

## OECD heading beyond the arm's-length principle without ring-fencing the digital economy



On 9 October 2019, the OECD published a proposed unified approach to reform profit allocation rules (Pillar One of its working plan to address the tax challenges arising from the digitalisation of the digital economy). This proposal builds up on prior publications earlier this year.

It suggests to apply new rules for recognising a taxable nexus with market/user jurisdictions and allocating to them part of the profits of customer-facing businesses, based on a three-tier profit allocation mechanism. Unlike previous proposals, this publication comes from the OECD Secretariat and does not constitute consensus within the OECD Inclusive Framework (which has over 130 participating jurisdictions). Rather, it is intended to further the discussions within that forum, which had come to a standstill. The proposal contains a public consultation open until 12 November 2019, which will be followed by a consultation meeting in Paris on 21 and 22 November 2019.

### Background

Building up on the 2015 report on BEPS Action 1 and the political momentum in the EU and several national jurisdictions, the OECD has committed to deliver in 2020 a solution to the tax challenges arising from digitalisation. Further to the policy note of 29 January 2019 (see our tax flash [here](#)) and a consultation document of 13 February 2019 (see our tax flash [here](#)), the OECD published a programme of work on 31 May 2019 (see our tax flash [here](#)). This programme provides for two pillars: (i) a reform of profit allocation rules, articulated around three methods, and (ii) a global anti-base erosion proposal, which aims at achieving minimum taxation at global level.

### The Unified Approach proposal for Pillar One

The proposal acknowledges that the scope of the new rules should not be limited to highly digitalised businesses but also address any other consumer-facing businesses. This appears at first sight to cover a very wide range of businesses, although no specific definition of consumer-facing business is provided yet. The OECD also notes the need for further discussions on carve-outs for some sectors (such as extractive industries or commodities).

The unified approach proposal essentially suggests a three-tier profit allocation scheme – referred to as Amount A, Amount B and Amount C – which aim to address different situations:

- Amount A implies the creation of a new taxing right for the market jurisdiction over a portion of MNE groups' residual profit, by proposing new nexus and profit allocation rules.

The new nexus rules would depart from the existing permanent establishment concept, which depends on physical presence, and be based on the "sustained and significant involvement" in a market jurisdiction. The proposal suggests setting a revenue threshold (to be adapted to the size of the specific market) as a primary indicator for determining sustained and significant involvement.

Once the nexus is established, the allocation of profits would follow a 4-step approach: (i) identification of the MNE group's profits, possibly starting with the consolidated financial statements; (ii) a carve-out of the remuneration corresponding to routine activities based on an agreed level of profitability (possibly determined based on a fixed percentage and with variances by industries); (iii) split of the residual profit attributable to the market jurisdictions and the profits that refer to other factors (such as trade intangibles, capital and risk, etc.); and (iv) allocation of the relevant portion of (residual) non-routine profit to each jurisdiction, based on a previously agreed allocation key. The proposal does not define the relevant variables (only sales are mentioned), but they would aim to "approximate the appropriate profit due to the new taxing right".

- Amount B would consist in simplifying the allocation of profits for "baseline" or routine marketing and distribution activities in the market jurisdiction by establishing a fixed return (potentially varying between industries or regions). The proposal acknowledges that a definition of the specific activities that would qualify for this fixed return would be required.
- Amount C aims to adjust the profit allocation outcome that could be derived from Amount B. In particular, it allows taxpayers and tax administrations to argue that, under the arm's length principle, the remuneration of the activities performed in the jurisdiction (not only marketing and distribution activities but also other business activities) should be higher than the fixed return calculated under Amount B. However, profits corresponding to those activities should not overlap with profit allocated under Amount A. The proposal stresses the need for effective and binding dispute prevention and resolution mechanism to avoid double taxation.

## **Next steps**

The proposal acknowledges that there are several other issues that require further thinking, such as taking into possible differentiations among business models, possible variations in the design of Amount A, or the need to address any risk of double counting due to the interaction of Amounts A, B and C. It also recognizes the challenges surrounding the implementation of the unified approach and the need to amend tax treaties to allow for the creation of a new taxable nexus and the allocation of taxing rights on the profits of non-resident companies in the absence of physical presence and in deviation from the arm's length principle.

The proposal is now the subject of a public consultation open until 12 November 2019. A consultation meeting will then be held in Paris on 21 and 22 November 2019. The OECD intends to reach an agreement on the outlines of a unified approach by January 2020. In the meantime a proposal on Pillar Two is expected to be released early November 2019 with a public consultation to be held in December 2019.