

Public consultation document

Secretariat Proposal for a “Unified Approach” under Pillar One

9 October 2019 – 12 November 2019



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Background

The Programme of Work (PoW) adopted by the Inclusive Framework on BEPS at its meeting of 28-29 May 2019, and approved by the G20 Finance Ministers and Leaders at their respective meetings in Japan in June 2019, provides for two pillars to be developed, on a without prejudice basis, with a consensus solution to be agreed by the end of 2020. For Pillar One, the PoW allocates work to explore the three proposals articulated so far, but recognises that for a solution to be delivered in 2020, the outlines of a unified approach would need to be agreed by January 2020. This outline will have to reduce the number of options available and bridge the remaining gaps to facilitate the task of arriving at a consensus on a unified approach to Pillar One in 2020.

Consistent with that objective and to help expedite progress towards reaching a consensus solution to Pillar One issues, the Secretariat prepared a proposed “Unified Approach”. It is built on the significant commonalities identified in the PoW, takes account of the views expressed during the March Public Consultation in Paris, and seeks to consider the different positions of the members of the Inclusive Framework. This proposal was discussed by the Task Force on the Digital Economy (TFDE) at its meeting on 1 October 2019 and is now released to the public for comments.

Public Consultation

The public consultation meeting on the proposed “Unified Approach” to deal with Pillar One issues will be held on 21 and 22 November 2019 at the OECD Conference Centre in Paris, France. The objective is to provide external stakeholders an opportunity to provide input into the ongoing work. Another separate public consultation meeting on Pillar Two issues will be organised in December 2019, and the related public consultation document is expected to be released in early November 2019.

This consultation document describes, at a high-level, the “Unified Approach” to Pillar One proposed by the Secretariat, and seeks comments from the public on a number of policy issues and technical aspects. The comments provided will assist members of the Inclusive Framework in the development of a solution for its final report to the G20 in 2020.

Interested parties are invited to send their comments no later than **Tuesday, 12 November 2019, noon Paris time**, by email to TFDE@oecd.org in Word format (in order to facilitate their distribution to government officials). They should be addressed to the Tax Policy and Statistics Division, Centre for Tax Policy and Administration.

Please note that all comments on this public consultation document will be made publicly available. Comments submitted in the name of a collective “grouping” or “coalition”, or by any person submitting comments on behalf of another person or group of persons, should identify all enterprises or individuals who are members of that collective group, or the person(s) on whose behalf the commentator(s) are acting. Speakers and other participants at the upcoming public consultation meeting in Paris will be selected from among those providing timely written comments on this consultation document. Information on the public consultation meeting is available on the [OECD website](#).

The proposals included in this consultation document have been prepared by the Secretariat, and do not represent the consensus views of the Inclusive Framework, the Committee on Fiscal Affairs (CFA) or their subsidiary bodies.

1. Introduction

1. The tax challenges of 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.¹ Policy discussion on those challenges remains an important part of the international agenda.
2. Following a mandate by G20 Finance Ministers in March 2017, the Inclusive Framework, working through its Task Force on the Digital Economy (TFDE) delivered an Interim Report in March 2018: *Tax Challenges Arising from Digitalisation – Interim Report 2018* (the Interim Report).²
3. Conscious of the ambitious G20 time frame and the significance of the issue, the TFDE further intensified its work following the delivery of the Interim Report. Drawing on the analysis included in the Action 1 Report as well as the Interim Report, and informed by the discussions at the July 2018 and December 2018 meetings of the TFDE on a “without prejudice” basis, a number of proposals were made by delegates to the TFDE. These proposals, together with the recent discussions and comments from members of the OECD/G20 Inclusive Framework, lay the grounds for the Inclusive Framework to agree on the way forward to achieving a consensus-based solution in 2020.
4. In January 2019, the Inclusive Framework issued a short Policy Note, which grouped the proposals under consideration into two pillars.³ Pillar One, with which this document is concerned, focuses on the allocation of taxing rights and seeks to undertake a coherent and concurrent review of the profit allocation and nexus rules. Pillar One comprises the “user participation”, “marketing intangibles”, and “significant economic presence” proposals. The Policy Note stated that these proposals would entail solutions that go beyond the arm’s length principle. Pillar Two is concerned with the remaining BEPS issues.
5. As part of the continuing work, a public consultation document was released on 13 February 2019, which sought input from external stakeholders.⁴
6. On 28 May 2019, the Inclusive Framework adopted a Programme of Work to develop a consensus solution to the tax challenges raised by the digitalisation of the

¹ OECD (2015), *Addressing the Tax Challenges of the Digital Economy*, Action 1 – 2015 Final Report, OECD/G20 Base Erosion and Profit Shifting Project, OECD Publishing, Paris.

² OECD (2018), *Tax Challenges Arising from Digitalisation – Interim Report 2018*, Inclusive Framework on BEPS, OECD/G20 Base Erosion and Profit Shifting Project, OECD Publishing, Paris.

³ *Addressing the Tax Challenges of the Digitalisation of the Economy – Policy Note*, as approved by the Inclusive Framework on BEPS on 23 January 2019, OECD 2019, accessible at www.oecd.org/tax/beps/policy-note-beps-inclusive-framework-addressing-tax-challenges-digitalisation.pdf

⁴ Public Consultation Document, *Addressing the Tax Challenges of the Digitalisation of the Economy*, 13 February – 6 March 2019.

economy.⁵ This was subsequently endorsed by G20 Finance Ministers at their meeting in Fukuoka on 8-9 June 2019, and by G20 Leaders in Osaka on 28-29 June 2019. The Programme of Work is a critical step towards responding to the request from the G20 to find and agree a consensus solution by the end of 2020.

7. The Programme of Work highlighted the commonalities of the three proposals presented to the TFDE to facilitate a consensus solution on Pillar One. It also identified various technical issues that need to be addressed and allocated this work to different working parties. However, the Programme of Work emphasised the necessity to agree on the outline of the architecture of a unified approach by January 2020, given the goal of arriving at a consensus solution by the end of 2020. It also acknowledged that without bridging the gaps between the three proposals, it will not be possible to deliver such a solution, which may in turn encourage more jurisdictions to adopt uncoordinated unilateral tax measures, including measures that tax gross revenues. Any such occurrence would undermine the relevance and sustainability of the international tax framework, and would damage global investment and growth.

8. As highlighted in the Programme of Work, the stakes are very high. In the balance are: the allocation of taxing rights between jurisdictions; fundamental features of the international tax system, such as the traditional notions of permanent establishment and the applicability of the arm's length principle; the future of multilateral tax co-operation; the prevention of aggressive unilateral measures; and the intense political pressure to tax highly digitalised MNEs.

9. In recent months, in light of the high stakes and the need for a clear direction, the Secretariat has undertaken extensive consultations to develop a "Unified Approach" which is outlined in this document. This document also aims to illustrate its application through an example.

2. A "Unified Approach" – the Secretariat's Proposal

10. The three alternatives set out in the Programme of Work 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.

⁵ OECD (2019), *Programme of Work to Develop a Consensus Solution to the Tax Challenges Arising from the Digitalisation of the Economy*, OECD/G20 Inclusive Framework on BEPS, OECD, Paris.

11. There are nevertheless gaps between the proposals. As noted, the focus on digital businesses varies, with the user participation proposal making specific reference to such businesses and the marketing intangibles proposal operating more broadly and not referring explicitly to digital businesses.

12. The nature of the reallocation of taxing rights also differs between the proposals, with the marketing intangibles and user participation proposals reallocating a portion of non-routine profit to the user/market jurisdiction, and the significant economic presence proposal looking at all profits (routine and non-routine) as the starting point.

13. The Secretariat has sought to develop a possible new approach based on the commonalities between the three proposals, taking account of the ultimate aim of these proposals, the views expressed during consultations, as well as the need to deliver a solution that is as simple as possible.

2.1. Summary of the proposal

14. It is thus essential to design a solution that attracts support from all members of the Inclusive Framework. The Secretariat's proposal for a "Unified Approach" has been developed with this goal in mind.

15. That proposal is summarised here at a relatively general level, recognising that certain aspects still require further work. A number of implementation and administration questions also need to be addressed. However, the technical work of the Secretariat, as well as consultations with the membership, indicate that this is a viable option. It draws on the three alternatives under Pillar One and the ensuing public consultation process, and aims to identify the key features of a solution, which would include the following:

- **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.
- **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 profit⁶ 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.

16. In a digital age, the allocation of taxing rights can no longer be exclusively circumscribed by reference to physical presence. The current rules dating back to the 1920s are no longer sufficient to ensure a fair allocation of taxing rights in an increasingly globalised world. It is also true that a number of the proposals that have already been made to address highly digitalised businesses fail to capture significant parts of the digitalised economy (such as digital services and certain high-tech businesses). The Secretariat's proposal is designed to respond to these challenges by creating a new taxing right. Therefore, and consistent with all the proposals that have been made, the Secretariat proposal includes a new nexus. From this follows the need to revise the rules on profit allocation as the traditional income allocation rules would today allocate zero profit to any nexus not based on physical presence, thus rendering changes to nexus pointless and invalidating the policy intent. That in turn requires a change to the nexus and profit allocation rules not just for situations where there is no physical presence, but also for those where there is. 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.

17. The Secretariat's proposal is designed to address the tax challenges of the digitalisation of the economy and to grant new taxing rights to the countries where users of highly digitalised business models are located. However, the approach also recognises that the transfer pricing and profit allocation issues at stake are of broader relevance. It recognises that current transfer pricing rules, even in a post-BEPS environment, face challenges. 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.

18. 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

⁶ The deemed residual profit used for Amount A would be the result of simplifying conventions agreed on a consensual basis. This means that it would only seek to approximate, without precisely quantifying, the amount of residual profit of a MNE group (see below para. 30 and 35).

following sections describe the key components of the “Unified Approach” in more detail, including a number of important pending questions.

2.2. Scope

19. The allocation of a new taxing right to market jurisdictions through new nexus and profit allocation rules would recognise that in today’s globalised and increasingly digitalised economy a range of businesses can project themselves into the daily lives of consumers (including users),⁷ interact with their consumer base and create meaningful value without a traditional physical presence in the market. These features could be said to be relevant for any business, but they are most relevant for digital centric businesses which interact remotely with users, who may or may not be their primary customers, and other consumer-facing businesses for which customer engagement and interaction, data collection and exploitation, and marketing and branding is significant, and can more easily be carried out from a remote location. This would include highly digitalised businesses which interact remotely with users, who may or may not be their primary customers, as well as other businesses that market their products to consumers and may use digital technology to develop a consumer base.

20. This supports the idea that the proposed “Unified Approach” should be focused on large consumer-facing businesses, broadly defined, e.g. businesses that generate revenue from supplying consumer products or providing digital services that have a consumer-facing element. It would also suggest that some sectors (for example, extractive industries and commodities) would be carved-out. Further discussion should take place to articulate and clarify this scope, including consideration of how a consumer-facing business might be defined and how the concepts of consumer products or consumer sales would deal with the supply of goods and services through intermediaries, the supply of component products and the use of franchise arrangements. Further discussion should also take place to consider whether other sectors (e.g. financial services) should also be carved out, taking into account the tax policy rationale as well as other practicalities. Such discussion should also include consideration of size limitations, such as, for example, the €750 million revenue threshold used for country-by-country reporting requirements.

2.3. A new nexus rule for the taxpayers in the scope

21. Currently, in a jurisdiction a non-resident company is taxable on its business profits only if it has a permanent establishment there. That means having some form of physical presence. Digitalisation has strained the applicability of this rule as companies can increasingly do business with customers in a jurisdiction without having a physical presence there. This is particularly true of the remote sales of highly digitalised businesses, whose activities have called into question the relevance of the existing physical presence rules – not least in the minds of the public and politicians.

22. In an increasingly digitalised economy, and perhaps beyond today’s business models, it seems likely that large businesses will conduct more and more consumer-facing and/or user-facing activities from a remote location, with no or minimal physical presence

⁷ The term “consumer” generally refers to individuals who acquire or use goods or services for personal purposes (i.e. outside the scope of a professional or business activity), while the term “customer” generally includes all recipients of a good or service (including business customers that are not end-users).

in the market. The new nexus rule would address this issue by being applicable in all cases where a business has a sustained and significant involvement in the economy of a market jurisdiction, such as through consumer interaction and engagement, irrespective of its level of physical presence in that jurisdiction. The simplest way of operating the new rule would be to define a revenue threshold in the market (the amount of which could be adapted to the size of the market) as the primary indicator of a sustained and significant involvement in that jurisdiction. The revenue threshold would also take into account certain activities, such as online advertising services, which are directed at non-paying users in locations that are different from those in which the relevant revenues are booked. This new nexus would be introduced through a standalone rule – on top of the permanent establishment rule – to limit any unintended spill-over effect on other existing rules.

23. The intention is that a revenue threshold would not only create nexus for business models involving remote selling to consumers, but would also apply to groups that sell in a market through a distributor (whether a related or non-related local entity). This would be important to ensure neutrality between different business models, and capture all forms of remote involvement in the economy of a market jurisdiction.

2.4. New and revised profit allocation rules

24. Once it is determined that a country has a right to tax profits of a non-resident enterprise, the next question is how much profit the rules allocate to that jurisdiction. This matter is currently answered by Article 7 (Business Profits) of both the OECD and United Nations Model Tax Conventions.

25. In the case of a resident enterprise transacting with its own affiliates, countries have taxing rights over the profits of that enterprise in accordance with Article 9 (Associate Enterprises).

26. While Articles 7 and 9 are a common feature of substantially all tax treaties, there is greater variation in the terms of Article 7. But most importantly, a large proportion of tax disputes for large MNE groups are about the interpretation and practical application of those articles, and this is particularly true for marketing and distribution activities.

27. As noted, 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. Therefore, new profit allocation rules are required for Amount A.

28. As recognised in the Policy Note issued by the Inclusive Framework in January 2019, the new profit allocation rules would go beyond the arm's length principle and beyond the limitations on taxing rights determined by reference to a physical presence, two principles generally accepted as cornerstones of the current rules. At the same time, while a number of criticisms of the arm's length principle have been voiced, there is a recognition that the current rules work reasonably well for most routine transactions. Therefore, 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.

29. The new rules, taken together with existing transfer pricing rules, will need to deliver the agreed quantum of profit to market jurisdictions and do so in a way that is simple, avoids double taxation, and significantly improves tax certainty relative to the

current position. It is also important that the new rules are reconciled with existing rules. That is, the new rules should not create distortions and should be effectively applicable to both profits and losses.

30. Against that background, the “Unified Approach” proposes the following three tier mechanism:

Amount A – A new taxing right for market jurisdictions over a portion of within the scope MNE groups’ deemed residual profit. This could potentially be calculated on a business line basis. In broad terms, this deemed residual profit would be the profit that remains after allocating what would be regarded as a deemed routine profit on activities to the countries where the activities are performed. This would be determined by simplifying conventions, and require the determination of the level of the deemed routine profit and also a decision on the proportion of the deemed residual profit that should go to the market, which in turn would be allocated to particular markets meeting the new nexus rule through a formula based on sales. Percentages remain to be determined and would be part of the consensus-based agreement among Inclusive Framework members.

Amount B – Activities in market jurisdictions, and in particular distribution functions, would remain taxable according to existing rules (e.g. transfer pricing under the arm’s length principle and permanent establishment allocation under Article 7). However, given the large number of tax disputes related to distribution functions, the possibility of using fixed remunerations would be explored, reflecting an assumed baseline activity. Appropriate and negotiated fixed returns could provide certainty to both taxpayers and tax administrations, and reduce the dissatisfaction with the current transfer pricing rules.

Amount C – Any dispute between the market jurisdiction and the taxpayer over any element of the proposal should be subject to legally binding and effective dispute prevention and resolution mechanisms. This would include those cases where there are more functions in the market jurisdiction than have been accounted for by reference to the local entity’s assumed baseline activity (which is subject to the fixed return in B above), and that jurisdiction seeks to tax an additional profit on those extra functions in accordance with the existing transfer pricing rules.

31. There is a more detailed discussion of the proposed approach to profit allocation in the Appendix to this document.

2.5. Pending key questions

32. A number of the areas in which further work would be required are already covered by the Programme of Work. These include work on the possible use of business line or regional segmentation, issues and options in connection with the treatment of losses, and the challenges associated with the determination of the location of sales. Some of this work is already underway.

Differentiation for business models

33. It is recognised that some jurisdictions wish to explore the possibility of applying mechanisms to reflect some degree of potential digital differentiation, or some kind of weighting in the amount of profit that would be re-allocated to market jurisdictions, whether under Amount A or by adapting the approach to Amounts B and C. The merits and

viability of any such approach (including possible options to deliver this result) would therefore have to be explored.

Definitions and quanta

34. The proposal raises certain additional issues on which technical work would be required, such as the definition of activities under Amount B or possible variations in the design of Amount A.

35. Similarly, agreeing multilaterally on the scale or amount of profits reallocated to market jurisdictions (in particular Amount A) will be an essential aspect of the “Unified Approach”. The amount of profits to be reallocated would be determined by simplifying conventions and will be informed by an impact assessment of the “Unified Approach”. However, the choice of this amount will ultimately be the result of a political agreement that needs to be acceptable to all members of the Inclusive Framework, small and large, developed and developing.

Elimination of double taxation

36. Because the existing domestic and treaty provisions relieving double taxation apply to multinational enterprises on an individual entity and individual country basis, the implementation of the proposed approach would require the identification of the member(s) of an MNE group that should be treated as owning the taxable profit in such market jurisdictions under Amount A (e.g. entity(ies) with high profitability, entity(ies) owning certain intellectual property (IP)). In particular, it will be important to explore to what extent identifying the relevant taxpayers and the relevant profit to be reallocated would allow existing mechanisms for eliminating double taxation to continue to operate effectively. This would involve how domestic and treaties rules to relieve double taxation could operate under the “unified approach”.

37. In addition, approaches to address any risk of double counting or duplications between the three possible types of taxable profit (Amounts A, B and C) that may be allocated to a market jurisdiction would need to be considered, in particular interactions between the new taxing right under Amount A and current profit allocation rules. Similarly, specific rules would need to be considered for the treatment of losses under Amount A (e.g. claw-back or “earn out” mechanism).

Other implementation issues

38. An important objective in the implementation of the “Unified Approach” would be to strike a balance between keeping the compliance and administrative burdens as low as possible, while ensuring that taxpayers fulfil their new obligations.

39. Where the tax liability for Amount A is assigned to an entity that is not a resident of the taxing jurisdiction, enforcement and collection could be more complex. It is worth exploring whether a withholding tax would be an appropriate mechanism for the collection of the designated Amount A. However, if countries choose to use it (and as an administrative mechanism to simplify and assure the collection of an underlying taxing right, it would be a matter for domestic law) it would be necessary to agree the features of the system of withholding that jurisdictions could commit to apply.

40. Any proposal seeking an allocation of taxing rights over a portion of a non-resident enterprise’s business profits in the absence of physical presence, and computed other than in accordance with the arm’s length principle, would require changes to existing tax

treaties. Different approaches could be envisaged to streamline the implementation of these changes and these options would need to be further assessed as part of the Programme of Work. More fundamentally, however, the re-allocation of taxing rights raises important political considerations. A crucial one is that these changes would need to be implemented simultaneously by all jurisdictions, to ensure a level playing field.

3. Illustration

3.1. Facts

41. The facts are as follows:

- Group X is an MNE group that provides streaming services. It has no other business lines. The group is highly profitable, earning non-routine profits, significantly above both the market average and those of its competitors.
- P Co (resident in Country 1) is the parent company of Group X. P Co owns all the intangible assets exploited in the group's streaming services business. Hence, P Co is entitled to all the non-routine profit earned by Group X.
- Q Co, a subsidiary of P Co, resident in Country 2, is responsible for marketing and distributing Group X's streaming services.
- Q Co sells streaming services directly to customers in Country 2. Q Co has also recently started selling streaming services remotely to customers in Country 3, where it does not have any form of taxable presence under current rules.

3.2. Application of the “Unified Approach” where a group has a taxable presence in the market jurisdiction (country 2)

42. In Country 2, Group X already has a taxable presence in the form of Q Co. This subsidiary is already contracting with and making sales to local customers.

43. Under the new taxing right (Amount A), it will be necessary to determine whether Group X has a new non-physical nexus in Country 2. For the purpose of this example, assume that Q Co makes sufficient sales in Country 2 to meet the revenue threshold. This would give Country 2 the right to tax a portion of the deemed non-routine profits of Group X (Amount A). Country 2 may tax that income directly from the entity that is treated as owning the deemed non-routine profit (in this example, P Co), with the possibility of Q Co held jointly liable for the tax due to facilitate administration. Relief from double taxation would be provided once P Co claims a foreign tax credit or an exemption in Country 1.

44. Q Co would be the taxpayer for the only applicable fixed return for baseline marketing and distribution activities (Amount B). Transfer pricing adjustments would be made to transactions between P Co and Q Co to eliminate double taxation.

45. Finally, if Country 2 considers that Q Co should have additional profits taxed under the arm's length principle because its activities go beyond the baseline activity assumed in the fixed return arrangement for marketing and distribution activities (Amount C), Country 2 would be subject to robust measures to resolve disputes and prevent double taxation.

3.3. Application of the “Unified Approach” where a group does not have a taxable presence in the market jurisdiction (country 3)

46. In Country 3, Group X does not have a taxable presence under existing rules. However, Q Co is making remote sales in the country.
47. Under the new taxing right (Amount A), it will be necessary to determine whether Group X has a non-physical nexus in that jurisdiction. For the purpose of this example, assume that Group X makes sufficient sales in Country 3 to meet the revenue threshold.
48. This would give Country 3 the right to tax a portion of the deemed non-routine profits of Group X (Amount A). Country 3 may tax that income directly from the entity that is treated as owning the non-routine profit (i.e. P Co), with P Co being held to have a taxable presence in Country 3 under the new nexus rules.
49. As, under current rules, Group X does not have an in-country presence in Country 3 (branch or subsidiary), Amount B would not apply.

Appendix – Detailed proposal on profit allocation

50. The way to address profit allocation under the proposed “Unified Approach” described in outline earlier in this paper proposes three possible types of taxable profit that may, according to the circumstances in any particular case, be allocated to a market jurisdiction (which, in some instances, is the location of the user). The three types of profit are described further below. The new taxing right (through the profit that is referred to here as Amount A) would generally increase the amount of business profit allocated to market jurisdictions, including in the absence of physical presence. Importantly, the second and third type of profit (Amounts B and C) would apply only by reference to the presence of a traditional nexus in the market jurisdiction (a subsidiary or permanent establishment), and not in the case of a taxable presence resulting from the application of the new non-physical nexus rule (which would give rise to Amount A). A strong emphasis on dispute prevention and resolution is integral to each of the three types of profit that make up the proposed new profit allocation rules.

Amount A

51. The first type of profit, Amount A, would reallocate a portion of the deemed residual profit of a multinational business (on a group or business line basis) to market jurisdictions irrespective of the location and/or residence of that business, consistent with the creation of a new nexus unconstrained by physical presence requirements. The deemed residual profit would represent the profit that remains after designating a deemed routine profit on the activities of the group or business line. This reallocation would specifically address the concerns raised by the remote and non-physical participation of some businesses in the economy of a market jurisdiction, and the question of how taxing rights on income generated from cross-border activities in the digital age are allocated. Similar to existing profit allocation rules, it would have effective application to both profits and losses, but specific rules may be considered for the treatment of losses (e.g. claw-back or “earn out” mechanism).

52. In broad terms, this approach would replicate features of both the residual profit split (RPS) method (by introducing a threshold based on profitability to exclude the remuneration of routine activities) and the fractional apportionment method (by relying on formula-based calculations). This combination presents two main advantages that contribute to the practicability of the proposal. First, it would permit the isolation of the deemed non-routine profits earned by a business. This is important because, by introducing a threshold based on profitability and targeting deemed non-routine profit, the proposed method is designed to materially limit the disruption of the conventional transfer pricing that is applied to routine activities. This would reduce the practical complexity of the proposal and also facilitate the goal of reaching consensus among the members of the Inclusive Framework (on the basis that no jurisdiction would be required to give up taxing rights over income generated by routine business activity physically located within its jurisdiction). Second, the use of simplified conventions would facilitate the administration of the new profit allocation approach alongside the current transfer pricing rules and reduce the scope for disputes – a feature contemplated by all Pillar One proposals.

53. The starting point for the determination of Amount A would be the identification of the MNE group's profits. The relevant measure of profits could be derived from the consolidated financial statements⁸ under the accounting standards of the headquarters jurisdiction prepared in accordance with the Generally Accepted Accounting Principles (GAAP) or the International Financial Reporting Standards (IFRS). The advantages of such an approach are that consolidated financial statements are (1) normally readily available and (2) not easily manipulated. To better approximate a proxy of residual profit, further consideration will need to be given to the appropriate measure of profits and also to potential standardised adjustments to the reported profit (as *per* the consolidated financial accounts). In addition, the fact that the profitability of an MNE group can vary substantially across business lines, regions or markets suggests that the relevant measure of profits may need to be determined on a business line and/or regional/ market basis. Otherwise, in the case of a business that combines a low-margin retail business line with a high-margin cloud-computing business line, distortions would arise that could benefit jurisdictions where the retail sales are concentrated, at the expense of jurisdictions where cloud-computing sales occur. This would also reduce the incentives the new taxing right may create for businesses to restructure. While this could create challenges, some assistance could be available from the fact that existing financial accounting reporting standards⁹ generally require publicly listed companies to disclose certain financial information by operating segments, which are typically based on business line and/or region, though this would clearly need further consideration. The task of determining the required data and documentation under the proposed approach would form part of the overall package of work.

54. The second step in calculating Amount A would seek to approximate the remuneration of the routine activities based on an agreed level of profitability. In broad terms, these are profits which, by analogy to the residual profit split method, would be regarded as rewarding routine functions. They are accordingly excluded from the calculation of the pool of profits from which the allocation to market jurisdictions would be made. The level of profitability deemed to represent such "routine" profits could be determined using a variety of approaches, but a simplified approach would be to agree a fixed percentage(s), possibly with variances by industry.

55. This simplified approach may be illustrated by an example. Assume that the proportion of profits to revenues (i.e. profit margin), derived from the consolidated financial statements as suggested above, is $z\%$. A portion of that percentage may be regarded as representing routine profits. If that portion is $x\%$, then $x\%$ would be ignored for the purposes of the calculation of the profits reallocated to market jurisdictions, with only the excess ($z\%-x\%$) being the subject of further consideration. In the discussion below, that excess is assumed to be $y\%$.

56. The completion of this step would not be intended to disturb the actual allocation of the remuneration derived from actual routine activities under the current transfer pricing framework. Instead, the purpose of the simplifying conventions would be merely to simplify the calculation of the deemed non-routine profit subject to the new taxing right.

⁸ For a definition of the term "*consolidated financial statements*" see OECD (2015), Transfer Pricing Documentation and Country-by-Country Reporting, Action 13 - 2015 Final Report, OECD/G20 Base Erosion and Profit Shifting Project, OECD Publishing, Paris, p. 40.

⁹ For instance, IFRS and the US GAAP.

57. Once profits in excess of the stipulated level of profitability are deemed to be the group's non-routine profits, it is then necessary to determine the split of those deemed non-routine profits between the portion that is attributable to the market jurisdiction and the portion that is attributable to other factors such as trade intangibles, capital and risk, etc. This is important as non-routine profit generated by MNE groups is attributable to many activities including those not targeted by the new taxing right. For example, a social media business may generate non-routine profit from its customers' data and valuable brand, but also from its innovative algorithms and software.

58. Given the practical difficulties of using conventional transfer pricing rules for this step, the proposed approach assumes that a share of the deemed non-routine profit attributable to the market jurisdiction would be determined in accordance with a simplifying convention, such as non-routine profit multiplied by an internationally-agreed fixed percentage, though it is possible that different percentages might be applied to different industries or business lines.

59. Returning to the example above, if the profit margin is $z\%$ from which $x\%$ is deducted on the basis that it represents the deemed routine profits, then the balance, assumed to be $y\%$, would be regarded as representing the group's deemed non-routine or residual profits. Under this third step, the amount of the non-routine profits – the $y\%$ – would then need to be allocated between the profits attributable to market jurisdictions (assumed here to be $w\%$) and the profits attributable to other factors such as trade intangibles (assumed here to be $v\%$). Again, a crucial aspect of the "Unified Approach" would be to determine and agree the method through which $w\%$ is determined, and whether this percentage should vary by industry.

60. The final step of the proposed approach would be to allocate the relevant portion of the deemed non-routine profit ($w\%$ in the above example) among the eligible market jurisdictions. This allocation should be based on a previously agreed allocation key, using variables such as sales. The selected variables would seek to approximate the appropriate profit due to the new taxing right.

61. An important aspect of this approach would be to determine the level of profitability to be taken as representing "routine" profits and also determine the portion or percentage of the deemed non-routine profit that should go to the market jurisdictions, through an allocation key based on sales. The level of profitability and the split of the non-routine profits could be determined using a variety of approaches, but, as illustrated in the discussion above, a simplified approach could be to agree on a formula through the application of fixed percentages, possibly with variances by industry.

Amount B

62. The second type of profit would seek to establish a fixed return (or fixed returns, varying by industry or region) for certain "baseline" or routine marketing and distribution activities taking place in a market jurisdiction. The fixed return under Amount B would seek to reduce disputes in this area, where tensions are important as a result of applying the transfer pricing rules. The intention would be to benefit taxpayers and tax administrations, as it would reduce the risk of double taxation as well as the substantial compliance costs arising from the aggressive enforcement of current transfer pricing rules.

63. Whilst the distinction between marketing and distribution activities and others performed by an MNE group will, in most cases, be clear, there will be some borderline issues. Therefore, a clear definition of the activities that qualify for the fixed return would

be required. The quantum of the fixed return could be determined in a variety of ways: it could be (1) a single fixed percentage; (2) a fixed percentage that varied by industry and/or region; or (3) some other agreed method.

Amount C

64. Taxpayers and tax administrations would retain the ability to argue that the marketing and distribution activities taking place in the market jurisdiction go beyond the baseline level of functionality and therefore warrant a profit in excess of the fixed return contemplated under Amount B, or that the MNE group or company perform other business activities in the jurisdiction unrelated to marketing and distribution. In either case an additional profit – Amount C – would be due where this is supported by the application of the arm's length principle, though this would require robust measures to resolve disputes and prevent double taxation. In this context (as well as in relation to any element of the proposal where a tax dispute arises in the market jurisdiction), it would be essential to consider existing and possible new approaches to dispute prevention and resolution, including mandatory and effective dispute prevention and resolution mechanisms to ensure the elimination of protracted disputes and double taxation.

65. In relation to Amount C, it would also be important to ensure that the profit under Amount A could not (whether in whole or part) be duplicated in the market jurisdiction, for example based on an argument that some or all of the profit under Amount A is also in some way referable to the functional activity in the market jurisdiction which is rewarded by Amount C. Further work on certain aspects of the detailed interaction of Amounts A and C would therefore be warranted.

Questions for public comments

Commentators' views are requested on the policy, technical and administrability issues raised by the proposal described above. In particular, comments are specifically requested on the following questions:

1. **Scope.** Under the proposed “Unified Approach”, Amount A would focus on, broadly, *large consumer* (including *user*) *facing businesses*. What challenges and opportunities do you see in defining and identifying the businesses in scope, in particular with respect to:
 - a. their interaction with consumers/users;
 - b. defining the MNE group;
 - c. covering different business models (including multi-sided business models) and sales to intermediaries;
 - d. the size of the MNE group, taking account of fairness, administration and compliance cost; and
 - e. carve outs that might be formulated (e.g., for commodities)?
2. **New nexus.** Under the proposed “Unified Approach”, a new nexus would be developed not dependent on physical presence but largely based on sales. What challenges and opportunities do you see in defining and applying a new nexus, in particular with respect to:
 - a. defining and applying country specific sales thresholds; and
 - b. calibration to ensure that jurisdictions with smaller economies can also benefit?
3. **Calculation of group profits for Amount A.** The starting point for the determination of Amount A would be the identification of the MNE group's profits. The relevant measure could be derived from the consolidated financial statements. In your view, what challenges and opportunities arise from this approach? Please consider in particular:
 - a. what would be an appropriate metric for group profit;
 - b. what, if any, standardised adjustments would need to be made to adjust for different accounting standards; and
 - c. how can an approach to calculating group profits on the basis of operating segments based on business line best be designed? Should regional profitability also be considered?
4. **Determination of Amount A.** In determining Amount A, the second step would exclude deemed routine profits to identify deemed residual profits. The final step would allocate a portion of the deemed residual profits (Amount A) to market jurisdictions based on an agreed allocation key (such as sales). In your view, what challenges and opportunities arise from this approach?

5. **Elimination of double taxation in relation to Amount A.** What possible approaches do you see for eliminating double taxation in relation to Amount A, considering that the existing domestic and treaty provisions relieving double taxation apply to multinational enterprises on an individual-entity and individual-country basis? In particular, which challenges and opportunities do you see in:
 - a. identifying relevant taxpayer(s) entitled to relief;
 - b. building on existing mechanisms of double tax relief, such as tax base corrections, tax exemptions or tax credits; and
 - c. ensuring that existing mechanisms for eliminating double taxation continue to operate effectively and as intended.
6. **Amount B.** Given the large number of tax disputes related to distribution functions, Amount B of the “Unified Approach” seeks to explore the possibility of using fixed remunerations, reflecting an assumed baseline activity. What challenges and opportunities does this approach offer in terms of simplification and prevention of dispute resolution? In particular, please consider any design aspects and existing country practices that could inform the design of Amount B, including:
 - a. the need for a clear definition of the activities that qualify for the fixed return; and
 - b. a determination of the quantum of the return (e.g., single fixed percentage; a fixed percentage that varied by industry and/or region; or some other agreed method).
7. **Amount C/dispute prevention and resolution.** In the context of Amount C of the “Unified Approach”, what opportunities do existing and possible new approaches to dispute prevention offer to reduce disputes and resolve double taxation? In particular, what are your experiences with existing prevention and resolution mechanisms such as:
 - a. (unilateral or multilateral) APAs;
 - b. ICAP; and
 - c. mandatory binding MAP arbitration?