The OECD Unified Approach Marches (Stumbles?) Forward

February 11, 2020

The OECD "Unified Approach" is marching – or perhaps stumbling – forward. The OECD Secretariat proposed the Unified Approach in October 2019 to address the tax challenges arising from the digitalization of the economy. In a December 2019 letter, U.S. Treasury Secretary Mnuchin expressed serious reservations about aspects of the Unified Approach and proposed its adoption on a "safe harbor" basis, only, casting doubt on its viability. Nonetheless, in a January 31, 2020, statement (the "Statement"), the 130+ countries of the OECD Inclusive Framework endorsed the Unified Approach as providing an "outline of an architecture" and a "basis for negotiations" for a consensus-based solution. By narrowing the scope of further technical work and holding to an ambitious, June 2020 deadline for agreement on key policy features, the Statement suggests (or at least reflects hope for) surprising progress.

Considerable uncertainty remains, however. The Statement itself cautions that discussions and technical work are proceeding on a "without prejudice" basis; that is, nothing is agreed until everything is agreed. Further, the Statement's Annex I suggests that progress has been achieved by prioritizing practical considerations over principles, moving the goalposts for "consensus," and deferring resolution of the most challenging issues to a later date.

Our view is that there is room for common ground among the United States and other major Inclusive Framework constituents. The U.S.-proposed safe harbor approach will not placate countries that have enacted or proposed turnover-based digital services taxes. Some generally-applicable new taxing right, even a small one, must be introduced. The United States presumably would not enter discussions for a consensus-based approach unless it is willing to accede to such a taxing right, but the Unified Approach is unlikely to be accepted by the United States in its current form. Our sense is that a much simpler regime that, in practice, captures only a small slice of the profits of a narrow range of companies might achieve consensus.

The Unified Approach: 3-3-11

The Unified Approach, as reflected in Annex I, has three key policy elements: (1) a new nexus rule not dependent on physical presence and largely based on in-country sales; (2) a modified residual profit split; and (3) enhanced dispute prevention and resolution mechanisms. Countries would have a new taxing right over non-routine profits (calculated under a residual profit split) attributable to sustained and significant activity within their jurisdictions (nexus). Allocations under a residual profit split would affect multiple jurisdictions, creating a need for multilateral dispute resolution mechanisms.

The Approach would allow market jurisdictions to tax profits equal to the sum of:

- Amount A: The amount arising from the new nexus rule, calculated as a portion of the MNE group's worldwide deemed non-routine profit and allocated among market jurisdictions on the basis of in-country sales.
- Amount B: A fixed, baseline return for certain routine marketing and distribution activities taking place in market jurisdictions, determined by reference to arm's length concepts.

- Amount C: A return for any additional activities in the jurisdiction not accounted for in Amount B, determined using traditional arm's length methods.

Annex I elaborates on Amounts A and B as well as dispute prevention and resolution measures, revealing technical developments since October 2019. These are discussed further below. Annex I also lays out a more refined work program for the remainder of 2020, identifying 11 distinct work streams with varied deadlines starting July 1, 2020.

Amount A: Progress on Scope but not the Formula

1. *Turnover Test*: Does the company's gross revenue exceed a specified threshold (e.g., the EUR 750M used for country-by-country reporting)?

2. *Activities Test*: Does the company provide automated digital services ("ADS") or have consumer-facing activities?[1] Annex I defines ADS as digital services provided on an automated and standardized basis to a large population of customers or users across multiple jurisdictions,[2] but not custom services involving a high degree of human judgment.[3] Consumer-facing businesses are defined generally as those that sell goods or services to individuals for personal use.[4]

3. *De Minimis Test On In-Scope Revenue*: Does the company's revenue from aggregated consumer-facing activities and/or ADS exceed a specified threshold?

4. *Business Line Profitability Test*: Does the company's revenue from in-scope business lines within aggregated consumer-facing activities and/or ADS exceed a specified threshold? The test would require MNEs to segment their consolidated profits and losses in a manner that may be wholly divorced from their management reporting and/or financial statement presentation. We expect this requirement, if part of any final approach, to generate many disputes.

5. *De Minimis Test on Aggregate Residual Profits*: Does the company's aggregate residual profit from the business line exceed a set threshold?

---

[1] ADS and consumer-facing activities of extractives, regulated financial services and insurance, and international air/marine traffic businesses would be out of scope.

[2] Examples include online search engines, social media platforms, online intermediation platforms and marketplaces, digital content streaming, online gaming, cloud computing services, and online advertising services.

[3] Examples include lawyers, architects, engineers, and consultants.

[4] Examples include personal computing products (e.g. software, home appliances, mobile phones), clothes, toiletries, cosmetics, luxury goods, branded foods and refreshments, franchise models, such as licensing arrangements involving the restaurant and hotel sector, and automobiles.

6. *Nexus Test in Each Market Jurisdiction*: Do in-country sales for that business line—and, for consumer-facing businesses, certain "plus" factors—create nexus with any market jurisdiction? This test, aiming to capture significant and continuous participation in the economic life of a jurisdiction, would treat as prima facie evidence of nexus in-country revenue generation over a period of years that exceeds a threshold calibrated to market size. For consumer-facing businesses (but not ADS) one or more "plus" factors (like direct targeting of advertising or exploitation of user data) would also be required. New income sourcing rules would apply.

The Formula: Unlike its scope, the calculation of Amount A—perhaps the most critical policy element of the Unified Approach—remains up in the air. Although a tentative consensus has formed around using profits before tax derived from consolidated financial accounts as the source of input data, a robust intergovernmental discussion and detailed technical work will continue around segmentation requirements, accounting for different businesses, business lines, regions, and degrees of digitalization, and the treatment of losses. Neither the Statement nor the Annex hints at how deemed non-routine profit and the portion allocable to market jurisdictions will be calculated.

Amount B: A Dose of Dispute Prevention

By fixing the return for baseline marketing and distribution activities, Amount B would eliminate a persistent source of transfer pricing disputes worldwide. For that reason, it has gained considerable traction in the business community. Although Amount B would deviate from the arm's length principle ("ALP") in the strictest sense, it would be "based on" the ALP and thus, according to Annex I, would not require changes to existing bilateral income tax treaties. This, together with the Annex's reference to further work around benchmarking studies and selection of range points, suggests the fixed return will be determined by reference to market comparables and will be set within the arm's length range.

Key technical matters to be developed with respect to Amount B include the definition of baseline marketing and distribution activities, selection of an appropriate measure for the fixed return (e.g., operating margin, return on total costs, Berry Ratio, etc.), and whether the fixed return should vary by industry.

Tax Certainty: Still Elusive

Acknowledging that the formulaic design of Amount A and simplified administration (e.g., the "one-stop shop") can significantly limit, but not eliminate, disputes, Annex I aims for innovative approaches to dispute resolution. These include, most significantly, dispute prevention, in the form of a panel of tax administrators, supported by a body of experts, who would perform "a review function and provide tax certainty" before disputes arise. For Amount A and also for Amounts B and C, "appropriate" mandatory, binding dispute resolution procedures are also under consideration, but domestic law limitations and sovereignty concerns remain.

Going Forward: Destination Unknown

The Inclusive Framework intends to reach consensus on key policy elements of the Unified Approach at or before its scheduled meeting of July 1-2, 2020, with a final report laying out technical details to follow by November 2020. Essential policy issues to be resolved in the next six months include:

- Dispute Prevention and Resolution Mechanisms – Domestic law limitations and sovereignty concerns have thus far prevented consensus on the scope and binding nature of new mechanisms related to Amounts A and C;

- "Digital Differentiation" – Some Inclusive Framework members favor weighting Amount A to account for different degrees of digitalization of in-scope business activities; and

- Regional Segmentation – Some Inclusive Framework members have suggested that regional factors must be taken into account in computing and allocating Amounts A.

But the most significant stumbling block is the United States' proposal that the Unified Approach must be elective for companies rather than mandatory. The parties seem to remain far apart. While Annex I includes a welcome, strong statement on the necessity of withdrawing "relevant" unilateral measures (i.e., digital service taxes), it also not-so-subtly acknowledges that such a requirement might not be supportable if the Approach is implemented on a safe harbor basis.

The United States has indicated that it would prefer that the OECD focus on its "Pillar II" Global Anti-Base Erosion (GloBE) proposal, which would provide a coordinated set of rules to address MNE profit-shifting to no- or low-tax jurisdictions. While the Statement applauds "significant progress" on the technical design of the GloBE's GILTI-like minimum tax and its rule disallowing benefits for undertaxed payments, that progress is not readily apparent from the Statement and its Annexes. GloBE has clearly taken a back seat to the Unified Approach.

Likewise on a slower track is the economic impact assessment originally forecast for fall 2019, which attempts to evaluate the effects of the Unified Approach on Inclusive Framework countries' tax revenues. Although initial results are expected to be released this week, the Unified Approach appears to have been developed and endorsed without any empirical foundation. The Inclusive Framework has tentatively agreed to move forward with dramatic changes to the allocation of taxing rights based only on intuition about which countries will benefit, which countries will lose, and in each case, by how much.

The Statement and Annex I do little to assuage companies' and commentators' concerns about the enormous challenges in adopting the Unified Approach. Many potential barriers to a final consensus remain, and the five-month deadline for agreement on key policy elements seems wildly unrealistic. Yet, Annex I lowers the bar for success to "acceptance in a critical mass of jurisdictions," and the OECD has pulled a rabbit from its hat (the BEPS Project) at least once in recent history. Accordingly, companies must evaluate their risks in the event that some version of the Unified Approach is adopted and implemented in at least some markets. The compliance costs for companies will be significant. And, without an economic impact assessment, whether the Unified Approach will yield meaningful benefits for market jurisdictions is unclear.

What is clear is that implementation of the Unified Approach will be messy. It will upend existing tax rules and severely impact MNEs. Notwithstanding the Inclusive Framework's emphasis on the need for new and more efficient dispute prevention and resolution mechanisms, disputes—many of them—are inevitable. Caplin & Drysdale is closely monitoring these developments and is ready to discuss the current state of the Unified Approach and its potential impact on your business.

For more information on this Alert, please contact a member of Caplin & Drysdale.

J. Clark Armitage
carmitage@capdale.com
202.862.5078

Elizabeth J. Stevens
estevens@capdale.com
202.862.5039

Moshe Dlott
mdlott@capdale.com
202.862.7862

About Caplin & Drysdale

Having celebrated our 50th Anniversary in 2014, Caplin & Drysdale continues to be a leading provider of legal services to corporations, individuals, and nonprofits throughout the United States and around the world. We are also privileged to serve as legal advisors to accounting firms, financial institutions, law firms, and other professional services organizations.

The firm's reputation over the years has earned us the trust and respect of clients, industry peers, and government agencies. Moreover, clients rely on our broad knowledge of the law and our keen insights into their business concerns and personal interests. Our lawyers' strong tactical and problem-solving skills - combined with substantial experience handling a variety of complex, high stakes, matters in a boutique environment - make us one the nation's most distinctive law firms.

With offices in New York City and Washington, D.C., Caplin & Drysdale's core practice areas include:

-Bankruptcy
-Business, Investment & Transactional Tax
-Complex Litigation
-Corporate Law
-Employee Benefits
-Exempt Organizations
-International Tax
-Political Law
-Private Client
-Tax Controversies
-Tax Litigation
-White Collar Defense

For more information, please visit us at www.caplindrysdale.com.

Washington, DC Office:
One Thomas Circle, NW
Suite 1100
Washington, DC 20005
202.862.5000

New York, NY Office:
600 Lexington Avenue
21st Floor
New York, NY 10022
212.379.6000