Background

February 2022 Draft Model Rules for Nexus and Revenue Sourcing

Next Steps

EU Tax Centre comment

Public consultation document on Pillar One – Draft Model Rules for Nexus and Revenue Sourcing


On February 4, 2022, the OECD launched a public consultation by releasing for public comment Draft Model Rules for Nexus and Revenue Sourcing in relation to Amount A of the OECD Pillar One solution to reallocate profits of multinational enterprises to market jurisdictions. Comments on the draft are due before February 18, 2022.

Background

The public consultation on the Draft Model Rules for Nexus and Revenue Sourcing forms part of the OECD’s two-pillar solution to address the tax challenges arising from the digitalisation of the economy which was agreed at political level by 137 members of the OECD/G20 Inclusive Framework (“IF”) on BEPS in October 2021 (“October agreement”), for previous coverage please refer to Euro Tax Flash issue 458. The October agreement sets out the architecture of the two-pillar solution, as follows:

- Pillar One deals with the reallocation of certain profits from highly profitable Multinational Enterprises (MNEs) to market jurisdictions;
- Pillar Two deals with a Global Minimum Tax (for more details please refer to Euro Tax Flash issue 463 and the KPMG’s Global Tax Policy website).
In the context of Pillar One, the October agreement provides for new profit allocation and nexus rules for highly profitable MNEs to market jurisdictions (Amount A of the Pillar One solution). Amount A requires the development of sourcing rules and a revenue-based allocation key, with the October agreement indicating that 25 percent of profits under Amount A would be allocated to market jurisdictions in respect of MNEs that have a turnover of greater than EUR 20 billion and profit before tax margins of 10 percent of revenue.

According to the October agreement, Amount A is to be implemented primarily by way of a Multilateral Convention (MLC) and accompanying explanatory statement, which serve to amend existing treaties to the extent needed to give effect to the rules, or to create the requisite relationships between countries that do not currently have bilateral treaties with one another. The MLC shall be supported by Model Rules and related commentary for Amount A to be implemented in an IF member’s domestic legislation.

In addition, the October agreement provides a proposal for rules dealing with standard remuneration for in-country “baseline” marketing and distribution activities which are embodied in Amount B of the Pillar One solution and which are developed separately from Amount A.

The October agreement also includes a moratorium on newly enacted digital services taxes (DST) or other relevant similar measures from October 8, 2021 and until the earlier of December 31, 2023 or the coming into force of the MLC, as well as a requirement to remove existing DSTs and other relevant similar measures. In this context, Austria, France, Italy, Spain, and the United Kingdom on one hand, and the United States on the other hand, reached a compromise agreement on October 21, 2021. The agreement allows the five European jurisdictions above to maintain their DSTs until Pillar One enters into force. Nevertheless, transitional measures would apply starting January 1, 2022, until the earlier of December 31, 2023 or the date of entry into force of the MLC implementing Pillar One. In return, the US will terminate its trade retaliation in relation to the DSTs listed above.

For more information on the October agreement, please refer to Euro Tax Flash issue 458 as well as the KPMG’s initial analysis of the October 2021 statement.

February 2022 Draft Model Rules for Nexus and Revenue Sourcing

The Draft Model Rules for Nexus and Revenue Sourcing published on February 4, 2022 are part of the to be developed Model Rules on the functioning of Amount A of the Pillar One solution. According to the public consultation document, the Model Rules are developed to serve as the basis for the substantive provisions that will be included in the MLC. They shall also provide a template for the implementation of the new taxing rights over Amount A in a jurisdiction’s domestic legislation.

It is noted that jurisdictions will be free to adapt the Model Rules to reflect their own constitutional law, legal systems, and domestic considerations and practices for structure and wording of legislation as required, whilst ensuring implementation is consistent in substance with the agreed technical provisions governing the application of the new taxing rights.

The Nexus and Revenue Sourcing Model Rules, in particular, are part of the Model Rules that are to be translated into the MLC and its explanatory statement and are intended to be binding on the implementing jurisdictions. The rules are structured as a general legislative article that
articulates the nexus rules and the sourcing principles at a high level, followed by a schedule that sets out detailed rules for identifying and sourcing revenue to the market jurisdiction.

The nexus rules provide for a nexus test that is only satisfied when the amount of revenue that an MNE derives from a jurisdiction is material. The threshold test is fulfilled where an MNE derives at least EUR 1 million in revenue. For a jurisdiction with annual gross domestic product (GDP) of less than EUR 40 billion, the threshold test is at least EUR 250,000. To determine whether an MNE has sufficient nexus to a jurisdiction, the revenue sourcing rules prescribe how to identify the jurisdiction in which revenue arises for a given type of revenue, namely finished goods, components, services, intangible property, real property, government grants, and non-customer revenues. Based on this identification, MNEs are required to source all revenue, generally on a transaction-by-transaction basis, to the respective market jurisdiction using reliable allocation indicators.

For a detailed analysis of the Draft Model Rules for Nexus and Revenue Sourcing, a comparison with the 2020 Blueprint and comments on outstanding issues, please refer to KPMG’s analysis of the Draft Model Rules for Nexus and Revenue Sourcing.

Next steps

According to the public consultation document, the Nexus and Revenue Sourcing Model Rules are a “working version” which does not yet reflect the IF’s consensus on their substance and may be subject to further changes. Accordingly, the IF is expected to continue its work on the Nexus and Revenue Sourcing Model Rules following the deadline of the public consultation on February 18, 2022. In that course of action, the IF will also address supporting record-keeping requirements to facilitate a systematic review of the MNE’s approach to revenue sourcing, without requiring the retention of transaction-level data.

The public consultation document, however, does not provide for a timeline in respect of the finalization of the Amount A Model Rules including its other parts on, for example, tax base, sectoral exclusions and tax certainty. There is also no timeline indicated for the release of the accompanying commentary.

Therefore, it remains to be seen whether the milestones set in the October agreement for the release and implementation of the Pillar One solution can be adhered to:

- the MLC and its explanatory statement, as well as model domestic legislation and commentary to be concluded by early 2022;
- the MLC signing ceremony to be organized by mid-2022;
- effective implementation of Amount A in 2023, once the MLC has been ratified by a critical mass of jurisdictions (to be defined in the MLC).

For Amount B of Pillar One, the OECD press release notes that a public consultation document will be issued in mid-2022, with a public consultation event to follow the comment period. Based on the October agreement, the Amount B deliverables are then to be released by end of 2022.

EU Tax Centre Comment

In addition to individual Member State’s interest in developments regarding Pillar One, Amount A is also relevant to the EU as a whole in light of the block’s needs to fund the EUR 750 billion
of funding committed as part of the European Union Recovery Instrument (NextGenerationEU) to mitigate the impact of the COVID-19 pandemic. As previously covered (see Euro Tax Flash issue 463), the European Commission’s proposal to establish the next generation of own resources for the EU budget published on December 22, 2021 requires Member States to provide a national contribution to the EU budget based on their share of 15 percent of the taxable profits of multinational enterprises re-allocated to each Member State under Pillar One.

Against this background and based on a previous statement by EU Commissioner for Economy Paolo Gentiloni, the Commission is carefully examining whether the Model Rules for Amount A need to be translated into a Directive to ensure consistent and effective implementation at EU level. In this context, the European Commission’s work program for the first half of 2022 has scheduled the release of a proposal to implement the OECD Pillar One solution for July 27, 2022.

Although all EU Member States have previously expressed their support of the OECD two-pillar solution (see Euro Tax Flash issue 459), questions remain regarding the implementation of Pillar One at EU level if progress stalls in the United States on the implementation of the OECD proposals. In this regard, concerns were most recently raised during the meeting of the Economic and Financial Affairs Council (ECOFIN) on January 18, 2022, where several EU Member States (Estonia, Hungary, Poland) cautioned against the rushed implementation of a Pillar Two EU Directive in light of an uncertain agreement on the Pillar One OECD proposal at international level. Those concerns are likely to be raised again once a proposal for an EU implementation of Pillar One has been brought to the table.

It remains to be seen how the EU will react if agreement on Pillar One is not reached at IF level. One potential way forward, in light of the EU’s funding needs, is for the EU to introduce a new EU-wide digital levy, as a new own resource for the EU, to apply until Pillar One is implemented by Member States.

Should you have any queries, please do not hesitate to contact KPMG’s EU Tax Centre, or, as appropriate, your local KPMG tax advisor.

Raluca Enache  
Director, KPMG’s EU Tax Centre

Robert van der Jagt  
Chairman, KPMG’s EU Tax Centre and Partner, KPMG in the Netherlands

Vinod Kalloe  
KPMG Regional Tax Policy Leader for EMA

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