OECD releases proposal for “Unified Approach” under Pillar One for addressing taxation of the digital economy

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On October 9, 2019, the Organisation for Economic Co-operation and Development (**OECD**) issued its proposal for addressing the tax challenges of the digital economy. This proposal follows several earlier statements and documents under Action 1 of the Base Erosion and Profit Shifting initiative (“BEPS”), including a Programme of Work issued on May 28, 2019.

The proposal acknowledges that the digital economy has made it necessary to make significant changes in the traditional concept of permanent establishment based on physical presence. Further, changes are needed in the traditional methods of allocating business profits to permanent establishments based on a functional analysis of assets, activities of employees, business risks, etc.

The new proposed rules are aimed at promoting a unified approach among tax authorities and concern income taxation and not indirect taxes like value-added tax or tax imposed on goods and services. The OECD has elsewhere advocated a shift to basing indirect taxes on destination, not unlike the Wayfair decision handed down by the United States Supreme Court.

The fear of countries taking a unilateral approach to these critical issues of taxable presence (also called permanent establishment and nexus) is well-founded. France, Greece, the United Kingdom, India, Israel, Austria, Chile, the Czech Republic, Mexico, Indonesia, Italy, and others have legislation that has been either proposed or enacted to tax the digital economy. Candidates in both the Canadian and US elections have also raised taxing the digital economy as a campaign issue.

The approaches used to define permanent establishment and the tax base found in these unilateral digital taxes vary widely among these tax jurisdictions. That is precisely why the OECD is attempting to stem the tide of unilateralism with a uniform approach. Should it fail, a large portion of the current international tax system may be in jeopardy.

The OECD proposal relies on a blend of brand-new approaches and more traditional concepts. It applies to highly digital businesses like Amazon or Netflix, for instance, and customer or consumer-facing businesses. The precise contours of which market segments would be subject to the new approach were left a bit vague, likely by design, but resource-based and extractive industries would be outside the scope of these rules. This exclusion is likely because the traditional approach, based on situs, tends to work well for that sector. The blending of new and traditional methods occurs between designated Amounts A, B, and C, which we explain below.

Amount A, which introduces an approach outside traditional international tax principles, relies on the new concept of nexus or permanent establishment based on sales or economic presence. The proposal considers combining the sales of multinational groups or by business line. It proposes to look through third-party distributors, whether on a commissionaire or buy/sell basis, or marketing platforms in certain cases that remain to be determined. Segment reporting and country-by-country reporting may be helpful, but additional financial information may be necessary. The proposal considers a “revenue threshold” (perhaps the €750 million already in use in the context of country-by-country reporting) below which economic nexus would be deemed not to be present. Above the threshold, the new nexus rule would confer on the market or destination jurisdiction a new “taxing right.” That right would exist without or alongside the traditional right to tax based on physical presence.

The proposal states that the approach would require multilateral agreement on a methodology for determining the scale or amount of profits reallocated to market jurisdictions. The proposal suggests that the new approach may require some form of deemed residual profit split that would remain after the allocation of routine profits (according to the traditional method of Amount B). This deemed residual profit might be allocated to market jurisdictions based on a sales formula and would deviate from the arm’s-length principle used in traditional transfer pricing. There is hope that a common multilateral framework for determining taxability and the tax base will promote consistency and ease of compliance and administration.

For **Amount B**, the routine profits associated with distribution and marketing in market jurisdictions (in which a traditional permanent establishment based on physical presence already exists) would continue to be taxable. This taxation would be based on the allocation of business profits to that permanent establishment according to the arm’s-length principle, functional analysis, and traditional transfer pricing methodologies. The routine profits of Amount B are subtracted from total profits to arrive at the deemed residual profit used in calculating Amount A.

Amount C is reserved for amounts reported or reportable in the market jurisdiction that are in controversy and have been referred to the competent authority. The proposal recommends binding dispute prevention and resolution. Commentators have interpreted this to be a recommendation in favour of binding arbitration.

As far as the next steps are concerned, the current proposal will lead to public written comments followed by public consultations in November 2019, revised proposals in January 2020, and a final report by the end of 2020. The proposal acknowledges that this timetable is ambitious. It emphasizes, however, that the stakes are high.

Unless the broad consensus needed for a multilateral approach to taxing the digital economy is achieved, the current trend toward inconsistent unilateral digital taxes is likely to continue and accelerate. This inconsistency makes compliance and administration difficult and increases the risk of multiple jurisdictions imposing a tax on the same income without granting foreign tax credit relief.

The OECD suggests a new approach to taxing the digital economy is urgently needed to preserve a reasonably fair and efficient international tax system. The current system evolved over decades during the first half of the twentieth century and now must cope with the profound changes that have accompanied the transition to the digital economy.

Stay tuned! Or perhaps the modern phrase for this is “stay digitally connected”! There will be lots more to come on this issue.