



## **OECD releases program to develop consensus solution to tax challenges arising from digital economy**

### **Global Transfer Pricing Alert 2019-018**

The Organisation for Economic Co-operation and Development (OECD), now working as the expanded OECD/G20 Inclusive Framework on Base Erosion and Profit Shifting (BEPS), released on May 31 a [program of work](#)<sup>1</sup> that, if it reaches fruition and is implemented by member nations, would fundamentally alter the longstanding rules that govern the international taxation of all large multinational entities (MNEs), not just those that might consider themselves “digital companies.”

The program of work calls for “a solution to be delivered in 2020,” a time frame the 129-member Inclusive Framework acknowledges is “extremely ambitious,” and would require “the outlines of the architecture” to be agreed to by January 2020.

The program of work, like the [policy note](#) released on January 29, 2019, and [the public consultation document](#) released February 13, 2019, describes a two-pillar approach that could form the basis for consensus. Pillar 1 is focused on revising the rules for allocating income to market jurisdictions and moving beyond the arm’s length standard, as well as the related nexus/permanent establishment (PE) rules that would broaden the circumstances in which an MNE’s contacts with a country would grant that country income taxing rights. Pillar 2 focuses on establishing a global minimum tax along with a backstop regime that would deny

<sup>1</sup> “Programme of Work to Develop a Consensus Solution to the Tax Challenges Arising from the Digitalisation of the Economy.”

deductions or impose withholding in cases of certain payments to low-tax jurisdictions. (For prior coverage of the policy note, see the February 2019 issue of [The Arm's Length Standard](#).)

## **Pillar 1: Revised nexus and profit allocation rules**

The public consultation document released in February articulated three proposals: a user participation proposal, a marketing intangibles proposal, and a significant economic presence proposal. Using different methods, each proposal allocated more taxing rights to the customer's and/or user's jurisdiction (the market jurisdiction). In addition, all three proposals contemplated the existence of a tax nexus without physical presence, contemplated using the total profits of a business (not just the profits of the group's entities in a jurisdiction), considered the use of simplifying conventions (including those that diverge from the arm's length principle), and would operate alongside the current profit allocation rules.

The program of work released on May 31 explains that it would explore options and issues relating to a modified residual profit split (MRPS) method, a fractional apportionment method, and distribution-based approaches. Specifically, detailed design considerations will look at the use of a residual profit split approach (either on a global or business line/regional basis) alongside existing transfer pricing rules, or the use of formulae or "fractional apportionment" by reference to metrics such as sales, employees, assets, or users. A newly proposed approach considers a base level of return for distribution activities in market countries. For each of these, the program highlights the significance of the technical work that needs to be completed. Key areas will include when a country has the right to tax trading profits and the rules for allocating trading profits to each country. A particular focus is on ensuring enough profit is awarded to the "market" jurisdiction, whether the country of users or sales. The program of work sets forth a goal of settling on one of these approaches by the end of 2019, and the members of the Inclusive Framework have committed to deliver a final report by 2020.

### *Modified residual profit split (MRPS) method*

The MRPS method is similar to the marketing intangibles proposal set forth in the February consultation draft and is widely understood to be the US's counter to narrower proposals that were aimed solely at digital businesses. This MRPS approach would allocate to market jurisdictions a portion of an MNE group's non-routine profit that reflects the value created in those markets that is not recognized under the existing profit allocation rules.

The MRPS method involves four steps: (i) determining total profit to be split; (ii) removing routine profit, using either current transfer pricing rules or simplified conventions; (iii) determining the portion of the non-routine profit that is within the scope of the new taxing right, using either current transfer pricing rules or simplified conventions; and (iv) allocating such in-scope non-routine profit to the relevant

market jurisdictions, using an allocation key such as revenues.

The use of simplified approaches under this proposal would include consideration of possible proxies – such as capitalized expenditures, projections of future income, or fixed percentages of total non-routine income – to determine non-routine profit. Furthermore, the MRPS method would coexist with the existing transfer pricing rules for purposes of determining non-market related returns. The Inclusive Framework recognizes that rules for coordinating these two sets of rules would be necessary to provide certainty, minimize disputes, and ensure the avoidance of double taxation.

#### *Fractional apportionment method*

The fractional apportionment method would tax MNE groups without making any distinction between routine and non-routine profit. This method would involve three steps: (i) determining the profit to be divided, (ii) selecting an allocation key, and (iii) applying this formula to allocate a fraction of the profit to the market jurisdiction(s). Under this method, one possible approach would be to take into account the overall profitability of the relevant group or business line.

In exploring this method, the Inclusive Framework will examine a number of issues, including how to determine the starting point for computing the relevant profits. The options may include looking at the profit of the selling entity as determined by the current transfer pricing rules or by applying a global profit margin to local sales. Under this approach, the Inclusive Framework will also examine what allocation keys to use, including employees, assets, sales, and users.

#### *Distribution-based approaches*

In addition to the two methods described above, the Inclusive Framework will also explore other simplified methods. Such an approach might address, in addition to non-routine profit, profit arising from routine activities associated with marketing and distribution.

One possibility would be to specify a baseline profit in the market jurisdiction for marketing, distribution, and user-related activities. Other options might also be considered, such as increasing the baseline profit based on the MNE group's overall profitability. Through this mechanism, some of the MNE group's non-routine profit would be reallocated to market jurisdictions.

In scenarios involving a remote activity, the Inclusive Framework will explore the question whether the amount of profit (including any baseline profit) taxable by that market jurisdiction would be the same as for locally based marketing and distribution activities, or whether that amount should be reduced in some formulaic manner.

In connection with distribution-based approaches, the program of work states that further consideration would

need to be given to issues such as whether such an approach would result in a “final allocation” – one that neither taxpayers nor tax authorities would be able to reevaluate under current transfer pricing rules – and whether the baseline profitability would function as a minimum or a maximum profit in the relevant jurisdiction.

#### *Other technical issues*

In exploring these three methods, the Inclusive Framework will also examine other technical issues, such as:

- The possibility of determining the profits subject to the new taxing right on a business line and/or regional basis.
- Scope limitations that apply either by reference to the nature of a given business (e.g., through safe harbors) or its size (e.g., thresholds based on revenue or other relevant factors). Although not specifically stated in the program of work, the reference to scope limitations has the potential for certain industries (e.g., financial services, extractive industries in developing countries), and smaller MNEs to seek exemption from the Pillar 1 approach.
- Application of the new allocation rules to both profits and losses.

#### *New nexus rules*

As part of this process, the Inclusive Framework will explore ways to revise the nexus rules to render the new profit allocation rules applicable in a far broader context than the current nexus/PE rules. The new rules will likely involve having a remote taxable presence even without a traditional physical presence and a new set of standards for identifying when a remote taxable presence exists.

The approaches considered to implement new nexus rules include the following:

- Amendments to the definition of a PE in Article 5 (Permanent Establishment) of the OECD Model Convention, along with potential changes to Article 7 (Business Profits) of the convention.
- Potential changes to Article 9 (Associated Enterprises) of the convention to allow market jurisdictions to exercise taxing rights over the measures of profits allocated to them under the new nexus and profit allocation rules.

### **Pillar 2: Income inclusion rule and tax on base-eroding payments**

Under Pillar 2, the members of the Inclusive Framework have agreed to explore an approach that considers the right of other jurisdictions to apply rules in cases where income is taxed at an effective rate below a minimum rate. The program of work makes no reference to what the minimum rate might be, but suggests that a single, agreed-upon rate would be preferable to either a rate set as a percentage of the rate in the MNE parent’s residence country or a band of rates that countries could choose from. As discussed below,

the program of work explores an inclusion rule, a switch-over rule, an undertaxed payment rule, and a subject-to-tax rule. These rules are discussed under the global anti-base erosion (GLoBE) proposal and through taxes on base-eroding payments.

### *Global anti-base erosion (GLoBE) proposal*

The GloBE proposal seeks to address the remaining BEPS challenges through the development of two interrelated rules:

- An income inclusion rule that would tax the income of a foreign branch or a controlled entity if that income was subject to tax in the recipient's jurisdiction at an effective rate below a minimum rate; and
- A tax on certain base-eroding payments not subject to tax at or above a minimum rate in the recipient's jurisdiction, which would operate by way of a denial of a deduction or imposition of source-based taxation (including withholding tax), together with any necessary changes to double tax treaties.

These rules would be implemented by way of changes to domestic law and double tax treaties. They would also incorporate a coordination or ordering rule to avoid the risk of economic double taxation.

The income inclusion rule would operate as a minimum tax by requiring a shareholder in a corporation to bring into account a proportionate share of the income of that corporation if that income was not subject to an effective tax rate above a minimum rate. Income taxed below the minimum rate but in connection with a harmful tax regime would nonetheless be taxed in the parent country at full rates. This rule could supplement a jurisdiction's controlled foreign corporation (CFC) rules. The Inclusive Framework would explore, among other options, an inclusion rule that would impose a minimum tax rate and an approach using a fixed percentage of the parent jurisdiction's corporate income tax (CIT) rate or corridor of CIT rates. Various carve-outs might be provided, such as a return on tangible assets. There is a need to ensure that the income inclusion rule applies to foreign branches as well as foreign subsidiaries. For example, in the case of profits attributable to exempt foreign branches, or that are derived from exempt foreign immovable property, the income inclusion rule could be achieved through a switch-over rule that would turn off the benefit of an exemption for income of a branch in exchange for a foreign tax credit regime.

### *Tax on base-eroding payments*

The second key element of the proposal is a tax on base-eroding payments that complements the income inclusion rule. This element of the proposal would explore:

- An undertaxed payments rule, which would deny a deduction or impose source-based taxation (including withholding tax) for a payment to a related party if that payment was not subject to tax at a minimum rate.

- A subject-to-tax rule in tax treaties, which would grant certain treaty benefits only if the item of income was subject to tax at a minimum rate.

The subject-to-tax rule could complement the undertaxed payment rule by subjecting a payment to withholding or other taxes at their source and denying treaty benefits on certain items of income when the payment is not subject to tax at a minimum rate. This rule contemplates possible modifications to the scope or operations of various treaty benefits, with priority given to interest and royalties.

### **Other topics covered**

The program of work covers a variety of other important topics, including administrative issues and the elimination of double taxation in connection with Pillar 1. It also includes a separate chapter on the need to analyze the proposals' "interlinkages with a particular focus on the importance of assessing the revenue, economic and behavioral implications of the proposals in order to inform the Inclusive Framework in its decision making."

#### *Elimination of double taxation*

The program of work observes that the work under Pillar 1, depending on the design options ultimately agreed to, "envisage[s] reallocating taxing rights over a proportion of an MNE's **group's** profit (however defined), rather than over the profit from **specific transactions or activities undertaken by specific entities**. It may therefore not be immediately clear which member(s) of an MNE group should be considered to derive the relevant income. This leads to questions about how, in practice, source jurisdictions would exercise the reallocated taxing rights, and how residence jurisdictions would provide relief from double taxation of the relevant income." (Emphasis added)

The program of work will consider these questions, including the effectiveness of the existing treaty and domestic law provisions and the need to develop new or enhanced provisions. It notes that consideration would also be given to a multilateral competent authority mutual agreement procedure or similar frameworks that would provide additional guidance. The program of work explains that the current dispute prevention and resolution procedures will be examined in the context of the new nexus and profit allocation rules, and when necessary the Inclusive Framework will make recommendations for changes or enhancements, including arbitration procedures, multilateral competent authority agreements, etc.

Notably, there is no more detail on how double taxation would be eliminated or how such a goal would be measured, nor is there any reference to mandatory binding arbitration as part of a minimum standard to which countries enjoying the benefits of a new approach would be required to adhere.

#### *Administration*

With respect to administering the provisions of Pillar 1, the program of work notes the need to identify the taxpayer that

bears tax liability in a jurisdiction, and its filing obligations, particularly in cases in which the liability is assigned to an entity that is not a resident of the taxing jurisdiction. It indicates that one option could be to design “simplified registration-based collection mechanisms,” along with enhanced exchange of information mechanisms, but considers that “a withholding tax mechanism will also be explored . . . where it does not lead to double taxation.” The program of work acknowledges that the application of any of the Pillar 1 approaches would likely require a number of data points to be available to tax administrations as well as the MNE group, which “would likely result in the need for new data, documentation and reporting obligations” such that “[t]he work program will develop recommendations for a system to report and disseminate information needed to administer the new taxing right.”

### *Economic analysis and impact assessment*

The program of work acknowledges the need to perform “an in-depth consideration of how [the proposals] would be expected to affect the incentives faced by taxpayers and governments, their impact on the levels and distribution of tax revenues and their overall economic effects, including their effects on investment, innovation and growth. The impact assessment will also need to consider how these effects vary across different kinds of MNEs, sectors and economies” and acknowledges that new empirical research will need to be undertaken. The economic analysis is expected to be carried out throughout the entire period of the program of work, with a goal of delivering additional information to members of the Inclusive Framework by the end of 2019, so that they can agree upon an overall “outline of the architecture” by January 2020.

### **Next steps**

The program of work will be presented for approval by G20 finance ministers during their meeting on June 8-9, 2019 in Fukuoka, Japan. OECD Working Parties will meet throughout the remainder of 2019 to consider the relevant technical issues and a report on the progress of work is expected in December 2019. Consideration will be given to holding further public consultations to gather business feedback as the various proposals are refined.

A recommendation for a unified approach on nexus and profit allocation and the key design elements of the global minimum tax will be submitted to the BEPS Inclusive Framework for agreement at the beginning of 2020. Work will continue to reach agreement on the policy and technical details, with a final report due by the end of 2020.

### **Observations**

The program of work acknowledges that the timeline to a final report by the end of 2020 is “extremely ambitious.” As should be clear from the above description of the work, it involves myriad challenging technical and political issues.

Consider, for example, the program of work’s suggestion with respect to Pillar 1 that increasing taxing right to

markets would need to be matched by reductions in taxing rights in other jurisdictions to avoid double taxation – all potentially done at the global MNE level, as opposed to the legal entity level.

Consider, too, the suggestion that in order to take into account losses as well as profits under Pillar 1 it may be necessary to have an MNE group develop a “notional cumulative loss account,” which, if done on a product line and/or regional basis, would raise a host of difficult issues, including the impact of mergers, acquisitions, dispositions, expense allocation, discontinuation of product lines, etc. Political issues relate largely to consideration of which countries will be impacted favorably or unfavorably in a global reallocation of taxing rights under Pillar 1. For example, countries that incentivize research and development through their tax laws may not be eager or willing to give up taxing rights when that R&D produces income for the entities in their jurisdictions under current rules.

As another example, developing countries – now an important bloc within the Inclusive Framework – with relatively small markets but large exporting extractive sectors may be unfavorably impacted as a result of such fundamental changes. Notwithstanding these challenges, leaders of the effort at the OECD and in the US Treasury express guarded optimism that these challenges can be met in light of what is widely perceived as the unacceptable alternative of growing uncertainty.

While the document contains ample references to simplicity, administrability, dispute resolution, and avoidance of double taxation, there is little detail on how these objectives might be met. The program of work explains that one of the drivers behind these efforts is the desire to avoid a “proliferation of uncoordinated and unilateral actions” by countries that would result from the failure to reach a global consensus on a new approach. In the event a consensus-based approach cannot be reached by the end of 2020, or if implementation requires additional time, companies may continue to face such uncoordinated, unilateral approaches and may wish to take this into account in their planning. Indeed, the program of work makes no reference to countries’ willingness to repeal any such actions already taken, such as so-called digital service taxes, if this effort achieves its goals.

The program of work explains that consideration will be given to the holding of public consultations as necessary to obtain stakeholder feedback as the various proposals are refined, and companies may want to consider how to continue to engage with the process as it unfolds.

The work program is ambitious in scope and timing and has the potential to upend long-standing principles of MNE taxation. Thus, close monitoring of developments is critical, as will be modeling of the potential changes as a final framework begins to come into focus.



## Contacts

**Bob Stack (Washington DC)**

[bstack@deloitte.com](mailto:bstack@deloitte.com)

**Keith Reams (Washington DC)**

[kreams@deloitte.com](mailto:kreams@deloitte.com)

**David Lenter (Washington DC)**

[dlenter@deloitte.com](mailto:dlenter@deloitte.com)

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