Miller & Chevalier

Brave New Taxing Right: OECD Releases Pillar One Consultation Document

Tax Alert
10.10.2019

Under immense pressure to devise a fair and administrable solution for taxing digital businesses by 2020, the OECD yesterday released a public consultation document to test the waters with a potential solution. The pressure on the OECD to develop a solution has grown in recent months—France enacted a digital tax but only agreed to put that tax on hold in August pending a digital-tax solution from the OECD; a host of other countries have announced or proposed digital taxes of their own. These digital taxes are irreconcilable with longstanding international tax norms, which have historically determined tax nexus based on physical presence. The OECD's proposal on a digital tax solution abandons that physical-presence approach to nexus, at least for some businesses. And it also suggests a formulary tax approach that departs from the arm's-length standard.

The OECD's latest proposal, which has not yet been agreed by participating countries, comes in the form of what it has termed a "unified approach" under its Pillar One. The first of the two pillars of work that the OECD has adopted to address the tax challenges that stem from the digital economy, Pillar One considers the allocation of taxing rights to income generated from cross-border activities. In its prior statements, the OECD floated three possible approaches to income allocation: (1) a user-participation approach (which would tax businesses in jurisdictions where their users are located, regardless of those companies' physical presence); (2) a marketing-intangibles approach (which would tax businesses in the jurisdictions where they reach consumers or users); and (3) a significant-economic-presence approach (which would determine nexus based on the location of a business's revenue sources). The unified approach is the OECD's attempt to combine these approaches into a workable tax regime. As such, it represents the OECD Secretariat's view of what is workable; it is up to the Inclusive Framework (which comprises over 130 countries) to arrive at a consensus-based solution in the next year. A consultation document on Pillar Two, which is intended to address remaining risk of profit shifting to low tax affiliates, is forthcoming later this year.

Comments on the unified approach are due no later than November 12. The public consultation meeting will be held on November 21 and 22 at the OECD Conference Centre in Paris.

Which Businesses Would Be Subject to the New Regime?

While the precise contours of the universe of affected taxpayers remain blurry, the consultation document reflects progress on this threshold issue. The OECD's consultation document says that the unified approach is "focused on large consumer-facing businesses," which it broadly defines as "businesses that generate revenue from supplying consumer products or providing digital services that have a consumer-facing element." As used in this context, the term "consumer" refers to individuals who "acquire or use goods or services for personal purposes," and includes individuals that use digital services. The unified approach thus applies more broadly than the digital taxes of France or other countries, but it does not cover industries that do not generate revenues from supplying goods or services used by consumers. The consultation document also contemplates a size threshold for businesses that will be subject to the new regime, suggesting perhaps the "€750 million revenue threshold used for country-by-country reporting requirements" is workable. The stakes are high in making any determination about whether a business (or, for those multinational enterprises (MNEs) with multiple business lines, whether each distinct business line) falls within the scope.

The OECD is clearer about which MNEs will be categorically excluded. The consultation document explicitly excludes extractive industries and commodities (*e.g.*, oil and gas businesses). And it proposes further discussion about whether other sectors, like financial services, may also be carved out.

Which Jurisdictions May Tax Those Businesses?

For businesses within the scope, the unified approach adopts a nexus rule that will use a revenue threshold to determine whether a business has "sustained and significant involvement in that jurisdiction," regardless of whether it has physical presence in that jurisdiction. But in applying that revenue threshold, the OECD anticipates looking beyond the jurisdictions "in which the relevant revenues are booked" to activities like online advertising that is "directed at non-paying users" in other jurisdictions. The OECD contemplates that this nexus rule will apply *in addition to* the permanent establishment rule, meaning that the unified approach can only increase the number of MNEs that are subject to tax in a given jurisdiction (and will not strip any jurisdiction of the right to tax MNEs that it already taxes). This tax nexus rule would be incorporated in an independent article of tax treaties.

How will the New Tax Regime Work?

The OECD's unified approach contemplates a mechanism under which affected MNEs determine their taxable income within a market in three distinct calculations. An in-scope MNE would first determine its "deemed residual profit" for the group based on consolidated financial results. This "Amount A" is meant to represent the MNE's deemed residual profit after allocating routine returns to the jurisdictions where the MNE performs business activities. The unified approach contemplates that the MNE would pay tax on a portion of this Amount A to the market jurisdictions where it has nexus (under the new nexus rule or otherwise) and that portion of the deemed residual profit would be allocated among those jurisdictions using "a formula based on sales." If there are no deemed residual profits, then it appears that the new nexus and attendant profit allocation rules generally will not apply.

For those jurisdictions where the MNE has a physical presence, the MNE would compute an "Amount B" that represents returns on its "baseline functions" (*e.g.*, marketing and distribution) in those jurisdictions. The OECD contemplates that Amount B would be taxed under the existing rules that determine nexus using physical presence and pricing under the arm's-length principle. The OECD warns, however, that because of the "large number of tax disputes related to distribution functions," the OECD may entertain "the possibility of using fixed remunerations" to price those functions.

Finally, the OECD anticipates that some market jurisdictions may lay claim to functional returns in excess of Amount B where an MNE performs "more functions in the market jurisdiction than have been accounted for" in Amount B. Those increased allocations for an "Amount C" would be based on existing transfer-pricing rules under which returns to activities are subject to tax where they are performed. But levying a tax on such an Amount C may add another layer of tax to some portion of the amount already taxed as Amount A, so the OECD provides that such an Amount C would have to be subject to "legally binding and effective dispute prevention and resolution mechanisms." These dispute prevention and resolution mechanisms are intended to ensure that taxpayers are not subject to double taxation, but it is not clear whether they would apply beyond the scope of the taxpayers subject to the new nexus and income allocation rules.

What Would It Take to Move This Forward?

Technical implementation issues in the OECD's unified approach abound. The OECD recognizes that the new taxing right should be both simple and fair, but those goals are rarely aligned. For instance, while the OECD may consider it fair to apply some of these rules—like the rules related to scope and the determination of deemed residual profit—on the basis of business line or geographic segmentation, any such segmentation would necessarily introduce complexity. Moreover, the OECD acknowledges that collection may be a challenge where the businesses subject to the tax have no physical presence in the market jurisdiction. The unified approach therefore posits that a withholding tax for Amount A may be appropriate. And the OECD is continuing work on addressing other issues, such as how losses will be treated under the unified approach and how to determine the location of sales.

The OECD posed several questions for which it is actively seeking comments, including: (1) whether there should be additional business carve outs; (2) how the unified approach should relieve MNEs from double taxation "on an individual-entity and individual-country basis;" and (3) how to define Amounts A, B, and C. These are critical design issues.

Following the consultation, the Inclusive Framework will work to develop a consensus agreement among countries. Given the issues involved, these negotiations will involve technical and political considerations. Actual implementation would require significant changes to domestic law and the execution of legally binding international agreements or treaties.

For more information, please contact:

Steven R. Dixon, sdixon@milchev.com, 202-626-5844

Layla J. Asali, lasali@milchev.com, 202-626-5866

Rocco V. Femia, rfemia@milchev.com, 202-626-5823

Loren C. Ponds, lponds@milchev.com, 202-626-5832

Jennifer E. Maul, jmaul@milchev.com, 202-626-5804

The information contained in this communication is not intended as legal advice or as an opinion on specific facts. This information is not intended to create, and receipt of it does not constitute, a lawyer-client relationship. For more information, please contact one of the senders or your existing Miller & Chevalier lawyer contact. The invitation to contact the firm and its lawyers is not to be construed as a solicitation for legal work. Any new lawyer-client relationship will be confirmed in writing.

This, and related communications, are protected by copyright laws and treaties. You may make a single copy for personal use. You may make copies for others, but not for commercial purposes. If you give a copy to anyone else, it must be in its original, unmodified form, and must include all attributions of authorship, copyright notices, and republication notices. Except as described above, it is unlawful to copy, republish, redistribute, and/or alter this presentation without prior written consent of the copyright holder.