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OECD – REVISED NEXUS AND PROFIT ALLOCATION RULES (PILLAR ONE)

NOVEMBER 2019

Your global tax partner

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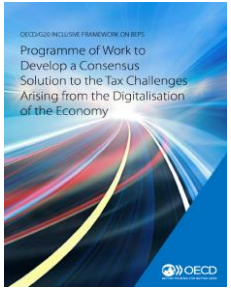
Reform proposals of OECD / G20 / Inclusive Framework

Previous Developments

2015

October:
BEPS Action 1
"Addressing the tax challenges of the digital economy"



2017

September - November:
OECD Call for:
input, commentaries & public consultation

2018

March:
OECD TFDE entitled:
"Tax Challenges Arising from Digitalisation – Interim Report 2018"

October:
Policy note on Tax and Digitalisation

2019

January:
OECD TFDE issued:
policy note (2 pillar approach)

February:
OECD issued:
a public consultation document seeking public comments

March:
OECD issued:
Policy brief on Tax and Digitalisation and Public Consultation

May:
Program of Work:
urgent need to agree on the outline architecture of a unified approach to taxation of digital economy

June:
Program of Work is approved by G20 leaders

October:
OECD Secretary issued:
high-level Proposal for a "Unified Approach" under Pillar One

October - November:
G20 Finance Ministers meeting to discuss proposed unified approach; Public Consultation under Pillar One; Release of Consultation document on Pillar Two

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Reform proposals of OECD / G20 / Inclusive Framework (1)

- In the Policy Note **Addressing the Tax Challenges of Digitalisation of the Economy**, approved on January 23, 2019, the Inclusive Framework agreed to examine and develop these proposals on a “without prejudice” basis.
  - **Pillar 1** focuses on the allocation of taxing rights (review of profit allocation and nexus rules).
  - **Pillar 2** focuses on the right to tax where other jurisdictions do not exercise taxation rights or tax “too low”.

Reform proposals of OECD / G20 / Inclusive Framework (2)

- **Public consultation meeting** at the OECD on March 13 and 14, 2019.
  - Dissatisfaction regarding taxing rights when there is no physical presence.
  - Risk that jurisdictions will adopt uncoordinated unilateral tax measures.
  - Dissatisfaction of many countries regarding lack of taxation rights without a physical presence.
  - Consideration of market presence for right to tax.

Reform proposals of OECD / G20 / Inclusive Framework (3)

- On May 28 and 29, 2019 the **Program of Work** to Develop a Consensus Solution to the Tax Challenges Arising from the Digitalisation of the Economy was approved by the OECD / G20 Inclusive Framework on BEPS.
  - Analysis of **possible solutions** for pillar 1 and pillar 2.

- On 9 October 2019 the OECD Secretariat published a second consultation document to present the current technical work to unify the three proposals that have been introduced beginning of the year under pillar 1
  - Comments can be provided until **12 November 2019** and another public consultation meeting on pillar 1 will be held in Paris on **21 and 22 November 2019**

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Reallocation of taxing rights – definition of a new nexus

Reallocation of taxing rights – definition of a new nexus (1)

- Development of a new concept of taxing rights **when there is no physical presence**.
  - New concept of taxable income source
  - No physical presence requirements

- Development of a new non-physical presence nexus rule to allow market jurisdictions to **tax market / customer-orientated profits**
  - Amendment of p.e. definition in Art. 5 OECD-MC?
  - Amendment of Art. 7 OECD-MC regarding profit allocation?
  - Definition of a new concept of income taxable in the source country?

Reallocation of taxing rights – definition of a new nexus (2)

- No reference to value creation as fundamental basis of definition of right to tax.
  - Existence of customer demand and buying power as argument for right to tax.
  - Justification by functions performed or risks assumed?

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New profit allocation rules - the OECD’s unified approach

New profit allocation rules (1)

- Concept:
  1. Allocation of taxing rights and profits to **jurisdiction of customer** and/or of user (“market jurisdiction”).
  2. Taxing right without a physical presence.
  3. New profit allocation rules based on the total profit of the business.

New profit allocation rules (2)

- **Three proposals** have been developed under **pillar 1** on how rights to tax income can be allocated among countries in the digital age. In the public **consultation document** published on **9 October 2019** the OECD Secretariat integrates the proposals in the so-called **unified approach**:
  1. The approach focuses on **highly digital business models** as well as on **consumer-facing businesses including user participation**
  2. The approach builds on existing transfer pricing principles and allocates so-called **non-routine profits (residual profit split)** according to a new methodology defined as Amount A, Amount B and Amount C
  3. The new methodology determines **profitability groupwide** thus ignoring the existence of separate entities

New profit allocation rules (3)

- **New Methodology**
  1. **Amount A** is the amount of profits that is allocated to countries where a MNE group has no physical presence;
  2. **Amount B** is a fixed remuneration for baseline marketing and distribution functions that take place in a market jurisdiction;
  3. **Amount C** is an adjustment of Amount B where a jurisdiction believes that the fixed remuneration is not compensating the performed in-country functions – Amount C is foreseen to be subject to binding and effective dispute prevention and resolution mechanisms

New profit allocation rules (4)

- **Application of unified approach**
  1. Determination of Amount A:
     - 4 steps:
       1. Determine the **total profit margin** of a MNE group (Z)
       2. Subtract a percentage that is considered routine profits (X) to achieve Y which is considered to represent **the non-routine profits** that is subject to the **residual profit split**
       3. Determine Y between the profits attributable to **market jurisdictions** (assumed here to be W%) and the profits attributable to other factors such as **trade intangibles** (assumed here to be V%).
       4. In a final step the deemed non-routine profit (W%) is allocated among the eligible market jurisdictions.

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New profit allocation rules (5)

- **Application of unified approach**
  2. Determination of Amount B:
     - Amount B seeks to establish a fixed return (or fixed returns, varying by industry or region) for certain “baseline” or routine marketing and distribution activities taking place in a market jurisdiction.
     - The fixed return under Amount B would seek to reduce disputes in this area, where tensions are important as a result of applying transfer pricing rules.
     - The intention would be to benefit taxpayers and tax administrations, as it would reduce the risk of double taxation as well as the substantial compliance costs arising from the aggressive enforcement of current transfer pricing rules.
     - Amount B could be (1) a single fixed percentage; (2) a fixed percentage that varied by industry and/or region; or (3) some other agreed method

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New profit allocation rules (6)

- **Application of unified approach**
  3. Determination of Amount C:
     - Amount C retains the ability of tax administrations and taxpayers to argue that the marketing and distribution activities taking place in the market jurisdiction go beyond the baseline level of functionality and therefore warrant a profit in excess of the fixed return contemplated under Amount B
     - An additional profit – Amount C – would be due where this is supported by the application of the arm's length principle
     - The introduction of Amount C would require robust measures to resolve disputes and prevent double taxation including mandatory and effective dispute prevention and resolution mechanisms to ensure the elimination of protracted disputes and double taxation.

For discussion - Pending key questions

- **To be addressed:**
  - Scope
    - What is consumer facing?
    - Carve-outs?
    - Thresholds?
  - Determination of group wide profits
  - Determination of business lines
  - Elimination of double taxation
  - Enforcement and tax collection

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Next Steps

2019

2020

21-22 November:
Public Consultation under Pillar One

December:
Public Consultation under Pillar Two

Begin of 2020:
Blueprint agreement ready for approval by meeting of OECD Inclusive Framework

November 2020:
OECD releases Final Report:
Final solution on Pillar 1 and 2 ready for G20 meeting in Riyadh

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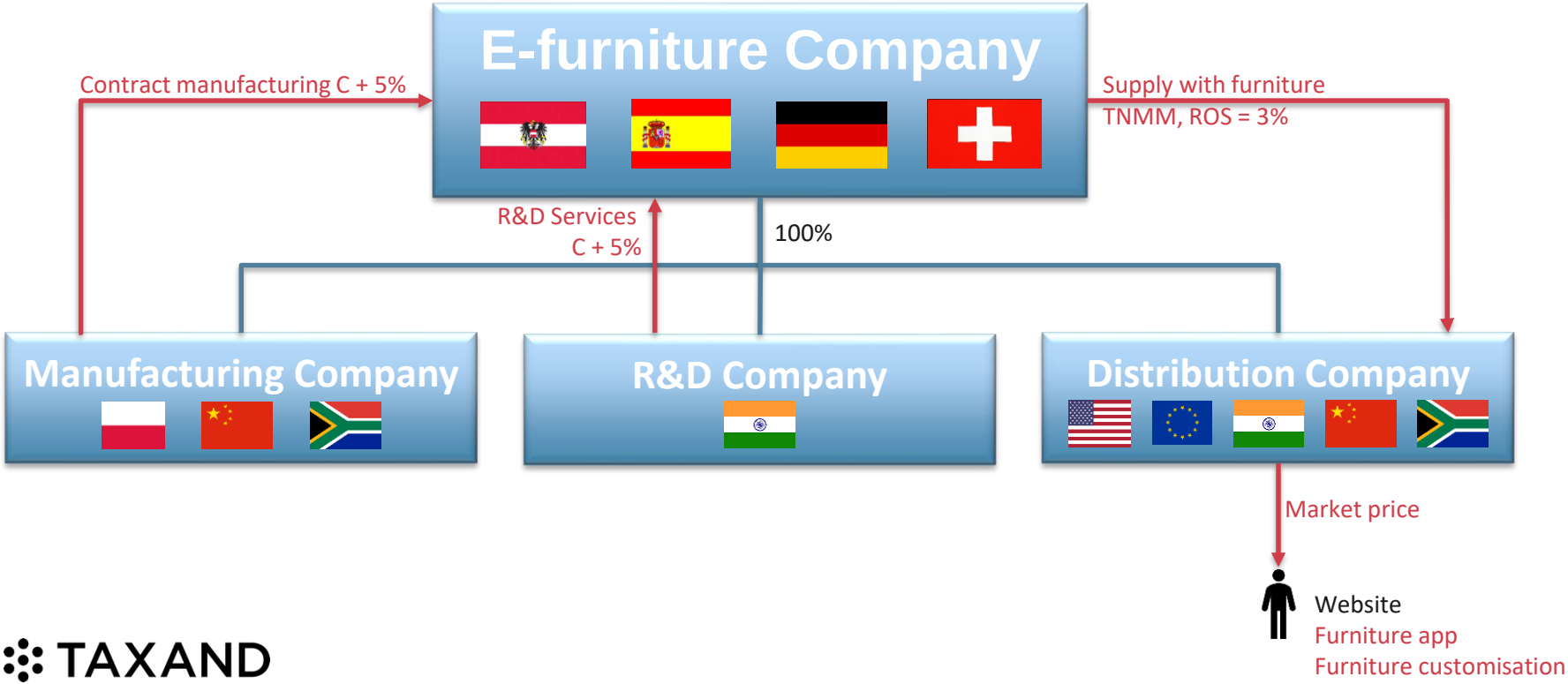
New profit allocation rules – case study



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For discussion

- Is the discussion / implementation of the new profit allocation rules the end of the arm's length principle?
- Is the profit split approach accepted in your country?
- Will the jurisdictions with the manufacturing and R&D functions accept the new rules?
- What does the new approach mean for E-furniture Company's tax return?
- Are the measures to avoid international double taxation sufficient?