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Global Tax Alert

OECD workplan envisions global agreement on new rules for taxing multinational enterprises

Executive summary

On 31 May 2019, the Organisation for Economic Co-operation and Development (OECD) released its document *Programme of Work to Develop a Consensus Solution to the Tax Challenges Arising from the Digitalisation of the Economy* (the Workplan).

The Workplan describes the planned approach for addressing the tax challenges of the digitalization of the economy that has been agreed upon by the 129 jurisdictions participating in the OECD/G20 Inclusive Framework on Base Erosion and Profit Shifting (BEPS). The Workplan was approved at the 28-29 May plenary meeting of the BEPS Inclusive Framework, which brought together 289 delegates from 99 member countries and jurisdictions and 10 observer organizations. The Workplan will be presented by OECD Secretary-General Angel Gurría to G20 Finance Ministers for endorsement during their 8-9 June ministerial meeting in Fukuoka, Japan.

Under the Workplan, an outline of the architecture of a long-term solution to address the challenges of the digitalization of the economy is to be submitted to the Inclusive Framework for agreement in January 2020. Work will continue to flesh out the policy and technical details of the solution throughout 2020 to deliver consensus agreement on new international tax rules by the end of 2020.

Building a better working world

The Workplan acknowledges that this is an extremely ambitious timeline due to what it describes as "the need to revisit fundamental aspects of the international tax system." The Workplan states that this reflects the "political imperative" that the participating jurisdictions attach to timely resolution of the issues at stake.

Detailed discussion

Background

Following a Policy Note released in January 2019,[1] the Public Consultation Document *Addressing the Tax Challenges of the Digitalisation of the Economy* released in February 2019,[2] and the public consultation held in Paris on 13 and 14 March 2019,[3] the Inclusive Framework has continued to develop the proposals presented earlier under the two Pillars used to organize the ongoing work:

- **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 with a view to assigning additional taxing rights to market jurisdictions.
- **Pillar Two**: focuses on what is described as the remaining BEPS issues and seeks to develop a global anti-base erosion proposal consisting of rules that would provide a jurisdiction with a right to "tax back" where other jurisdictions have not exercised their primary taxing rights or the payment is otherwise subject to low levels of effective taxation.

The Workplan acknowledges that there is overlap between the two Pillars that will need to be considered as the work progresses.

The Workplan is organized into five chapters:

- **Chapter I: Introduction**: provides detailed background, reviewing the OECD's work in this area to date
- **Chapter II: Revised Nexus and Profit Allocation Rules (Pillar One)**: describes a wide range of technical issues that needs to be addressed in revising the profit allocation and nexus rules
- **Chapter III: Global anti-base erosion proposal (Pillar Two)**: describes the work to be undertaken to develop rules to address the perceived continued risk of profit shifting to entities subject to no or very low taxation
- **Chapter IV: Economic analysis and impact assessment**: discusses the work to be undertaken in connection with the economic analysis required to assess the impact of the proposals
- **Chapter V: Organisation of the work to deliver the programme of work and next steps**: explains how the work under both Pillars is to be organized

Chapter II – Revised Nexus and Profit Allocation Rules (Pillar One)

As set out in the Public Consultation Document released in February 2019, Pillar One involves three alternative proposals: the "user participation" proposal, the "marketing intangibles" proposal and the "significant economic presence" proposal. The aim of these proposals is to amend the existing global international rules to recognize and tax the value created by a business's activities or participation in user/market jurisdictions.

To date, the OECD has not been able to reach agreement to narrow the three alternative Pillar One proposals down to one proposal. However, the Workplan recognizes that the long-term solution to be submitted to the Inclusive Framework in January 2020 will have to reduce the number of options to be pursued under Pillar One so that political agreement on a unified approach can be reached.

The three proposals have important differences relating to the objective and scope of the reallocation of taxing rights. However, the Workplan focuses on their common aspects with respect to allocating more taxing rights to the jurisdiction of the customer and/or user (the market jurisdiction), the finding of nexus in the absence of physical presence, and the possibility of simplifying conventions. The Workplan states that this commonality will allow the technical issues that need to be resolved under Pillar One to be grouped into three building blocks: new profit allocation rules, new nexus rules, and implementation of the new market jurisdiction taxing right.

New profit allocation rules

The new market jurisdiction taxing right requires a method to quantify the amount of profit to be reallocated to market jurisdictions, and a method to determine how that profit should be allocated among the market jurisdictions entitled to tax under the new taxing right.

The Workplan sets out three different methods – a modified residual profit split method, a fractional apportionment method, and a distribution-based approach:

- The **modified residual profit split method** (MRPS) aims to allocate part of the non-routine profit of a group to market jurisdictions through the following four-step approach:

(i) determine the total profit to be split; (ii) eliminate routine profit (either through existing transfer pricing rules or simplified conventions); (iii) assess the portion of non-routine income that is subject to the new taxing right (either through existing transfer pricing rules or simplified conventions); and (iv) allocate this income to the relevant market jurisdiction through an allocation key.

The MRPS method is intended to coexist with existing transfer pricing rules. As such, additional coordinating rules will be required to manage the interactions between these rules.

- The **fractional apportionment method** does not differentiate between routine and non-routine profit to determine the allocation of profit subject to the new taxing right. The fractional approach would follow the following three-step approach: (i) determine the profit to be divided; (ii) select the appropriate allocation key; and (iii) apply this allocation key to distribute a fraction of the income to the market jurisdictions. In determining the profits to be re-allocated, the overall profitability of the group could be used, or a more traditional transfer pricing determination of the profits allocable to the defined market activity could be undertaken. The fractional apportionment method is a type of formulary apportionment approach. The Workplan notes that it will need to be determined whether the approach should be applied on an entity, group or business line basis.
- Finally, the **distribution based approach** seeks to determine the "new taxing right" in a simple and administrative manner. No distinction is made between routine and non-routine profits. Also, the profits allocated are not linked to a total amount of profits for a certain activity that has been identified. One option for this approach would be to assert a baseline profitability for the market jurisdiction, possibly increasing (note: *not* decreasing) based on the group's overall profitability or other variables to reflect market and industry specificities.

  The Workplan notes that there are a series of questions raised by this type of approach that are still to be answered, including whether the new taxing right would replace or be a floor for the current transfer pricing rules, how such adjusted profits could be applied when the group has no presence in the specific jurisdiction and whether remote activities should be allocated a lower return than locally-based marketing and distribution activities.

The application of all three of these methods would lead to a deviation from the arm's-length principle to some extent. Moreover, the selected method would only apply to the profits in scope for re-allocation. The Workplan refers to the profits in scope as the profits to be (re)allocated to the market jurisdiction, but it does not define which profits would be in scope for such re-allocation. The profits in scope could be the "user participation profits," the "marketing intangibles profits" or the "significant economic presence profits," as reflected in the Public Consultation Document. It is likely that the scope of the profits to be re-allocated will be determined in the policy dialogue between the members of the Steering Group of the Inclusive Framework. For all profits outside the scope of re-allocation, it is envisaged that the traditional transfer pricing methodologies would be retained. This raises questions on the interaction between the different rules applicable to these two pools of profits.

The Workplan notes that further work will be done on how to minimize compliance costs and disputes, and to investigate scoping limitations based on the nature or size of a business. The feasibility of segmentation – per business line or region – also will be considered, as well as potential limitations on scope (by nature or size of a given business) and the treatment of losses.

New nexus rules

While the Workplan includes a fairly lengthy discussion of issues with respect to the new profit allocation rules, it provides less information on what a new nexus rule might look like.

While the concept of remote taxable presence (i.e., a taxable presence without traditional physical presence) is endorsed by the jurisdictions in the Inclusive Framework, a new set of standards for identifying when such a remote taxable presence exists still needs to be developed. In addition, the ongoing work will consider a new concept of taxable income sourced in (i.e., derived from) a jurisdiction, which would generally not be constrained by physical presence requirements.

Developing a new non-physical presence nexus rule to allow market jurisdictions to tax the measure of profits allocated to them under the new profit allocation rules would require an evaluation of the relative merits of alternative approaches, including amendments to the definition of a "permanent establishment" in Article 5 of the OECD Model Convention, and potential resulting changes to Article 7 (business profits) of the OECD Model Convention, as well as the development of a standalone rule establishing a new and separate nexus, either through a new taxable presence concept or a new concept of source.

Implementation of the new market jurisdiction taxing right

The new market jurisdiction taxing right may reallocate taxing rights with respect to a proportionate part of a group's overall profit, rather than with respect to the profits from specific transactions or activities undertaken by particular separate entities. This approach leads to series of practical questions on how source jurisdictions would exercise their taxing rights, and how relief from double taxation would be provided by the residence jurisdictions. The Workplan indicates that the ongoing work will include analyzing these questions and exploring existing treaty and domestic provisions, as well as evaluating the need to develop new provisions. It will also asses the current dispute resolution mechanisms and possibly recommend changes or enhancements.

Enforcement and collection issues will be examined, including the potential use of simplified registration-based collection mechanisms complemented by a withholding tax mechanism will be explored.

In order to apply these new rules in an effective manner, various information will need to be available. The Workplan indicates that recommendations will be developed on how to report and disseminate the information – possibly based on the same technology as is used for country-by-country reports.

Finally, any changes to the allocation of taxing rights may require modification to existing tax treaties. Different options are to be considered depending on the exact nature of the changes, with one option being an amendment or supplement to the *Multilateral Convention to Implement Tax Treaty Related Measures to Prevent BEPS* (the MLI).

Chapter III – Global anti-base erosion proposal (Pillar Two)

Under Pillar Two, the jurisdictions participating in the Inclusive Framework have agreed to continue work on a global anti-base erosion (GloBE) proposal that would, through changes to domestic law and tax treaties, provide jurisdictions with a right to "tax back" where other jurisdictions have not exercised their primary taxing rights or the payment is otherwise subject to low levels of taxation.

The GloBE proposal sets out two inter-related rules:

- An **income inclusion rule** that would tax the income of a foreign branch or a controlled entity if that income is subject to tax at an effective rate that is below a minimum rate.
- A **tax on base eroding payments** that would operate by way of the denial of a deduction or imposition of source-based taxation (including withholding tax), together with any necessary changes to double tax treaties, for certain payments unless that payment is subject to tax at or above a minimum rate.

The Workplan states that these rules are intended to advance a multilateral framework that achieves a balanced outcome, limiting the distortive impact of direct taxes on investment and business location decisions.

The Workplan makes it clear that the scope of the GloBE proposal is not limited to highly digitalized businesses.

Income inclusion rule

The income inclusion rule would operate as a minimum tax rule by requiring a shareholder in a corporation to take into account for tax purposes a proportionate share of the income of that corporation if that income is not subject to an effective rate of tax above a minimum rate. In practice, this rule could supplement a jurisdiction's Controlled Foreign Company (CFC) rules.

The Workplan indicates that the ongoing work will explore options and issues related to the design of the income inclusion rules. Specifically, the work will explore an inclusion rule that would impose:

- A "**top up to a minimum rate**" of tax where income is not taxed at least at the minimum level, with the preferred approach being the adoption of a transparent and simple global standard that sets a floor for tax rates and makes it easier to develop consistent and coordinated rules.
- A **fixed percentage** rather than a percentage of the parent company's jurisdiction's tax rate or a range of tax rates. It is recognized that the use of an approach which would be dependent on the parent company's jurisdiction's tax rate would give rise to significant variations in the rates used under the inclusion rule, which could lead to outcomes not in line with the intended policy of the GloBE.

To improve compliance and administration for both taxpayers and tax administrations, and to neutralize the impact of structural differences in the calculation of the tax base, the Workplan states that the ongoing work will explore simplifications that could serve to make the rules more transparent and help with coordination in the operation of the rules (e.g., to start with relevant financial accounting rules subject to any agreed adjustments as necessary).

The ongoing work also will explore options and issues with the design of a "switch-over" rule for tax treaties that would allow the state of residence to apply the credit method instead of the exemption method.

Tax on base eroding payments

The second element of the GloBE proposal is a tax on base eroding payments that would complement the income inclusion rule by allowing a source jurisdiction to protect itself from the risk of base eroding payments.

More specifically, this element of the proposal would include:

- An ***undertaxed payments rule*** that would deny a deduction or impose source-based taxation (including withholding tax) for a payment to a related party if that payment was not subject to tax at a minimum rate.
- A ***subject to tax rule*** in tax treaties that would complement the undertaxed payment rule by subjecting a payment to withholding tax or other taxes at source and denying treaty benefits on certain items of income where the payment is not subject to tax at a minimum rate.

The ongoing work will consider options and issues with the design of the undertaxed payment rule, including the benefits of a withholding tax instead of a deduction denial approach, the degree of overlap with the undertaxed payments rule, and whether any measures need to be included to avoid double taxation.

Rule coordination, simplification, thresholds and compatibility with international obligations

The Workplan provides that further work will be required on rule coordination, simplification measures, thresholds and carve-outs to ensure the GloBE proposal avoids the risk of double taxation, minimizes compliance and administration costs and has rules that are targeted and proportionate. In this regard, the ongoing work will address the priority in which rules are applied and how they interact with the broader international framework, such as the compatibility with international obligations (such as non-discrimination) including, for European Union (EU) Member States, the EU fundamental freedoms and how compatibility in that case could depend on the rule's detailed design.

Chapter IV – Economic analysis and impact

Following the release of the Policy Note in January 2019, the jurisdictions participating in the Inclusive Framework expressed the desire for a more in-depth analysis of the proposals under each Pillar and their interlinkages, with a particular focus on the importance of assessing the revenue, economic and behavioral implications of the proposals. Accordingly, the Workplan provides that an economic analysis and impact assessment will be carried out. This will involve an in-depth consideration of how the proposals are expected to affect the incentives faced by taxpayers and governments, their impact on the levels and distribution of tax revenues and their overall economic effects, including their effects on investment, innovation and growth. The impact assessment also will consider how these effects vary across different kinds of multinational enterprises, sectors and economies.

The analysis of the economic impacts of the proposals will draw upon the existing public finance literature and will also require new empirical research to be undertaken.

The OECD Secretariat has already done some preliminary economic analysis that was presented to the Inclusive Framework meeting in May 2019. A preliminary analysis has drawn on macro-level and micro-level data sources, including National Accounts data, Balance of Payments data, anonymized and aggregated Country-by-Country report data and the OECD ORBIS database. The Workplan provides for further Secretariat-led analysis to be shared with the jurisdictions participating in the Inclusive Framework by the end of 2019. This analysis is intended to support the Inclusive Framework jurisdictions as they continue their work throughout 2020 on the key technical decisions to be made on the design of the proposals.

One of the key questions raised by commentators during the Public Consultation in March 2019 was what information had led to the conclusion by certain jurisdictions in the Inclusive Framework that there are still BEPS concerns remaining. This question is closely linked to the impact assessment. The Workplan indicates that these jurisdictions are of the view that profit shifting is particularly acute in connection with profits relating to intangibles, prevalent in the digital economy, but also in a broader context; for instance, group entities that are financed with equity capital and generate profits, from intra-group financing or similar activities, that are subject to no or low taxes in the jurisdictions where those entities are established. It is interesting to note that these conclusions are drawn based on available sources of information that are not accessible to the public (aggregated and anonymized Country-by-Country reporting data) and that involve years prior to the Action 4 proposals on interest deductibility limitations that were being implemented by countries, and also prior to when the new transfer pricing rules (including for example the rules on hard-to-value intangibles) took effect.

Chapter V: Organization of the work to deliver the Program of Work and next steps

The Workplan sets out the separate but related workflows that will be followed to deliver on the consensus solution:

- The Steering Group of the Inclusive Framework will continue the process aimed at reaching agreement on a unified approach to addressing the issues of profit allocation and nexus under Pillar One and agreement on the key design elements of the GloBE proposals under Pillar Two.
- The working groups within the OECD will provide technical input on issues that arise during the development of a consensus-based solution as well as the preparation of final reports that will set out the details of the agreement reached by the Inclusive Framework.
- The Secretariat will conduct an economic analysis and impact assessment of the proposals under the two Pillars.

Although certain parts of the work can be advanced in parallel, the Workplan acknowledges that there will be many interactions among different aspects of the work that will have to be addressed.

The OECD working groups responsible for the substantive and policy work on the two Pillars and the impact assessment will meet in June and July and subsequently throughout the remainder of 2019 to consider relevant technical issues arising in connection with the Workplan. The Workplan contemplates that an outline of architecture of the long-term solution will be submitted to the Inclusive Framework for agreement in January 2020.

Following agreement on the architecture of the solution, work will continue on the policy and technical details throughout 2020 in order to deliver the consensus-based solution by the end of 2020. The Workplan indicates that public consultations may be held to obtain stakeholder feedback as the various proposals are refined, but does not make a firm commitment to holding any consultations during this phase of the work.

Implications

The proposals addressed in the Workplan will have implications well beyond digital businesses or digital business models. These proposals could lead to significant changes to the overall international tax rules under which multinational businesses currently operate. It is important for businesses to follow these developments closely as they unfold in the coming months.

Endnotes

1. See EY Global Tax Alert, *OECD's new insights describe growing support on comprehensive changes to international tax policy, beyond digital*, dated 29 January 2019.
2. See EY Global Tax Alert, *OECD opens public consultation on addressing tax challenges arising from digitalization of the economy: time-sensitive issue impacting all multinational enterprises*, dated 14 February 2019.
3. See EY Global Tax Alert, *OECD hosts public consultation on document proposing significant changes to the international tax system*, dated 18 March 2019.

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