling to consumers but would also apply to groups that sell in a market through a distributor.
- This rule would be introduced as a standalone rule to limit any unintended spill-over effect on other existing rules.

Profit allocation using a three tier mechanism to increase tax certainty

The document proposes creation of a new profit allocation rule[2]. This rule largely retains the current transfer pricing rules based on the arm's length principle for most routine transactions, but compliments them with the new rules for an appropriate level of business activity to achieve tax certainty for taxpayers and tax administrations. The rule consists of a three-tier profit allocation mechanism as follows:

Amount A

- A share of deemed residual profit[3] allocated to market jurisdictions using a formulaic approach, ie the new taxing right.
- This approach replicates features of both the residual profit split (RPS) method and the fractional apportionment method (by relying on formula-based calculations).
- The routine profits can be determined by a variety of approaches, including a simplified approach based on fixed percentages with variances by industry.

Amount B

- This represents a fixed remuneration for baseline marketing and distribution functions that take place in the market jurisdiction.

Amount C

- Any dispute between the market jurisdiction and the taxpayer over any element of the proposal should be subject to legally binding and effective dispute prevention and resolution mechanisms including any additional profit where in-country functions exceed the baseline activity compensated under Amount B.

[2] applicable to taxpayers within the scope, and irrespective of whether they have an in-country marketing or distribution presence (permanent establishment or separate subsidiary) or sell via unrelated distributors

[3] This deemed residual profit would be the profit that remains after allocating what would be regarded as a deemed routine profit on activities to the countries where the activities are performed.

Pending overarching questions

The secretariat noted that work on the following front is required to develop a unified approach:

- Challenges associated with the determination of the location of sales
- Definition of activities under Amount B or possible variations in the design of Amount A
- Possible use of business line or regional segmentation in profit attribution
- Analyse how domestic and treaty rules avoiding double taxation could operate under the 'unified approach'
- Manner of amending existing tax treaties since the proposal seeks to allocate taxing rights over a portion of a NRE's business profits in the absence of physical presence and computed other than in accordance with the arm's length principle. Changes to be implemented simultaneously by all jurisdictions
- Enforcement and collection of Amount A may be complex and exploring whether withholding tax is an appropriate mechanism
- Specific rules for treatment of losses under Amount A

Our comments

The proposal is a major step towards taxing digital businesses. The proposals would lead to a paradigm shift on transfer pricing approach as this is a move away from the arm's length principle which has governed transfer pricing concepts for so long.

It should be kept in mind that incorporating such a proposal would need consensus among member and non-member nations as the proposal plans to put formulae-based rewards/remuneration for the market role as well as for routine functions.

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