

## The OECD takes next step on BEPS 2.0 - Proposal for a “unified approach” for additional market country tax

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### Executive summary

On 9 October 2019, the Organisation for Economic Co-operation and Development (OECD) released a public consultation document outlining a proposal from the OECD Secretariat for a “unified approach” under Pillar One (Secretariat Proposal) of the ongoing project titled “Addressing the Tax Challenges of the Digitalisation of the Economy” (the Consultation Document). The Secretariat Proposal does not represent the consensus view of countries that are members of the Inclusive Framework on Base Erosion and Profit Shifting (BEPS). The Secretariat Proposal provides high-level suggestions on the scope of the new rules being developed under Pillar One, an approach to the new nexus concept, and an approach for new and revised profit allocation rules. It is intended to facilitate negotiations among the countries, with the aim of achieving the objective of a political agreement among the Inclusive Framework jurisdictions by the first half of 2020.

The scope of the Secretariat Proposal for a “unified approach” covers highly digitalized business models and also non-digitalized businesses that are consumer-facing. The Secretariat Proposal includes a new nexus concept that is not dependent on physical presence and is largely based on sales. This new nexus is proposed to be separate from the existing permanent establishment concept, and it would operate regardless of whether taxpayers have an in-country marketing or distribution presence or sell through related or

unrelated distributors. In addition, the Secretariat Proposal contains a three-part approach to new and revised profit allocation rules, which would provide a formulaic approach to allocating deemed non-routine profits to market jurisdictions under the new nexus concept, a formulaic approach for a fixed return to baseline marketing and distribution activities in situations where there is nexus under existing principles, and an approach for allocating additional profit to the market jurisdiction where the local activities exceed such baseline activity. Finally, the Secretariat Proposal contemplates binding and effective dispute prevention and resolution mechanisms that would cover all three parts of the profit allocation approach.

The Secretariat Proposal acknowledges that further technical work is required and includes an annex with a series of specific questions for public comment on significant policy, technical and administrability issues.

Interested parties are invited to submit comments on the Consultation Document no later than 12 November 2019. The OECD will hold a consultation meeting in Paris on 21 and 22 November 2019 to give stakeholders an opportunity to discuss their comments with the Inclusive Framework countries.

The Consultation Document does not address the Pillar Two work on development of new global minimum tax rules. However, the OECD Secretary-General Tax Report to G20 Finance Ministers and Central Bank Governors, which was released on 9 October 2019 in advance of their 17 October 2019 meeting in Washington, notes that progress is being made on the Pillar Two work, with agreement reached on the design of new rules to operate as a top-up to a fixed minimum rate of tax that will be agreed on once other key design elements of the minimum tax rules are finalized. The OECD Secretariat has indicated that a consultation document on this topic will be released in November 2019, with a consultation meeting to be held in December 2019.

The report to the G20 also includes a brief outline of preliminary findings in the Impact Assessment of the Pillar One and Pillar Two proposals. The report indicates that the two pillars taken together are expected to result in an overall increase in global tax revenues with a redistribution of taxing rights. It further indicates that investment hubs with high levels of residual profits would be expected to see a reduction in their tax base. The report does not indicate which countries are expected to see this adverse impact.

## Detailed discussion

### Background

In October 2015, the OECD released the Final Report on Action 1 (the Action 1 Final Report), *Addressing the Tax Challenges of the Digital Economy*, together with the final reports on the other 14 elements of the Action Plan on BEPS. The Action 1 Final Report provides the OECD conclusions regarding the digital economy and recommended next steps to address the tax challenges presented by its evolution. The Action 1 Final Report states that special rules designed exclusively for the digital economy would prove unworkable, broadly stating that the digital economy cannot be ring-fenced because it “is increasingly becoming the economy itself,” and summarizes key features of evolving digital business models that the OECD considers relevant for the overall BEPS analysis. In addition, the Action 1 Final Report considers broader direct and indirect tax challenges raised by the digital economy and evaluates options to address those challenges. However, the Action 1 Final Report does not recommend any of the options analyzed and leaves it up to individual countries to introduce any of them as additional safeguards against BEPS.<sup>1</sup>

In March 2018, the OECD released a document “Tax Challenges Arising from Digitalisation – Interim Report 2018” (the Interim Report) as a follow up to BEPS Action 1. The Interim Report sets out the Inclusive Framework jurisdictions’ agreed direction of work on digitalization and the international tax rules through 2020. The Interim Report does not make any specific recommendations to countries, indicating instead that further work will need to be carried out to understand the various business models operated by enterprises offering digital goods and services, as well as digitalization more broadly. However, despite the technical complexity and the diverse positions, the Inclusive Framework jurisdictions agreed to undertake a coherent and concurrent review of the rules and achieve a consensus-based solution by 2020.<sup>2</sup>

In January 2019, the OECD released a Policy Note communicating that the renewed international discussions were going to focus on two central pillars: one pillar addressing the broader challenges of the digitalization of the economy and focusing on the allocation of taxing rights, and a second pillar addressing remaining BEPS concerns.<sup>3</sup> Following the Policy Note, the OECD released, in February 2019, a Public Consultation Document<sup>4</sup> describing the two pillar proposals at a high level, received extensive comments from stakeholders, and held a public consultation in March 2019.<sup>5</sup>

Following the public consultation, in May 2019, the OECD released the “Programme of Work to Develop a Consensus Solution to the Tax Challenges Arising from the Digitalisation of the Economy” (the Workplan). Under the timeline set forth in 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 BEPS Inclusive Framework for agreement in January 2020 and 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.<sup>6</sup>

On 9 October 2019, the OECD released a public consultation document with a proposal developed by the OECD secretariat for a “unified approach” under Pillar One. The OECD also held on the same date webcast where members of the Secretariat described the Secretariat Proposal and discussed the current status and next steps in the project.

### A “unified approach” under Pillar One

The Consultation Document states that the proposal for a “unified approach” does not represent the consensus view of the Inclusive Framework jurisdictions. The Consultation Document emphasizes that the proposed “unified approach” is a Secretariat Proposal that is intended to facilitate negotiations among the countries, with the aim of achieving the objective of a political agreement among the Inclusive Framework jurisdictions by the first half of 2020.

The Consultation Document acknowledges further work is required. In this regard, the Consultation Document includes an annex with questions for public comment on policy, technical and administrability issues.

The Secretariat Proposal builds on the alternative approaches for Pillar One described in the February 2019 Consultation Document and the commonalities among them identified in the Programme of Work, taking into account the views expressed during the March 2019 Public Consultation, the ultimate objective of these approaches, and the different perspectives of the jurisdictions participating in the Inclusive Framework.

According to the Consultation Document, the commonalities across the three alternative approaches under Pillar One (the “user participation” proposal, the “marketing intangibles” proposal and the “significant economic presence” proposal) are the following: 1) all the proposals envision a new nexus rule that would not depend on physical presence in the user/market jurisdiction; 2) all the proposals go beyond

the arm’s-length principle and depart from the separate entity principle; 3) all the proposals would reallocate taxing rights in favor of the user/market jurisdiction; and 4) all the proposals seek simplicity, administrability, and increased tax certainty through effective and binding dispute prevention and resolution mechanisms.

Drawing on these commonalities, the Secretariat Proposal is designed to grant new taxing rights to market jurisdictions. 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 there are increased tensions.

### Scope

The Secretariat Proposal suggests that a “unified approach” under Pillar One should focus on large consumer-facing businesses. This would cover highly digitalized business models and also businesses interacting with final customers. The Secretariat Proposal broadly defines large consumer-facing businesses as businesses that generate revenue from supplying consumer products or providing digital services that have a consumer-facing element. In this regard, the Secretariat Proposal notes that further work is needed to articulate the scope of the “unified approach,” including how to define a consumer-facing business and how to deal with the supply of goods and services through intermediaries, the supply of component products and the use of franchise arrangements.

Moreover, the Secretariat Proposal indicates that some sectors should be carved out, citing extractive industries and commodities in particular. It also notes that there should be further consideration of whether other sectors (e.g., financial services) should be carved out. In addition, it indicates that consideration should be given to a size-base limitation (e.g., using the BEPS Action 13 country-by-country reporting €750 million revenue threshold).

### New nexus

The Secretariat Proposal describes a new nexus concept that is not dependent on physical presence and is largely based on sales that would be separate from the existing permanent establishment concept. The new nexus would ensure that a business that has sustained and significant involvement in the economy of a market jurisdiction is taxable there, even if such a business is not physically present in that jurisdiction.

The Secretariat Proposal suggests that the simplest approach for the new nexus would be to define a revenue threshold. The revenue threshold could be adjusted depending on the size of the market jurisdiction and should take into account certain activities, such as online advertising services that are directed to non-paying users in that jurisdictions (even though the revenue related to such activity may be recorded somewhere else). The revenue threshold should also apply to groups that sell in a market through a distributor (whether a related or unrelated local entity) in order to ensure neutrality between different business models and capture all forms of remote involvement in the economy of a market jurisdiction.

Moreover, the Secretariat Proposal indicates that the new nexus should be a standalone treaty provision, operating on top of the permanent establishment rule. It is suggested that taking this approach would limit unintended spill-over effects on other existing rules.

### New and revised profit allocation rules

Once it is determined that a jurisdiction has the right to tax profits of a nonresident enterprise under the new nexus approach, the next question would be how much profit should be allocated to that jurisdiction. The Secretariat Proposal describes a new profit allocation rule that is applicable to taxpayers within the scope of the “unified approach” and that would operate regardless of whether taxpayers have an in-country marketing or distribution presence (a permanent establishment or a subsidiary) or sell through unrelated distributors.

The Secretariat Proposal suggests that the new and revised profit allocation rules, taken together with existing transfer pricing rules, will need to be simple, avoid double taxation, and significantly improve tax certainty relative to the current position. The rules should be applicable to both profits and losses in order to avoid distortions. The Secretariat Proposal for a “unified approach” under Pillar One proposes a three-tier mechanism for allocating profits.

### Three-tiered mechanism

#### *Amount A - a new profit allocation rule*

As the existing profit allocation rules could not apply where there is no nexus under existing principle, the Consultation Document puts forward a new profit allocation rule (Amount A). This new rule goes beyond the arm’s-length principle by using a formulary approach - in view of reducing complexities and facilitating the goal of obtaining a consensus.

This Amount A - which reallocates part of the deemed residual profit of a multinational enterprise (MNE) - is to be determined in a four-step process:

1. *Determination of the total profit.* Total profit is proposed to be done at the MNE level (likely on business line and/or regional/market basis) and would be derived from the consolidated financial statements under accounting standards of the headquarter jurisdiction prepared in accordance with Generally Accepted Accounting Standards (GAAP) or International Financial Reporting Standards (IFRS). The Secretariat Proposal indicates that further work would need to be done on how segmentation could apply and whether standardized profit adjustments could be applied to this accounting profit.
2. *Exclude “deemed” residual routine profit to define residual profit.* This is proposed to be done by using an agreed level of profitability - a fixed percentage - that represents profits regarded as rewarding routine functions. This percentage could vary by industry.
3. *Allocate a portion of the “deemed” residual profit to market jurisdictions,* using again a formulary approach - i.e., fixed percentage. The portion of profit that is considered attributable to factors such as trade intangibles, capital and risk, would first be excluded. The percentage of remaining deemed residual profit that would be allocated to market jurisdictions may vary per industry or business lines.
4. *Allocate the relevant portion of the deemed residual profit between market jurisdictions.* Once the amount that needs to be reallocated is determined, then this portion of the deemed residual profit would be allocated among the market jurisdictions based on a pre-agreed formulaic approach (such as sales), potentially with variances per industry.

The document also explicitly states that the new profit allocation rules would apply to both profit and losses - and indicates that specific rules may need to be considered for the treatment of losses (e.g., claw-back or earn-out mechanism).

#### *Amounts B & C - revised profit allocation rules*

While the above Amount A applies to cases where there is a new taxing right (as well as to cases with nexus under existing rules), Amounts B & C would only apply where there is already a nexus in the market jurisdiction under the existing rules.

#### ► Amount B

Under the Secretariat Proposal, a fixed return should be established for certain “baseline” or routine marketing and distribution activities in a jurisdiction, in view of reducing disputes. At this stage, the document does not provide significant level of detail on what activities are seen as “routine marketing and distribution” (and acknowledges that clear definitions will be required) and does not indicate how this fixed return would be determined – proposing the use of either a (a) single fixed percentage, or (b) fixed percentage that varies per industry and/or region or (c) another agreed method.

#### ► Amount C

Finally, under the Secretariat Proposal, where activities go beyond the baseline, or where an MNE performs other activities in a market jurisdiction (i.e., other than marketing and distribution), profit in excess of the fixed return under Amount B should be allocated to that market jurisdiction for those activities – Amount C. This should be supported based on the existing arm’s-length principle. The Consultation Document indicates that this would require robust measures to resolve disputes and prevent double taxation. New approaches to dispute prevention and resolution are to be considered, including mandatory and effective dispute prevention and resolution mechanisms.

The document also states that the interaction between Amount A and Amount C must be clearly defined to avoid a situation where profit under Amount A would be also allocated to a market jurisdiction under Amount C (due to functional activity in that jurisdiction).

### **Pillar Two and Impact Assessment**

On 9 October 2019, the OECD also released the OECD Secretary General report to the G20 Finance Ministers and Central Bankers, which provides an update on the ongoing work on this project (including the progress made on Pillar Two and the preliminary findings of the Impact Assessment) and on the OECD’s work tax transparency.

In addition to an overview of the Consultation Document on Pillar One, the report includes a brief update on the Pillar Two work, noting that progress is being made on the Pillar Two work, with agreement reached on the design of new rules to operate as a top-up to a fixed minimum rate of tax that will be agreed on once other key design elements of the minimum tax rules are finalized. According to the report, it is hoped

that some of the main features of Pillar Two can be agreed by the next meeting of the Inclusive Framework in January 2020, while a political agreement on the architecture of Pillar Two is expected in the first half of 2020.

The report also provides a brief update on the work on the Impact Assessment, which aims to measure the economic and tax revenue impact of the proposals. According to the report, the work has started but the final outcomes will depend on the design of the proposals and the behavioral responses of countries and MNEs. Nonetheless, based on a preliminary assessment it is expected that the combined effect of Pillars One and Two would be a significant increase in global tax revenues as well as a redistribution of taxing rights to market jurisdictions. Under this preliminary assessment, on average, low and middle-income economies would be expected to gain from Pillar One, experiencing a higher rate of increase in revenues than high-income economies even though larger market jurisdictions would be expected to gain more revenue in absolute terms. Investment hubs, where the analysis suggests that current levels of residual profit are high, would be expected to experience significant losses in tax base. The report further indicates that MNEs operating in digital-oriented and intangible-intensive sectors would be significantly impacted by both pillars.

### **Next steps**

Interested parties are invited to submit comments on the Consultation Document no later than 12 November 2019. The OECD will hold a consultation meeting in Paris on 21 and 22 November 2019 to give stakeholders an opportunity to discuss their comments with the Inclusive Framework countries.

On Pillar Two, the OECD expects to release a consultation document in early November 2019, be followed by a consultation meeting in December 2019.

### **Implications**

The Secretariat Proposal included in the Consultation Document does not represent the consensus views of the jurisdictions participating in the Inclusive Framework. However, the proposal was developed by the OECD Secretariat to facilitate negotiations among the countries on a “unified approach” in an effort to make progress in the coming months so that a political agreement on Pillar One can be reached in the first half of 2020. The re-allocation of

taxing rights under Pillar One has fundamental implications for the international tax framework and such changes would need to be implemented simultaneously by all jurisdictions in order to avoid double taxation.

The complex issues underlying both the Pillar One and Pillar Two proposals will continue to be the subject of both policy and technical discussions among the Inclusive Framework jurisdictions through at least 2020. The Consultation Document underscores that the international tax changes being contemplated will have implications well beyond digital businesses and digital business models. These proposals

could lead to significant changes to the overall international tax rules under which multinational businesses operate and could have important consequences in terms of businesses' overall tax liability and countries' tax revenues.

It is important for companies to follow these developments closely as they unfold in the coming months and to consider engaging with the OECD and policymakers at both national and multilateral levels on the business implications of these proposals. Companies should also begin to evaluate the potential impact of these changes on their business models.

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## Endnotes

1. EY Global Tax Alert, [OECD issues final report on the tax challenges of the digital economy under Action 1](#), dated 23 October 2015.
2. EY Global Tax Alert, [The OECD's interim report on tax challenges arising from digitalisation: An overview](#), dated 20 March 2018.
3. EY Global Tax Alert, [OECD's new insights describe growing support on comprehensive changes to international tax policy, beyond digital](#), dated 29 January 2019.
4. 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.
5. EY Global Tax Alert, [OECD hosts public consultation on document proposing significant changes to the international tax system](#), dated 18 March 2019.
6. EY Global Tax Alert, [OECD workplan envisions global agreement on new rules for taxing multinational enterprises](#), dated 3 June 2019.

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EYG no. 001196-19Gbl

1508-1600216 NY  
ED None

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