Insights on OECD's revised "Unified Approach" to tax challenges of digitalisation

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The Organisation for Economic Cooperation and Development (OECD) on 31 January 2020 issued a statement (the Statement) by the OECD/G20 Inclusive Framework on BEPS, reaffirming its commitment to reach a consensus-based long-term solution to the tax challenges arising from the digitalisation of the economy, and stating that the Inclusive Framework will continue following a two-pillar approach in working toward an agreement by the end of 2020. In aid of this goal, the Inclusive Framework announced its intent to reach agreement on the key policy features of the two-pillar solution by its next meeting in early July 2020.

Read about the Statement and the OECD release (31 January 2020): ***TaxNewsFlash***

The Statement is accompanied by a revised version of the Unified Approach released on 9 October 2019, which the Inclusive Framework adopted as the basis for negotiations with respect to Pillar One, and that identifies a number of remaining technical challenges and significant policy differences among the participants that would need to be resolved in order to reach agreement. In addition, the Statement takes note of a U.S. proposal to implement Pillar One on a "safe harbor" basis, as proposed in a December 2019 letter from the U.S. Treasury Secretary to the OECD Secretary-General. The Statement notes that many Inclusive Framework members expressed concern about the proposal, but that a final decision would be made only after agreement had been reached on the other elements of Pillar One.

The Statement is also accompanied by an updated Programme of Work setting out the timeline for the work on Pillar One and the remaining technical challenges to be addressed. The Inclusive Framework also stated its expectation that any consensus-based solution would need to include a commitment by members to implement the solution and withdraw relevant unilateral measures.

The Statement also welcomes progress on Pillar Two, noting that more work remains to be done. Finally, it welcomes progress on economic analysis and impact assessment, and calls for more detailed analysis by the end of March 2020.

KPMG observation

The Inclusive Framework effectively decided to finish developing the overall Pillar One package before addressing the U.S. safe harbor proposal, which appears to represent a gamble that a final agreement with respect to the U.S. proposal will be more possible when the final shape of the Pillar One solution is known than when the technical and policy details are still in flux.

KPMG observation

The stated expectation that members would be expected to withdraw relevant unilateral measures is welcome. It is unclear, however, which unilateral measures will be considered relevant, and the Programme of Work indicates that this determination will be part of the overall work on implementation and administration.

Updated "Unified Approach"

The Statement is accompanied by an outline of the architecture of a "Unified Approach" to Pillar One, which will serve as the basis for negotiations by the Inclusive Framework. The Unified Approach identifies three types of taxable profit to be allocated to market jurisdictions:

- **Amount A:** A share of residual profit allocated to market jurisdictions using a formulaic approach applied at the level of the multinational group (or potentially business line by business line). It would apply regardless of the existence of physical presence-based nexus under traditional rules, and is intended to reflect the profits associated with "active and sustained participation" in the economy of a market jurisdiction.

- **Amount B:** Fixed remuneration for defined "baseline" distribution and marketing functions taking place in a market jurisdiction. Amount B is not intended to create new taxing rights, and is intended to reflect an improvement in the "practical application" of the arm's length principle.

- **Amount C:** Any additional profit due to in-country functions that exceed the baseline activity covered by Amount B. Like Amount B, it is not intended to change existing taxing rights under the arm's length principle. The Unified Approach notes the importance of improved dispute resolution in this context.

The Unified Approach identifies a number of key components and challenges associated with these three elements.

Amount A

The Unified Approach notes, at a broad level, the need to agree on a limited scope and a limited quantum of profit to be reallocated, designed in a way that will be simple, avoid double taxation, and effectively work alongside the arm's length principle. The Unified Approach makes a number of refinements to the earlier version released October 2019, as highlighted below:

Scope

While the original Unified Approach identified "consumer-facing" businesses, defined broadly, as in scope, the new version of the Unified Approach identifies two categories of businesses that will be covered.

- **Automated digital services.** Businesses generating revenue from providing "automated digital services . . . on a standardized basis to a large population of customers or users across multiple jurisdictions." Using digital means to deliver services that involve a high degree of human interaction but judgment not intended to be exercised. This would include in particular, online search engines, social media platforms, other intermediation platforms/online marketplaces (whether used by businesses or consumers), digital content streaming, online gaming, cloud computing services, and online advertising services.

- **Consumer-facing businesses.** Businesses that generate revenue from the sale of goods and services of a type commonly sold to individual consumers purchasing items for personal use rather than for commercial or professional purposes.

KPMG observation

These refinements appear to have been driven by a realization that the prior focus on "consumer-facing" business would exclude many cloud computing businesses. The exact scope of these categories is unclear. With respect to automated digital services, the Unified Approach states that merely using digital means to deliver services involving a high degree of human intervention and judgment is not intended to be covered. The dividing line between covered services and excluded services will need substantial refinement to be administrable.

The Unified Approach states that extractive industries and other producers and sellers of raw materials and commodities will not be considered "consumer-facing" even if they are incorporated further down the supply chain into consumer products. It notes that this would be limited to generic goods sold and priced on the basis of their inherent characteristics, so that, e.g. sacks of green coffee beans would not be subject to the new taxing right, while branded jars of coffee will be.

KPMG observation

The exclusion for extractive industries and commodities appears to be quite narrowly confined. While it carves out producers and sellers of raw materials and commodities for incorporation into other products, in cases when a single multinational (MNE) group both extracts commodities and incorporates them into branded products, those later stages of the supply chain appear to be in scope of Amount A. This is consistent with the broad definition of consumer-facing businesses based on whether products sold are of a type purchased by consumers, rather than whether the initial purchaser is a consumer.

The Unified Approach notes also that most activities of the financial services sector (including insurance) take place with commercial customers and would not be in scope, and that there is a "compelling case" for excluding consumer-facing business lines based on the impact of regulation that ensures that residual profits are largely realized in local customer markets.

KPMG observation

The Unified Approach stops short of broadly carving out financial services, and notes in particular the need to consider whether digital peer-to-peer lending platforms or other "unregulated elements" of the financial services sector may require further consideration.

The Unified Approach also states that due to the longstanding tax treaty practice of assigning exclusive taxing rights over profits from operating ships and aircraft in international traffic to the residence country, it would be inappropriate to subject airline and shipping businesses to the new taxing right.

KPMG observation

The exclusion of airline and shipping businesses from the new taxing right is consistent with treaty rules that eliminate source country taxing rights. The exact scope of the intended carve-out is unclear, however, particularly for businesses doing a mix of shipping, air transport, and other transportation activities. It appears (though it is not stated) that this carve-out is intended to apply regardless of whether a treaty in fact applies to the income in question.

Overall revenue thresholds

The Unified Approach states that a number of thresholds would apply to reduce compliance and administrative burden. These would include:

- **Gross revenue threshold.** The new tax would apply only to MNE groups exceeding a gross revenue threshold (e.g., €750 million).

- **In-scope revenue threshold.** A further carve-out is being considered for MNE groups with in-scope revenue below a certain threshold.

- **De minimis carve-out**. A carve-out could also be considered where profit to be allocated under the new taxing right would be minimal.

KPMG observation

As noted below, the formula used for calculation of Amount A will effectively exclude businesses below a certain level of profitability. It is unclear how a de minimis carve-out would modify or expand on this approach.

Nexus

In addition to these general revenue-based thresholds, in-scope MNEs would be subject to tax in a market jurisdiction only if they had nexus with that market jurisdiction. This nexus rule would be a stand-alone rule that is not intended to change existing permanent establishment or other nexus rules.

The primary nexus rule (and the sole rule in the case of automated digital businesses) would be the generation of in-scope revenue in a market jurisdiction in excess of a threshold (which may be adjustable depending on the size of the market, subject to an absolute floor) over multiple years. For consumer-facing businesses, however, additional evidence of "sustained interaction" with the market may be required in order to minimize administrative burden. The Unified Approach indicates that further work will be done to identify "revenue plus" factors, such as the existence of physical presence in a market or targeting advertising at the market jurisdiction.

The Unified Approach also notes the need to develop sourcing rules to determine when in-scope revenue will be attributable to a market, noting in particular that online advertising and sales through intermediaries.

KPMG observation

While the introduction of "plus" factors helps mitigate some of the challenges associated with this nexus for consumer-facing businesses, the decision to include sales through unrelated intermediaries still appears to raise substantial challenges in developing a sourcing rule that will be administrable. The Programme of Work is somewhat more circumspect, seeming to acknowledge the practical challenges with this approach, including possibility that looking through independent distributors may not be feasible.

Quantum of Amount A

Amount A is intended to be reallocate a portion of the residual profits of a MNE group. As a result, the Unified Approach notes that for businesses below a certain threshold of profitability, Amount A would not apply. The profitability thresholds and the portion of deemed residual profits to be reallocated are among the topics remaining to be negotiated among the members of the Inclusive Framework. A number of issues are being considered in this regard, including:

- Setting the level of profitability and the portion of deemed residual profits subject to reallocation at a level that balances the interests of small and large economies
- "Digital differentiation" in which the quantum of profits subject to Amount A might differ based on differing degrees of digitalisation among in-scope business activities
- The possibility of different portions of profit being allocated to different businesses
- The possibility of identifying certain activities that would be deemed to be performed in market jurisdictions, as an alternative to subjecting those activities to increased Amount A allocations

KPMG observation

Reaching agreement on the quantum of Amount A remains one of the key political obstacles to consensus. The Unified Approach identifies no underlying principle for reaching agreement on any of the options being considered, suggesting that this will end up being largely a political decision.

Amount A is intended to be calculated on the basis of "profit before tax" derived from consolidated group financial accounts, with minimal adjustments intended to address only differences among accounting standards that are significant in amount and duration. The rules are intended to apply to both profits and losses, and will include loss carryforward rules (addressing both post-Amount A losses and pre-Amount A losses).

KPMG observation

The treatment of losses is one of the more challenging issues to be addressed in arriving at a coherent Pillar One solution. For example, if the Pillar One solution applies to businesses only to the extent that their profit margin exceeds 10%, consider the treatment of a business that consistently earns a 5% profit margin but has a single year in which it earns 20%. One option would be to treat that business as having exceeded the Amount A threshold by 10%, so that it would be subject to Amount A in that year. Another would be to consider the business to carry forward a 5% "residual loss" from prior years so that it is only subject to Amount A if its overall profitability over time exceeds 10%.

The Unified Approach notes that segmentation by region or business line may be required in some circumstances, including where out-of-scope revenues are material or where profitability varies materially by region or business line.

KPMG observation

Developing segments on a basis other than the segments used by an MNE group for financial reporting purposes appears to raise substantial risk of burden for both taxpayers and tax authorities. Permitting the use of financial reporting segments would substantially reduce that complexity, though work would need to be done to allocate centralized expenses to arrive at a reliable figure for profit and loss by segment that is consistent with group consolidated income.

After determining the total amount of profit included in Amount A, taxing rights to those profits would be allocated to market jurisdictions in which the MNE group has nexus using an agreed allocation key, which would be based on in-scope sales sourced to the market jurisdiction.

Elimination of double taxation

Reconciling Amount A with existing rules and relieving double taxation will require the identification of specific taxpayer entities that are considered to own the deemed residual profits that are subject to reallocation under Amount A. The Unified Approach suggests that existing credit and exemption methods for relieving double taxation may be able to relieve double taxation once the appropriate taxpayer entity is identified.

KPMG observation

Identifying an appropriate taxpayer is one of the more significant challenges to be addressed in the Unified Approach. Once that taxpayer is identified, adapting existing credit and exemption methods to Amount A in a way that will effectively relieve double taxation appears to raise substantial additional complexity. It is unclear from the draft whether more straightforward methods such as simply granting a deduction for the Amount A tax to the relevant taxpayer entity are being considered.

Interactions and potential for double counting

The Unified Framework makes clear that transfer pricing under the arm's length principle (including Amounts B and C) would apply first, and that Amount A would be allocated as a partial override to those results. While no significant interaction is expected between Amount A and Amount B, the Unified Approach notes that transfer pricing adjustments under Amount C may change which entity is considered a taxpayer for purposes of Amount A, and which jurisdiction is therefore required to provide relief. Further work will be done to explore this interaction.

Amount B (Fixed return for defined baseline distribution and marketing activities)

Amount B focuses on defining a fixed return based on the arm's length principle for entities performing "baseline marketing and distribution activities," with the goal of reducing complexity and disputes. To ensure that the result is based on the arm's length principle, the Unified Approach notes that work will focus on how to account for different functionality levels, as well as differentiation in treatment between industries and region. It further notes that while results are generally expected to be consistent with the arm's length principle, agreement will require countries to compromise between strict compliance and administrability.

KPMG observation

A number of comments requested that Amount B be implemented as a safe harbor. The Unified Approach rejects this approach, based on the assertion that the results of Amount B are intended to be an implementation of the arm's length principle.

"Baseline" activities will be defined as part of the work on Amount B, and are expected to include distribution arrangements with routine levels of functionality, no ownership of intangibles, and no or limited risks.

KPMG observation

Limited risk distributors have been the subject of substantial attention from tax administrations, frequently resulting in disputes as to whether a particular distribution arrangement is actually limited in risk. A rule that defines distribution activities to focus exclusively on such limited risk distribution activities seems to carry with it the risk of generating the same types of disputes.

Dispute prevention and resolution

The Unified Approach calls for continued work to explore "innovative and inclusive processes" to improve tax certainty, recognizing: (1) that disputes under Amount A are likely to be multilateral in nature; and (2) that mechanisms to improve tax certainty, including dispute resolution measures, will be critical to overall agreement on a Pillar One solution.

With respect to Amount A, the Unified Approach suggests that work will be done to develop a process in which taxpayers could receive binding agreements from tax administration before tax assessments are made, covering all aspects of Amount A. One option being considered is the establishment of representative panels of government officials. Work will be done on the process and governance of those panels (including the role of the residence country of the ultimate parent entity), and could include providing assistance to panel members from tax administrations with resource constraint.

For disputes under Amount A that are not dealt with by the early dispute prevention process, the Unified Approach states that a mandatory binding dispute resolution process will be developed. For Amount B, it is intended that clear and detailed guidance on the scope of Amount B would limit the amount of disputes. The Unified Approach notes, however, that while agreement on the scope and nature of enhanced dispute resolution is critical to reaching consensus in 2020, members of the Inclusive Framework differ on the extent to which any such measures would apply to broader transfer pricing disputes (Amount C).

KPMG observation

A mechanism to provide certainty on a multilateral basis in advance of assessment would be welcome, though it appears that very little detail has been developed at this point. The Programme of Work suggests that this approach may be not be performed until the implementation phase, as part of the development of a multilateral convention. Reaching agreement on mandatory binding arbitration or similar dispute resolution mechanisms appears critical given the breadth of the new rules being considered.

Implementation and administration

The Unified Approach notes that implementation will require both domestic law and treaty changes, and suggests the negotiation of a new multilateral convention to ensure that all jurisdictions can implement the Unified Approach consistently and at the same time. This could include both treaty changes and measures to coordinate where no treaty exists. Implementation on a phased basis could also be considered, including the use of simplified transition measures. The Unified Approach emphasizes that any consensus will require members to commit to implement, and also to commit to withdraw relevant unilateral measures and not implement unilateral actions in the future.

Alternative global safe harbor

Further work will also be done on the design of a safe harbor system in light of the U.S. proposal.

Considerations would include changes to: (1) scope of Amount A; (2) operating and administration rules; and (3) measures to avoid double taxation. Interaction with unilateral measures and behavioral incentives would also be considered.

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