Deloitte.

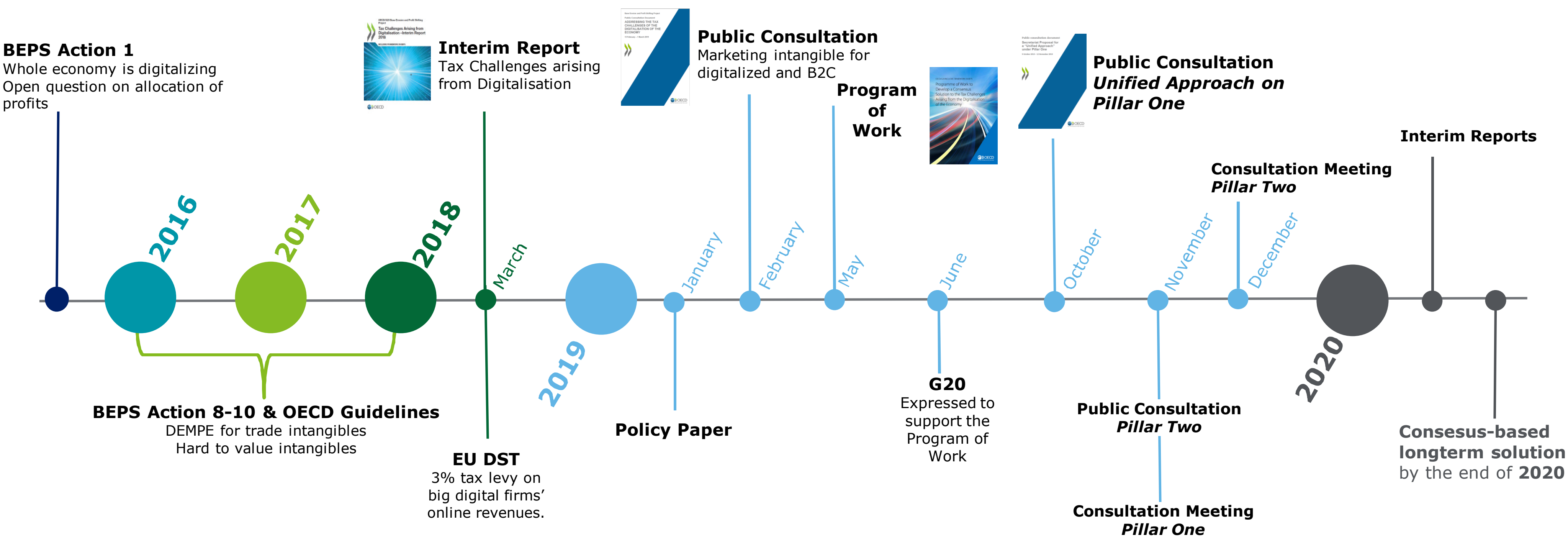
The OECD Unified Approach

November 14, 2019 – SDA Bocconi

Contents

Overview of regulatory framework

Transfer Pricing Developments

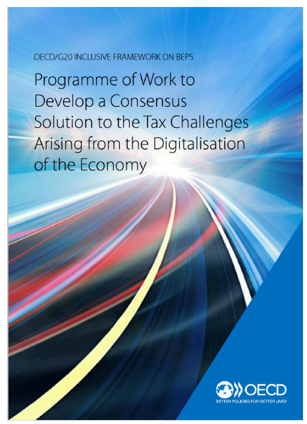


Overview of regulatory framework

OECD Publications

March 16, 2018

February 13, 2019



May 31, 2019

October 9, 2019

November 8, 2019

OECD Guidelines (July 2017)
Separate Entity Approach and the Arm’s Lenght Principle

“OECD member countries have chosen separate entity approach as the most reasonable means for achieving equitable results and minimising the risk of unrelieved double taxation. Thus, each individual group member is subject to tax on the income arising to it (on a residence or source basis).

To ensure the correct application of the separate entity approach, OECD member countries have adopted the arm’s length principle, under which the effect of special conditions on the levels of profits should be eliminated.

OECD member countries continue to endorse the arm’s length principle as embodied in the OECD Model Tax Convention (and in the bilateral conventions that legally bind treaty partners in this respect) and in the 1979 Report.

The arm's length principle […] is the international transfer pricing standard that OECD member countries have agreed should be used for tax purposes by MNE groups and tax administrations.” (par. 1.1)

OECD Guidelines (July 2017)
Separate Entity Approach and the Arm’s Lenght Principle

“There are several reasons why OECD member countries and other countries have adopted the arm’s length principle.

A major reason is that the arm's length principle provides broad parity of tax treatment for members of MNE groups and independent enterprises.

Because the arm’s length principle puts associated and independent enterprises on a more equal footing for tax purposes, it avoids the creation of tax advantages or disadvantages that would otherwise distort the relative competitive positions of either type of entity.

In so removing these tax considerations from economic decisions, the arm's length principle promotes the growth of international trade and investment.”

(par. 1.8)

OECD Guidelines (July 2017)
Separate Entity Approach and the Arm's Lenght Principle

"Nevertheless, there are some significant cases in which the arm's length principle is difficult and complicated to apply, for example, in MNE groups dealing in the integrated production of highly specialised goods, in unique intangibles, and/or in the provision of specialised services. **Solutions exist to deal with such difficult cases, including the use of the transactional profit split method**." (par. 1.9).

"In sum, OECD member countries continue to support strongly the arm's length principle. In fact, no legitimate or realistic alternative to the arm's length principle has emerged. Global formulary apportionment, sometimes mentioned as a possible alternative, would not be acceptable in theory, implementation, or practice." (par. 1.15).

"The purpose of the following sections is to provide guidance for determining whether the conditions of certain financial transactions between associated enterprises are consistent with the arm's length principle." (OECD Discussion Draft on Financial Transactions, "Introduction", July 3, 2018).

Addressing the Tax Challenges of The Digital Economy

The tax challenges arising from the digitalisation of the economy were identified as one of the main areas of focus of the Base Erosion and Profit Shifting (BEPS) Action Plan, leading to the 2015 BEPS Action 1 Report on *Addressing the Tax Challenges of the Digital Economy* (the Action 1 Report).

In addition, the Action 1 Report observed that beyond BEPS, digitalisation raised a series of broader direct tax challenges, which it identified as data, nexus and characterisation.

These challenges chiefly relate to the question of how taxing rights on income generated from cross-border activities in the digital age should be allocated among countries. While identifying a number of proposals to address these concerns, none were ultimately recommended.

After the release of the OECD/G20 BEPS package, countries agreed to renew the mandate of the Task Force on the Digital Economy (TFDE) and continue to monitor developments in respect of digitalisation.

Proposals to the TFDE (July and December 2018 Meetings)

1. User Contribution:

- Revise the existing rules on profit allocation and nexus by **reference to "active user contribution"**
- **Would apply to highly digitalised businesses**
- Would recognise the **value created by users** of digital services

2. Marketing Intangibles:

- Revise the existing rules on profit allocation and nexus by **reference to "marketing intangibles"**
- **Applies broadly to all types of businesses**
- Would recognise the **value created by the market jurisdiction**

3. Significant Economic Presence

- Grounded in the 2015 BEPS Action 1 report
- **Nexus based on a significant economic presence**
- Aims for simplified, easy to administer solutions

Addressing the Tax Challenges of the Digitalisation of the Economy
Inclusive Framework’s Policy Note (Jan 23, 2019)

Policy Note *Addressing the Tax Challenges of the Digitalization of the Economy*:

- **Agreement to examine proposals involving two pillars** which could form the basis for consensus:
  - Pillar One focuses on the allocation of taxing rights, and seeks to undertake a coherent and concurrent review of the profit allocation and nexus rules;
  - Pillar Two focuses on the remaining BEPS issues («tax back» right).

- Proposals going **beyond the arm’s length principle**

- Should not result in taxation when there is no economic profit nor should they result in double taxation

- Stresses the importance of tax certainty and effective dispute prevention and dispute resolution tools

Addressing the Tax Challenges of the Digitalisation of the Economy
Public Consultation Document – February 2019

[The] central question would be, in what situations can it be said that a business, with a physical situs outside of a market jurisdiction, has an active presence or participation in that jurisdiction and generates value in that jurisdiction through its user or customer related activities?

It is considered active presence or participation to be a function of a business's active outreach to and interaction with users or customers, including the use of digital technologies to cultivate, interact with and leverage a local customer or user base in a way that creates meaningful value for the enterprise.

Addressing the Tax Challenges of the Digitalisation of the Economy
Public Consultation Document – February 2019

The question then is whether this is relevant:

- only in situations in which digital-centric businesses engage, interact with and leverage contributions from a participatory user base on a digital platform, as per the user participation proposal;

- in a broader range of situations in which, for example, consumer facing businesses use digital technologies to develop a customer base, collect customer data or deliver highly targeted marketing and personalization of products; or

- in all situations in which businesses have significant marketing intangibles that can be attributed to customers of a jurisdiction, as per the marketing intangibles proposal.

The PoW

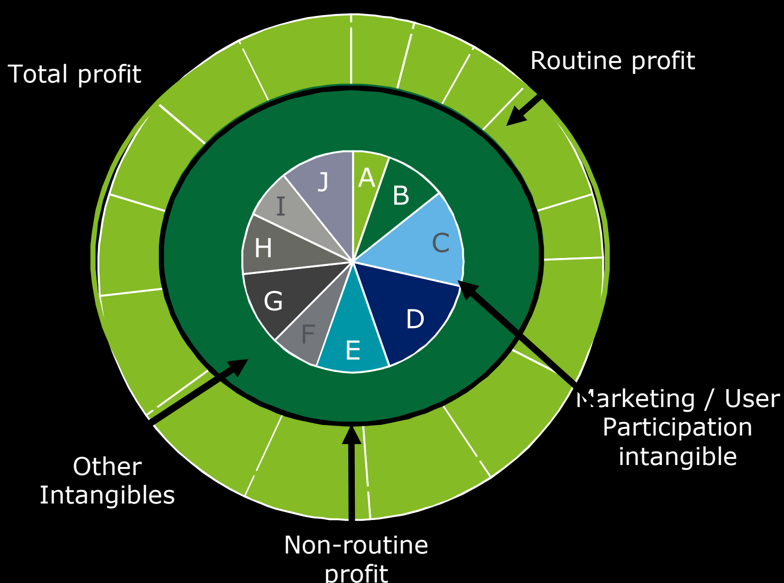
In May 2019, the OECD/G20 Inclusive Framework on BEPS agreed a Programme of Work ("PoW") for Addressing the Tax Challenges of the Digitalisation of the Economy, including the development of new "profit allocation" and "nexus rules".
The three alternatives subject to the PoW under Pillar One have a number of significant commonalities:

- though there is some variation in how the proposals address the digitalisation issue, to the extent that highly digitalised businesses are able to operate remotely, and/or are highly profitable, all proposals would reallocate taxing rights in favour of the user/market jurisdiction;
- all the proposals envisage a new nexus rule that would not depend on physical presence in the user/market jurisdiction;
- they all go beyond the arm's length principle and depart from the separate entity principle; and
- they all search for simplicity, stabilisation of the tax system, and increased tax certainty in implementation.

The PoW

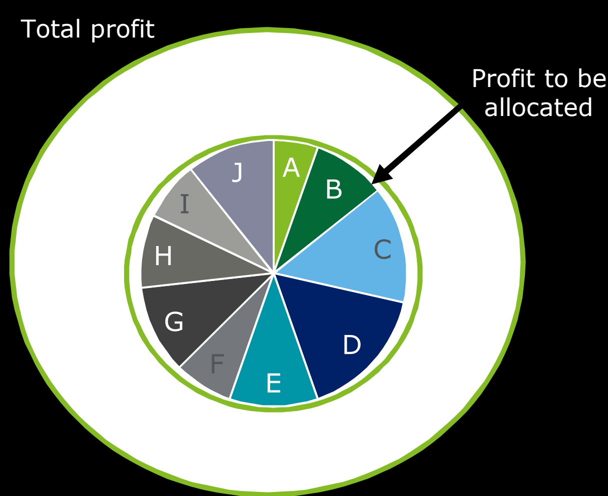
Hypotheses of new “profit allocation rules”:

Modified residual profit



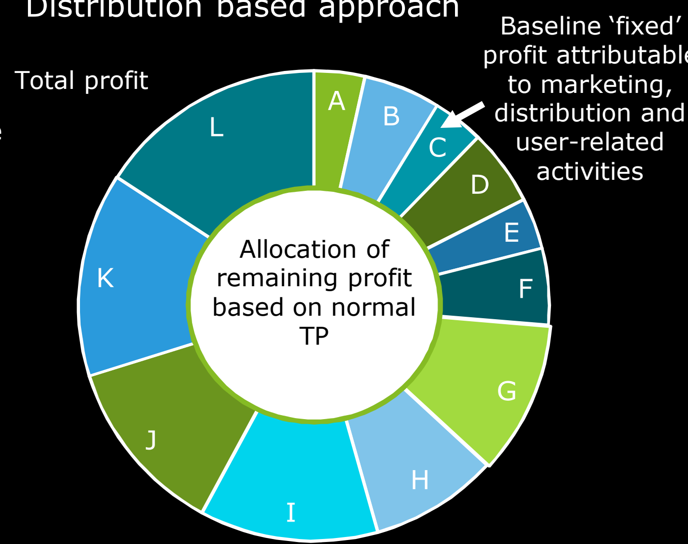
- Top down approach
- Most similar to current TP method

Fractional apportionment method



- Formula based (e.g. global profitability % on sales) – no distinction between routine and non-routine profit;
- More simple to apply and less prone to dispute

Distribution based approach



- Bottom up approach
- Non-routine + routine profit;
- Could be more simple in practice

The Unified Approach
Secretariat Proposal for a «Unified Approach» under Pillar One

While there seems to be adherence among Inclusive Framework members to the principle that routine transactions can normally be priced at arm's length, there are increasing doubts that the arm's length principle can be relied on to give an appropriate result in all cases (such as, for example, cases involving non-routine profits from intangibles).

Moreover, there seems to be agreement that the arm's length principle is becoming an increasing source of complexity and that simplification would be desirable to contain the increasing administration and compliance costs of trying to apply it. Thus, an "administrable" solution is essential, especially for emerging and developing countries. And a simple system will lower the risks of disputes, which currently endanger the cohesion of the international tax system.

Against that background, the proposed "Unified Approach" would retain the current rules based on the arm's length principle in cases where they are widely regarded as working as intended, but would introduce formula-based solutions in situations where tensions have increased – notably because of the digitalisation of the economy

The Unified Approach
Secretariat Proposal for a «Unified Approach» under Pillar One

Possible new approach based on the commonalities between the three proposals:

- **Scope.** The approach covers highly digital business models but goes wider – broadly focusing on consumer-facing businesses with further work to be carried out on scope and carve-outs. Extractive industries are assumed to be out of the scope.
- **New Nexus.** For businesses within the scope, it creates a new nexus, not dependent on physical presence but largely based on sales. The new nexus could have thresholds including country specific sales thresholds calibrated to ensure that jurisdictions with smaller economies can also benefit. It would be designed as a new self-standing treaty provision.
- **New Profit Allocation Rule going beyond the Arm's Length Principle.** It creates a new profit allocation rule applicable to taxpayers within the scope, and irrespective of whether they have an in-country marketing or distribution presence (permanent establishment or separate subsidiary) or sell via unrelated distributors. At the same time, the approach largely retains the current transfer pricing rules based on the arm's length principle but complements them with formula based solutions in areas where tensions in the current system are the highest.

The Unified Approach

Increased Tax Certainty delivered via a Three Tier Mechanism. The approach increases tax certainty for taxpayers and tax administrations and consists of a three tier profit allocation mechanism, as follows:

- **Amount A** a share of deemed residual profit allocated to market jurisdictions using a formulaic approach, i.e. the new taxing right;
- **Amount B** a fixed remuneration for baseline marketing and distribution functions that take place in the market jurisdiction; and
- **Amount C** binding and effective dispute prevention and resolution mechanisms relating to all elements of the proposal, including any additional profit where in-country functions exceed the baseline activity compensated under Amount B.

The Unified Approach

New profit allocation rules are required for Amount A: given that the new taxing right would create a nexus for an MNE group even in the absence of a physical presence, it would be impossible to use the existing rules to allocate profit to this new nexus in cases where no functions are performed, no assets are used, and no risks are assumed in the market jurisdictions.

The new rules would allow for the taxation at an appropriate level of business activities in market jurisdictions, while retaining transfer pricing rules where they work relatively well in that market jurisdiction.

A change to the nexus and profit allocation rules is required not just for situations where is no physical presence though, otherwise, taxpayers could simply side-step the new rules by using alternative forms of an in-country presence (whether a local branch or related entity), making the new taxing right elective for taxpayers and creating an open invitation for tax planning.

Pillar One
Unified approach – key features

Scope

Digital and Consumer-facing businesses

- Highly digital business models
  - intermediation platform, online advertising
- Consumer facing
  - Derive meaningful value from interactions with customers/users
  - Intermediates, franchise and component suppliers?

Carve – Out (tbd)

- Extractive;
- Commodities;
- Financial services;
- Other?

New Nexus

- Consumer-facing and/or user-facing with no physical presence
- Define revenue threshold in market as primary indicator
- Threshold take into account digital activities directed at non-paying users, such as online advertising services
- New standalone treaty provision – on top of the PE rule

Pillar One
Unified approach – key features


Public consultation document
Secretariat Proposal for a "Unified Approach" under Pillar One
9 October 2019 – 12 November 2019
OECD

Three tier mechanism

Amount A

- Share of deemed (non-routine) residual profit allocated to market jurisdictions using a formulaic approach, i.e. the new taxing right

Amount B

- Baseline remuneration for marketing and distribution functions that take place in the market jurisdiction, e.g. by using fixed remunerations

Amount C

- Dispute resolution on additional profits for non- sales & marketing/distribution activities
- Binding and effective dispute prevention

Complementing the Arm's length principle

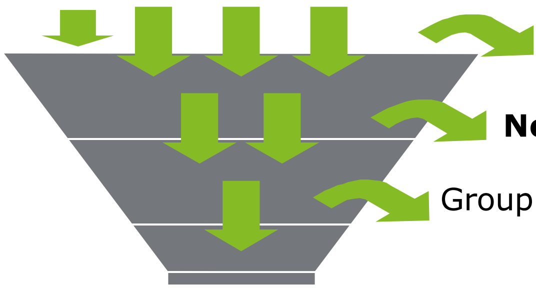
- Independent of physical presence (PE/distributor)
- Formulaic approach, without the need for precise arm's length benchmarking
- Based on group/business line profits

Losses

- Losses may also be allocable, but potentially subject to claw-back or "earn out" mechanism
- Treatment of legacy investments upon introduction of new regime

Pillar One

Unified approach – methodology

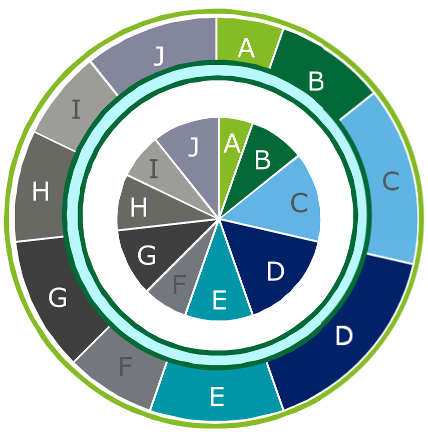


Carve-out:

Not Digital or consumer facing

Group and country threshold (e.g. turnover)

Unified approach



A

Total profit minus **Deemed routine profit**

New taxing right "market" portion of deemed residual profit

Market jurisdiction by allocation key

B

Marketing & Distribution

Fixed remuneration baseline vary by industry

Minimize disputes

Arm's length principle

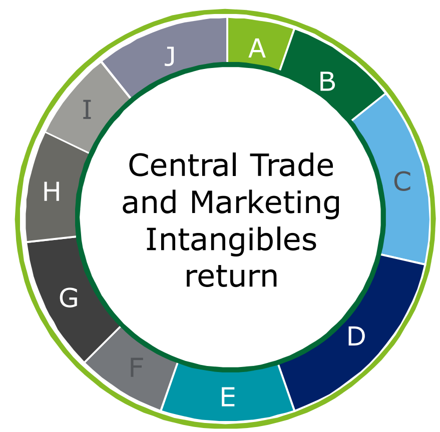
C

Other profits
Trade IP, Capital & Risk
Other routine

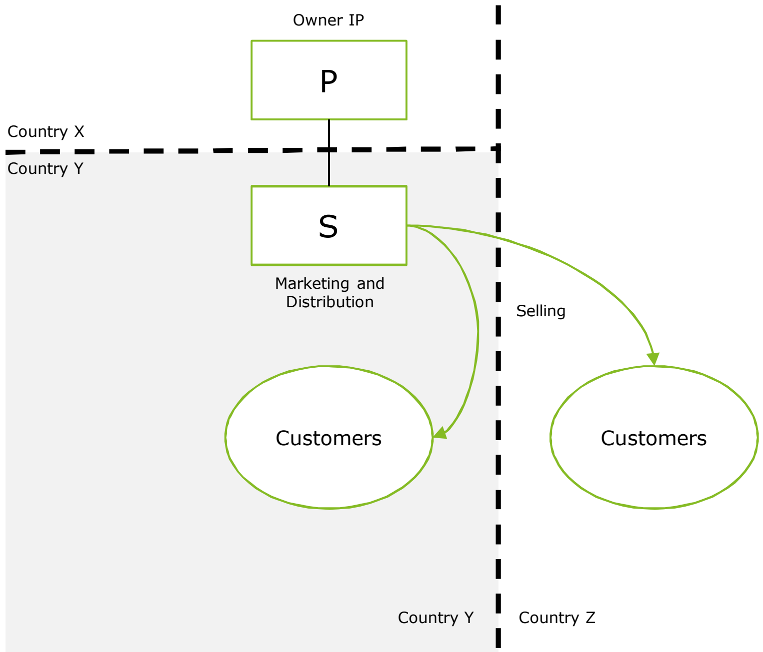
Dispute resolution

Arm's length principle

Arm's length Principle



Pillar One
Unified approach – example



	Item	Comment
Amount A	Deemed non-routine residual profit	Intangibles / IP owners

Country Y allocation

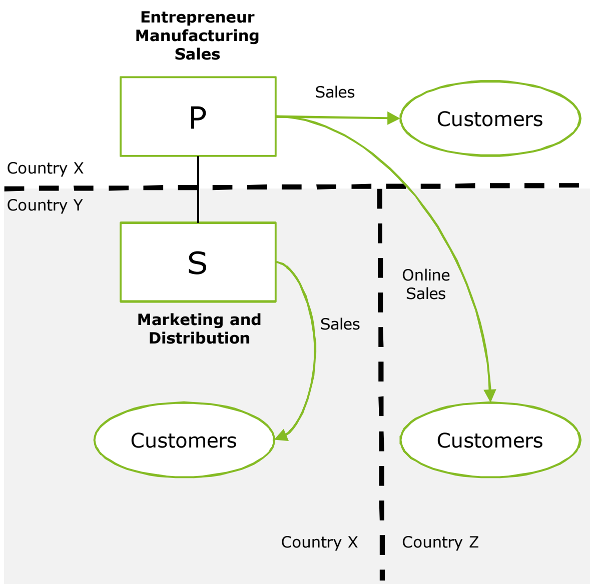
- Assuming that S meets revenue threshold in Country Y
- Country Y has the right to tax a portion of the deemed non-routine profits directly from P
- Country Y holds P and S jointly liable for the tax due, to facilitate administration
- P claims a foreign tax credit or an exemption in Country X (Double Tax Treaty)

Country Z allocation

- Assuming that revenue threshold of the Group is met in Country Z
- Under the new taxing rules, P has taxable presence in Country Z. As a result, Country Z has the right to tax a portion of the deemed non-routine profits of the Group from P

Pillar One

Detailed Examples – Central model 1 (1/3)



P&L	Consolidated Group	S	P
Revenue	3.000	1.000	2.600
COGS	1.500	600	1.500
SG&A	900	300	600
PBT	600	100	500

Country X

3rd party	1.000
COGS	500
SG&A	300
PBT	200

IC Sales to Y

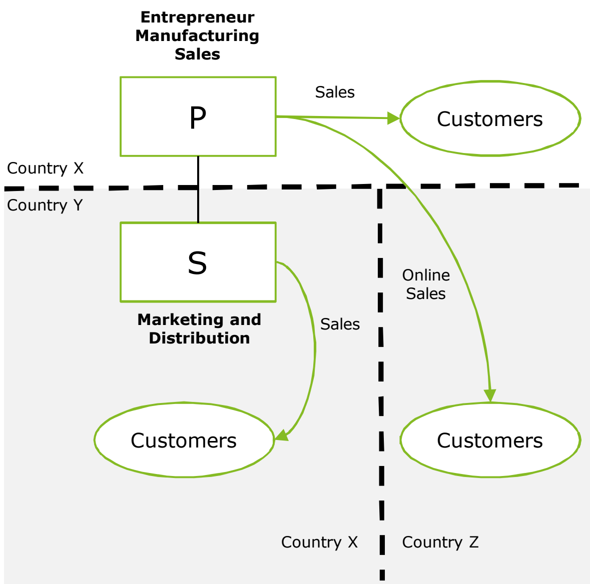
IC Sales	600
COGS	500
PBT	100

Country Z

3rd party	1.000
COGS	500
SG&A	300
PBT	200

Pillar One

Detailed Examples – Central model 1 (2/3)



P&L	Consolidated Group	S	P
Revenue	3.000	1.000	2.600
COGS	1.500	600	1.500
SG&A	900	300	600
PBT	600	100	500

Country X

3rd party	1.000
COGS	500
SG&A	300
PBT	200

IC Sales to Y

IC Sales	600
COGS	500
PBT	100

Country Z

3rd party	1.000
COGS	500
SG&A	300
PBT	200

Amount A	
Group profit	600
Deemed routine market profit (**10%**)	-/-300
Deemed Manufacturing (C+10%)	-/-150
Deemed residual profit	150
Allocable to market jurisdiciton (50%)	75
Per market jurisdiction *	**25**

Country X

Amount	+25
Relief	-75

Country Y

Amount	+25

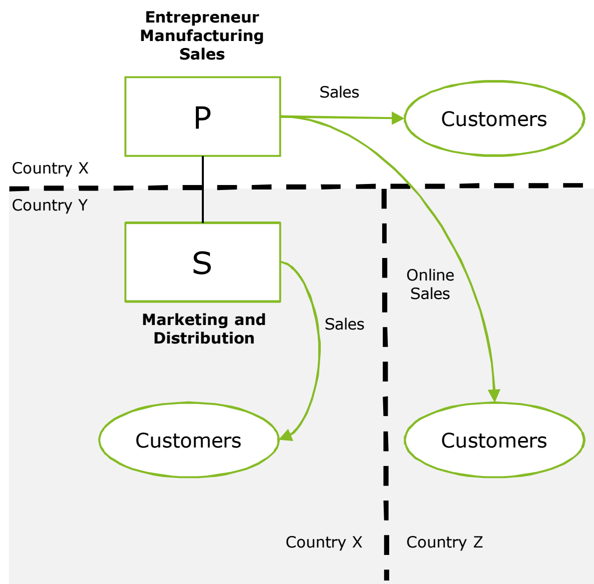
Country Z

Amount	+25

* Based on sales.

Pillar One

Detailed Examples – Central model 1 (3/3)



P&L	Consolidated Group	S	P
Revenue	3.000	1.000	2.600
COGS	1.500	600	1.500
SG&A	900	300	600
PBT	600	100	500

Country	Z	Y	X
Amount A	25	25	25
Relief for A			-75
Amount B (10%)		100	200
Amount C: Routine manuf			150
Amount C: Residual/non-A			75

Country X

3rd party	1.000
COGS	500
SG&A	300
PBT	200

IC Sales to Y

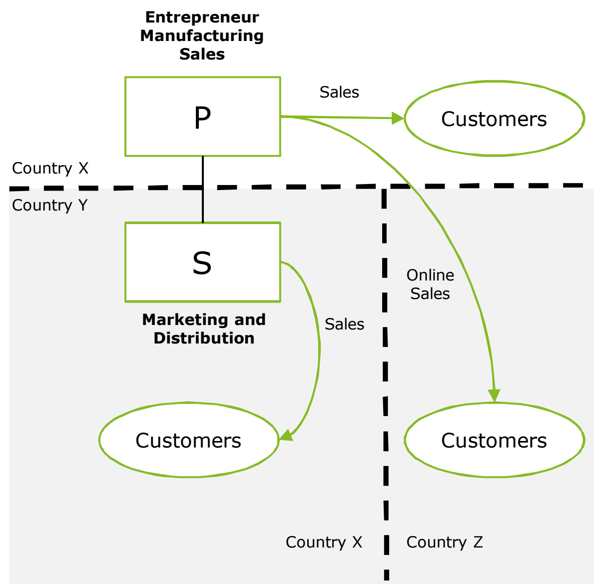
IC Sales	600
COGS	500
PBT	100

Country Z

3rd party	1.000
COGS	500
SG&A	300
PBT	200

Pillar One

Detailed Examples – Central model 2 (1/2)



P&L	Consolidated Group	S	P
Revenue	3.000	1.000	2.600
COGS	1.500	600	1.500
SG&A	900	300	600
PBT	600	100	500

Country X

3rd party	1.000
COGS	500
SG&A	300
PBT	200

IC Sales to Y

IC Sales	600
COGS	500
PBT	100

Country Z

3rd party	1.000
COGS	500
SG&A	300
PBT	200

Amount A	
Group profit	600
Deemed routine market profit (**5%**)	-/-150
Deemed Manufacturing (C+10%)	-/-150
Deemed residual profit	300
Allocable to market jurisdiciton (50%)	150
Per market jurisdiction	**50**

Country A

Amount	+50
Relief	-150

Country B

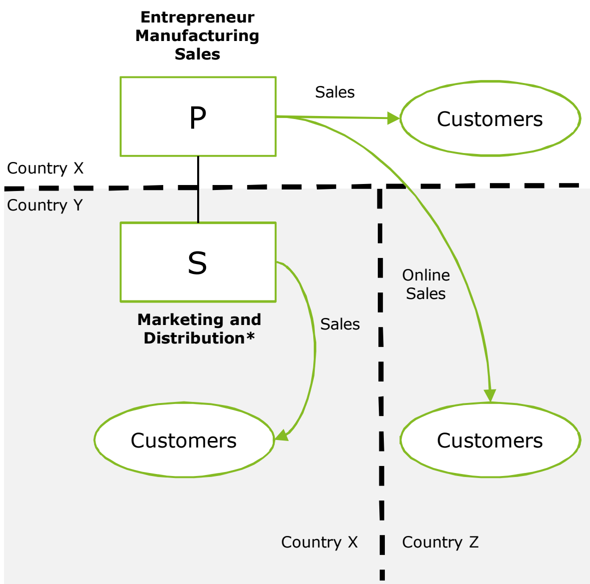
Amount	+50

Country C

Amount	+50

Pillar One

Detailed Examples – Central model 2 (2/2)



P&L	Consolidated Group	S	P
Revenue	3.000	1.000	2.600
COGS	1.500	600	1.500
SG&A	900	300	600
PBT	600	100	500

Country	Z	Y	X
Amount A	50	50	50
Relief for A		?	-150
Amount B (5%)		50	100
Amount C: Routine manuf			150
Amount C: Residual/non-A		50	100

Country X

3rd party	1.000
COGS	500
SG&A	300
PBT	200

IC Sales to Y

IC Sales	600
COGS	500
PBT	100

Country Z

3rd party	1.000
COGS	500
SG&A	300
PBT	200

* Exceeding «baseline» marketing and distribution activities.

Pillar One

Detailed Examples – Decentralized model

	Country X	Country Y	Country Z
Operations	Computers local sales, marketing and R&D	Phones local sales, marketing and R&D	Phones local sales, marketing and R&D
Revenue	1.000	1.000	1.000
PBT	300	100	200
Amount A (no segmentation)	+50 -100*= -50	+50	+50 -50= -0
Amount A (segmentation)	N/A	+50	+50 -100 = -50

* 300-100 (routine) * 50%

Calculation Amount A

- Routine: 10% OPM
- 50% residual is attributable to market jurisdiction

No Segmentation

- (profit 600 -/- routine 300)*50% = 150 allocated as 50 to country X, Y and Z;
- Relief assumed to based on residual profit :
  - Country X = 200 (= 300-100)
  - Country Y = 0 (=100-100)
  - Country Z = 100 (= 200-100)

Segmentation

<u>Phones segment:</u>

- (profit 300-/- routine 200)*50% = 50 allocated to country Y and country Z

<u>Computer segment:</u>

- No amount A, since only one country in this segment