

## OECD Proposal May Increase Multinationals' Worldwide Tax

By **Michael Kummer and Drew Cummings** (October 25, 2019, 1:17 PM EDT)

The Organization for Economic Cooperation and Development recently proposed that consumer-facing businesses that make nonroutine profits would be taxed in market jurisdictions where consumers are located, regardless of where intangibles are owned or key functions are performed.

This so-called unified approach to pricing controlled cross-border transactions attempts to create a single framework from its many past recommendations in an effort to prevent more countries from implementing unilateral — and conflicting — taxing regimes.

The arm's-length standard has been the international norm for pricing controlled transactions for nearly a century.

On Oct. 9, the Organization for Economic Cooperation and Development Secretariat proposed to (1) eliminate the arm's-length standard for certain companies that derive value from consumers in market jurisdictions, (2) create new nexus rules that do not require physical presence in a particular jurisdiction, and (3) depart from the well-established separate-entity principle — together, called the unified approach.

The unified approach attempts to create a single framework from multiple recommendations the OECD has proposed to date so as to prevent more countries from implementing unilateral (and discordant) taxing regimes.

The unified approach is “focused on large consumer-facing businesses.” For those businesses — which the unified approach does not define with specificity — the proposal would generally allocate more profits to market jurisdictions where companies have significant economic activity, regardless of any physical presence.

The proposal reflects several significant changes from current rules, which focus on jurisdictions where intangibles are owned and key functions are performed. Under the proposal, consumer-facing businesses that make nonroutine profits would be taxed in market jurisdictions where consumers are located, regardless of where the intangibles are owned or where key functions are performed.



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However, these proposed rules are an overlay on the current permanent establishment rules. Thus, any company with a permanent establishment in a jurisdiction will continue to have nexus with that jurisdiction. Routine profits would continue to be allocated based on traditional transfer pricing rules.

While proposing significant changes, the unified approach only outlines a high-level framework for future discussion.

But there is some urgency: The OECD is pushing for a consensus among member states by the end of 2020. To that end, the OECD is seeking comments from the public by Nov. 12. These comments — something any multinational with consumer-facing operations should consider submitting — will inform a more detailed framework to be released in January 2020.

### **BEPS and the Inclusive Framework**

The OECD's recent proposal has been years in the making. Beginning in 2013, the OECD and G20 countries have been working to close gaps in international tax rules that allowed for perceived opportunities for base erosion and profit shifting, or BEPS.

A major focus of the OECD's efforts is the tax challenges presented by the digital economy.[1] Much of this work relates to the question of how taxing rights on income generated from cross-border activities in the digital age should be allocated among countries.

Over the last few years, the OECD developed two pillars to address this question.[2] Pillar One — to which the unified approach relates — focuses on existing profit allocation and nexus rules.

Pillar Two, or the global minimum tax rule, provides for income inclusion rules (taxing income that was subject to a low effective tax rate) and a tax on base-eroding payments (denying deductions or treaty relief for certain payments unless a payment was subject to a certain minimum rate).[3]

With respect to Pillar One, one of the key issues in the digital tax debate is the ability of digital businesses to solicit substantial contributions from a jurisdiction's residents (enabling them to generate substantial value) without current rules giving that jurisdiction the right to tax the business's income.

The OECD developed the following three proposals to address this issue, each of which proposes to enlarge current nexus rules to include a "remote" presence test that does not require a permanent establishment to establish nexus.

#### **User Participation Proposal**

- This proposal would apply to highly digitized businesses, such as social media platforms, search engines and online marketplaces.
- It would modify current profit allocation rules to require that an amount of profit be allocated to market jurisdictions, irrespective of whether those businesses have a physical presence there.
- This proposal would allocate profit based on a nonroutine or residual profit split approach.

#### **Marketing Intangibles Proposal**

- This proposal is similar to the user participation proposal but is not limited to highly digitized businesses.
- It would apply to companies that use marketing intangibles — such as trademarks, trade names, brand names, and customer lists and data — in a market jurisdiction.
- The proposal would require that the nonroutine or residual income of the company attributable to marketing intangibles be allocated to the market jurisdiction, even in the absence of a physical presence there.

### **Significant Economic Presence Proposal**

- This proposal would create a taxable presence based on significant economic presence, using factors such as size of user base, volume of market-specific digital content and sustained marketing and sales promotion activities to attract customers.
- It would allocate profit based on a fractional apportionment method, apportioned using factors such as sales, assets and employees.

### **Unified Approach**

The unified approach creates a “possible new approach based on the commonalities between the three proposals.” Notably, however, the unified approach focuses on consumer-facing businesses (instead of focusing exclusively on highly digitalized businesses), e.g., “businesses that generate revenue from supplying consumer products or providing digital services that have a consumer-facing element.”

The unified approach notes that certain sectors (such as extractive industries and commodities) should be carved out, but does not specify with certainty which will be.

For businesses within its proposed scope, the unified approach creates new nexus rules that are not dependent on physical presence. Nexus would be largely based on sales, with potential sales thresholds “calibrated to ensure that jurisdictions with smaller economies” can still benefit.

The unified approach also proposes new profit allocation rules “going beyond” the arm’s-length principle that apply regardless of any physical presence in the market jurisdiction.

Because absent a physical presence it may be impossible to use existing transfer-pricing rules to allocate profit to this new nexus (because a company may not perform any functions, have any assets, or assume any risks in the market jurisdiction), the unified approach creates a new profit allocation rule.

The profit-allocation rule envisions three tiers.

The first tier, called “Amount A,” would be a share of deemed residual profits allocated to the market jurisdiction using a formulaic approach that (potentially) would be based on sales. The residual profits would exclude routine profits based on transfer-pricing rules or potentially using a fixed percentage.

The second tier, called “Amount B,” would remain taxable under existing rules, and would require remuneration for baseline marketing and distribution functions that take place in the market jurisdiction.

The third tier, called "Amount C," would include any additional profits where market jurisdiction functions exceed the baseline activity compensated under Amount B. The proposal would also create a binding dispute resolution mechanism relating to all elements of the proposal.

### **Outstanding Issues**

At this time, the unified approach is only a high-level framework proposed by the secretariat. Many of the key details have not yet been proposed or agreed to. Some of these outstanding issues include the following.

#### ***Which companies are covered?***

The unified approach is intended to focus on large consumer-facing businesses; in other words, businesses that generate revenue from supplying consumers with products or providing digital services that have a consumer-facing element. Some sectors (such as extractive industries, finance, and commodities) may be excluded.

The proposal also questions whether a size limitation should be implemented, such as a €750 million (approximately \$834 million) annual revenue threshold.

#### ***How are routine versus nonroutine profits determined?***

The unified approach would retain the current rules based on the arm's-length principle where the rules are "working as intended," such as outside of calculating "Amount A." But, when calculating "Amount A," there may be line-drawing challenges in determining which transactions or functions should be valued as routine and how much routine profit should be allocated to those transactions or functions.

Because routine profits are excluded from "Amount A," companies or nonmarket jurisdiction countries may argue for a higher or lower routine return based on the facts. To avoid this line drawing, the proposal indicates that a simplifying convention may be used to determine routine profits to calculate "Amount A."

These simplifying conventions could take a variety of approaches, but would likely include fixed percentages with possible variances by industry. Depending on whether the "simplifying" conventions are tied to comparability considerations, the proposed rules could potentially fairly mimic the arm's-length standard in many instances.

#### ***How are trade intangibles versus marketing intangibles determined?***

As part of calculating the residual profits for "Amount A," the starting point is identifying a company's total profits and then excluding routine profits.

After isolating residual or nonroutine profits, it would be necessary under the proposal to determine the "split of those deemed nonroutine profits between the portion that is attributable to the market jurisdiction and the portion that is attributable to other factors such as trade intangibles, capital and risk, etc."

This line drawing could potentially increase the level of double taxation that might occur because

countries may allocate the same income based on different views of the value drivers of a company between trade versus marketing intangibles. For example, the proposal explains that a social media company may generate residual profits from its customers' data and its well-known name, but also from its innovative algorithms and software.

To avoid this problem, the proposed approach may deem a portion of the residual profits attributable to the market jurisdiction. It will be important to see if the percentage is fixed (or if a range is provided based on facts and circumstances), or even if a taxpayer can overcome the "deemed" portion based on the facts.

The proposal explains that different percentages might be applied to different industries or business lines, and that without a global consensus, different countries may wish to apply different percentages.

### ***How are losses treated?***

The proposed rules may also apply to losses. But it is unclear at the moment how those losses will be allocated. For example, if losses are only allocated to jurisdictions with key functions, then market jurisdictions may be allocated an inappropriate amount of income in the future (without an offsetting amount of losses).

Thus, the proposal notes that specific rules may need to be considered for losses, especially under Amount A, such as a claw-back or an "earn out" mechanism.

### ***How will the dispute resolution methods work?***

It may be difficult to avoid double taxation if multiple jurisdictions will be attempting to tax the same income under the unified approach. But it remains to be seen if the OECD will propose efficient mechanisms to resolve double-taxation disputes, such as mandatory binding arbitration.

This will be extremely important for businesses that operate in a large number of countries and where multiple jurisdictions are attempting to tax the same income. Indeed, there would be no need for a uniform set of dispute resolution procedures if there were not a real risk of double taxation.

Potentially more important, even if the dispute resolution method is designed flawlessly, it puts substantial pressure on executing the procedures quickly and efficiently. In turn, this implicates which entity or entities will be conducting the resolution, and who will have a seat at the resolution table.

As it stands, the competent authority network may well be overburdened already, even before the original BEPS action items are fully implemented. Thus, it may be impracticable for the competent authorities to also have to hear disputes from the unified approach.

### ***What will become of the arm's-length standard?***

Perhaps more importantly, moving away from the arm's-length principle, which has been the backbone of international tax for nearly a century, may well lead to more uncertainty for multinational companies and result in more double taxation.

Instead of core principles that have (or had) near universal consensus, the unified approach moves to simplifying conventions. But these conventions are only effective if there is universal agreement on them.

Any differences between countries may result in double taxation because instead of universally applying the arm's-length principle, countries may well be applying different thresholds and percentages.

## **Conclusion**

The unified approach proposes several drastic changes to existing international tax regimes — including a shift away from the arm's-length standard that may portend more substantial changes in the future. And, while not free from detractors, the proposal is gathering steam.

Any multinational, consumer-facing business should follow the unified approach and consider submitting comments in response to the overall framework and some of the specific questions raised above. Comments are due to the OECD by Nov. 12.

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[1] OECD/G20 Base Erosion and Profit Shifting Project, Addressing the Tax Challenges of the Digital Economy, Action 1, 2015 Final Report. Action 1 rejected “a new nexus in the form of a significant economy presence,” which would have allowed “countries to impose a tax in situations where a foreign enterprise derives considerable sales income from the country without a physical presence therein.”

[2] See Addressing the Tax Challenges of the Digitalisation of the Economy; Programme of Work to Develop a Consensus Solution to the Tax Challenges Arising from the Digitalisation of the Economy, Inclusive Framework of BEPS. See also Tax Challenges Arising from Digitalisation, Interim Report 2018.

[3] While the Unified Approach only addresses Pillar One, Pillar Two is expected to be addressed in a separate document later this year.