OECD publishes proposal to rewrite international profit allocation rules

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In brief

On 9 October, the Secretariat of the Organisation for Economic Co-operation and Development (OECD) published *Secretariat Proposal for a "Unified Approach" under Pillar One* (the "Pillar 1 Unified Approach") that, if ultimately agreed, would fundamentally alter the international tax regime. The Pillar 1 Unified Approach represents an effort by the OECD to bring together three proposals for consideration by the 134 countries of the OECD Inclusive Framework under the OECD/G20 "tax challenges of the digitalisation of the economy" project. The proposal does not ringfence the so-called "digital economy" and instead seeks to allocate a greater share of taxing rights to the countries where consumers are located - regardless of a business' physical presence there.

Together with proposals expected later this year on a global minimum tax coupled with the denial of deductions on "insufficiently taxed" payments, this would represent the biggest change in the international tax regime since the 1920s, should the Inclusive Framework countries agree to the Secretariat's proposals. The proposal would impact a large number of "consumer facing" businesses; not just "tech" or online platform businesses.

In detail

The proposal

The Pillar 1 Unified Approach recommends a departure from the "arm's length principle" (ALP) in certain circumstances, allocating shares of "global" profits in addition to the existing transactional allocations required under the ALP. At the same time, it could simplify the ALP for some routine activities. In effect, the Pillar 1 Unified Approach would maintain the existing ALP but supplement it with two formulaic measures, one based on traditional ALP concepts and the other an entirely new approach to the allocation of global profits.

This is to be achieved through one new rule, and two modifications to the existing rules:

1. **Amount A** is a new formulaic allocation of a portion of deemed global residual profit (in excess of an agreed baseline and potentially based on financial statements and on a group or business line basis), among countries where customers are located, regardless of where the business's physical activities are located. No percentages are confirmed in the OECD consultation document, but it would apply equally to both profits and losses.

2. **Amount B** envisages creating a fixed percentage return that would be allocated to some "routine" functions (specifically, marketing and distribution), thus simplifying and standardising a distribution return to market countries.
3. **Amount C** would apply where the business' activities in a country are deemed greater than "routine" functions compensated by Amount B. In this case, a country could seek to assess additional amounts if warranted under traditional transfer pricing facts and circumstances tests, much like the existing transfer pricing system works today.

Dispute resolution mechanisms (i.e., mandatory binding arbitration or similar mechanisms) relating to the allocation of all three Amounts also form a key part of the proposals, and simultaneous implementation by countries is said to be crucial.

The changes are focused on "large consumer-facing" businesses. While this is not yet a defined term, it is noted to be most applicable to "digital centric businesses which interact remotely with users, who may or may not be their primary customers, and other consumer-facing businesses for which customer engagement and interaction can more easily be carried out from a remote location". It would also include those selling through unrelated distributors.

Local nexus thresholds would also be determined, which could be adapted to the size of the market and would require a new self-standing treaty provision (and although it is not discussed in the document, changes in domestic legislation would also be required in many countries). The simplest way to set the nexus threshold is said to be through revenue thresholds, but it would need to take into account scenarios where non-paying users are not located where revenues are booked (e.g., online advertising).

While extractive industry activities (for example) would be defined as out of scope, other sector specific carve-outs may apply (e.g., financial services, commodities, and, likely, some B2B situations). Open questions remain on how broad these carve-outs will be, what adjustments will need to be made to global profits, and whether (and how) different business lines within a group will be segmented, although the OECD is looking at financial accounting standards (including reporting requirements for different segments) as one option.

The proposals are expected to be complemented by additional proposals in November 2019 (with a public consultation in December 2019) for Global Anti-Base Eroding ("GloBE") rules intended to ensure minimum levels of effective tax are paid on all income (by granting headquarters' countries the right to levy additional taxes on investors) and by denying tax deductions and treaty benefits where the relevant income is not subject to minimum effective tax rates.

Consultation questions

In addition to general policy, technical, and administrability issues raised by the unified approach proposal, comments are specifically requested from stakeholders on many key elements:

- *Scope*: defining "consumer facing" businesses (and identifying appropriate carve-outs)
- *New nexus rule*: how to define and apply country specific sales; calibration for small economies
- *Amount A issues*: calculating group profits; determining deemed residual profits, allocation keys; eliminating double taxation issues
- *Amount B issues*: defining activities subject to a fixed return; how the formula should apply (e.g., single fixed percentage; fixed percentage variable by industry/region; other method)?
- *Amount C dispute resolution/prevention*: APAs, ICAP, and mandatory binding MAP arbitration

Next steps

Following a period to 12 November 2019 for stakeholders to provide written comments on the proposals, a public consultation meeting will take place in Paris on 21 and 22 November 2019. The OECD seeks political agreement among the members of the Inclusive Framework on the basic architecture of the proposed changes in January 2020 so that more detailed technical work on the mechanics can take place throughout 2020.

The takeaway

The proliferation of unilateral measures targeting interaction between “users” and businesses (e.g., Digital Services Taxes) has heightened the urgency among policymakers to reach agreement on fundamental multilateral reforms. There is a desire from many large countries (and a commitment from the G20) to reach agreement swiftly.

While the approach is described as unified, the process of reaching consensus remains in an early stage, and many key elements require further work. In particular defining with specificity what business activities are “consumer facing”, the profits attributable to them, and the rates of return deemed to be “routine” (for Amount B) and “excess” (for Amount A) remain significant policy decisions. Regarding nexus, the type of threshold (e.g., volume of sales) and the degree of local flexibility will need to be agreed in order to develop an appropriate new treaty article. Finally, how the proposals could be legally implemented (including dispute resolution mechanisms) is a critical workstream.

These proposals could result in greater certainty for taxpayers if they reduce the likelihood of disputes through a) dispute prevention caused by commonly agreed rules and b) robust dispute resolution mechanisms. However, the additional complexity of the new formulaic Amount A, and how it interacts with Amounts B and C, could increase the compliance burden, and if not applied uniformly it could give rise to additional dispute and double taxation risks. Reallocation percentages not grounded in an objective principle such as the ALP could be subject to constant pressure for change.

Taxpayers will want to analyse the potential impact on their businesses, and the outstanding challenges outlined above - in terms of the impact of both prospective tax liability and increased compliance and filing burden. Given the wide-ranging implications of this project, taxpayers will want to make their views known to the OECD and national governments as the project moves forward in an effort to achieve a stable and sustainable consensus agreement.

Let’s talk

For a deeper discussion of how these issues might affect your business, please call your usual PwC contact. If you don’t have one or would otherwise prefer to speak to one of our global specialists, please contact one of the people whose details are set out below.

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