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OECD publishes proposal on a “unified approach” to tax the digital economy

On 9 October 2019, the OECD published a proposal for a “unified approach” to the nexus and profit allocation challenges arising from the digital economy.

Background

The proposal combines elements of three competing proposals from several OECD member countries and reflects, according to the OECD, the common ground between these proposals. The OECD aims to reach consensus by 2020 for the “challenges arising from digitalization of the economy”; this to avoid the risk that more countries will take unilateral steps to tax digital companies. This would increase the risks of double taxation and might have negative consequences for the global tax system.

The unified approach aims to complement the arm’s-length principle with a formula-based solution for market jurisdictions and leave the existing transfer pricing rules in place. This would mean the proposal would be a second layer on top of the existing transfer pricing regime.

Scope

The approach covers Multinational Enterprises (“MNEs”) with highly digital business models, but goes wider, broadly focusing on consumer-facing businesses. Further work has to still be carried out on scope and carve-outs (e.g. group-revenue based thresholds are being considered and extractive industries are assumed to be out of the scope).

In principle, the approach would ensure that MNEs, conducting significant business in places where they do not have a physical presence, be taxed in such jurisdictions, through the creation of new rules stating:

- Where tax should be paid (“**new nexus**” **rules**), and
- On what portion of profits, they should be taxed (“**profit allocation**” rules).

<u>New nexus rules</u>

The new nexus does not depend on physical presence but is largely based on sales (through a related or third-party distributor). The new nexus could have thresholds, such as country specific sales thresholds, to ensure that jurisdictions with smaller economies can also benefit. It would be designed as a new self-standing treaty provision.

<u>Profit allocation rules</u>

With respect to profit allocation, the proposal recognizes that existing profit attribution rules work well for most routine transactions. As such the proposal recommends that current transfer pricing rules are retained but are complemented with formula-based solutions to allow for the taxation of business activities in more complex scenarios. The OECD therefore proposes the introduction of the following three-tier mechanism for allocating profit.

- **Amount A** – a share of deemed residual profits allocated to the market jurisdictions using a formulaic approach, i.e. new taxing rights;
- **Amount B** – a fixed remuneration for baseline marketing and distribution functions that take place in the market jurisdiction, and

- **Amount C** – binding and effective dispute prevention and resolution mechanisms relating to all parts of the proposal, including any extra profits where in-country functions exceed the baseline activity compensated under Amount B.

Following this mechanism, market jurisdictions would get greater taxing rights over residual profits based on the formulaic system, while the arm's-length principle continues to apply to routine profits.

Remarks

- The deemed residual profit used for Amount A would be the result of simplifying conventions agreed on a consensual basis. This means that it would only seek to approximate, without precisely quantifying, the amount of residual profit of an MNE group.
- Amount B has less of a link to the "digital economy" (more to a wider BEPS agenda), and is included with the intention to reduce disputes in the area of the remuneration for marketing & distribution functions.

Next steps

The OECD invites comments from the public, with a view to discussing the results during a public consultation on 20 & 21 November 2019. Interested parties are invited to send their comments ultimately by 12pm (CET) on Tuesday, 12 November 2019, using the email address TFDE@oecd.org.

The OECD targets to reach an agreement on the unified approach by January 2020. As mentioned above, this ambitious timeline is set to avoid the risk that countries will take unilateral steps to tax digital companies.

The Secretariat proposal for a unified approach under Pillar One

The proposal of the OECD can be accessed through the link below:

https://www.oecd.org/tax/beps/public-consultation-document-secretariat-proposal-unified-approach-pillar-one.pdf

Thereby, the OECD has held a webcast on 9 October, which focused on the proposed unified approach which can be accessed through the link below:

https://www.youtube.com/watch?time_continue=1&v=JmjKl2hHIy4