

An OECD “Unified Approach” to Addressing the Challenges of the Digital Economy

November 4, 2019

On October 9, the OECD announced its much-anticipated proposed “Unified Approach” to tackling tax challenges arising from the digitalization of the economy.¹ The Unified Approach, as expected, would make dramatic changes to the existing international tax system. Focused on consumer-facing businesses,² the Unified Approach would:

- Create a new nexus rule – a new self-standing treaty provision not dependent on physical presence and based largely on in-country sales;
- Introduce a modified “Residual Profit Split” method involving a “Three Tier Mechanism” with formulary elements overlaying existing arm’s length principles as a means of allocating a pre-determined slice of income to market jurisdictions;³ and
- Provide for enhanced dispute resolution, which purportedly means mandatory binding arbitration for certain disputes.

The Unified Approach, at its core, is a departure from the arm’s length principle. However, for now, the Approach represents only a high-level recommendation from the OECD Secretariat. Successful implementation will require consensus among the 130+ countries of the Inclusive Framework, not only that the Approach is sensible, but on a multitude of technical details that must be fleshed out. These details may include fixed margin percentages to approximate routine returns (by industry or business line), non-routine margins (by industry or business line), and a method to distinguish consumer-facing operations from business-to-business operations (again, by industry or product line). Local GAAP differences may require adjustments for specific countries or regions. Further, the new taxing right of the Unified Approach must be reconciled with existing transfer pricing, withholding tax, and customs rules. Unless negotiators can develop conventions that eliminate the need for some of these determinations, the Unified Approach would seem to be anything but simple and the OECD’s chances of achieving consensus seem remote.

We explain here the basics of the Unified Approach and some of the challenges it presents.

Key Steps involved in the Three Tier Mechanism

The core of the Unified Approach is its Three Tier Mechanism for calculating income allocable to market jurisdictions. As the label implies, the total income allocable to a market jurisdiction would be the sum of three component amounts:

- **Amount A.** The amount attributable to a “new taxing right” for market jurisdictions, calculated as follows:
 - Step 1. Identify the MNE group’s worldwide profit from the consolidated financial statement with needed adjustments. This may be measured on a business line and/or regional/market basis ($z\%$).
 - Step 2. Calculate the level of profitability deemed to represent the baseline “routine” profit ($x\%$) and deduct it from the overall profitability ($z\% - x\% = y\%$). The remainder ($y\%$) would represent the deemed non-routine profit.
 - Step 3. A portion of the non-routine profit ($w\%$) would then be attributed to market jurisdictions, with the remaining portion ($1 - w\% = v\%$) allocated among other value-creating factors such as trade intangibles, capital and risk, etc., presumably through traditional arm’s length methods. The portion of non-routine profit attributable to market jurisdictions ($w\%$) could be an internationally-agreed fixed percentage.
 - Step 4. Allocate the relevant portion of the deemed non-routine profit ($w\% \times y\%$) among eligible market jurisdictions. In-country sales may be used as the allocation key. The market jurisdictions – regardless of the existence of a local PE – would have the (new) right to tax the allocated income.
- **Amount B.** A fixed, baseline return for certain routine marketing and distribution activities taking place in market jurisdictions. This amount would not be subject to the new taxing right. That is, only a jurisdiction in which a taxpayer has a local presence may tax Amount B. The Unified Approach suggests using “agreed fixed returns” (i.e., a formulary approach) to establish routine marketing and distribution returns.
- **Amount C.** A return for any additional activities not accounted for in the assumed baseline return (Amount B), to be determined using traditional arm’s length methods. Any dispute between the market jurisdiction and the taxpayer over an Amount C (including its relationship to Amount A) would be subject to legally binding and effective dispute prevention and resolution mechanisms.

Short-Term Outlook: Continued Uncertainty

As noted above, the Unified Approach is not yet a consensus proposal. However, many countries, including the United States, believe that reaching a successful multilateral agreement through the OECD-led process is the most realistic way to avoid the disorder created by proliferating unilateral measures. Widespread consensus on the need to reach a multilateral agreement is matched with equally widespread skepticism that the Unified Approach will gain momentum, mainly due to the abundance of open questions regarding implementation. These open questions include:

- **Defining “consumer-facing businesses”:** Since the proposal would apply only to “consumer-facing businesses,” debates as to how to ring-fence those businesses seem inevitable. For instance, if a multi-sided online platform provides advertising services to companies, is it a platform operator, an advertising business, or both, and is it a consumer-facing business?⁴ The definitional issue becomes even more critical when considering its interplay with the Amount A threshold, i.e., depending on how a company slices up its lines of business, a certain business line may or may not reach the Amount A profitability threshold. Many VAT/GST regimes which tax electronic service providers operating under the ‘B2C model’ may provide guidance.
- **Using “deemed” amounts:** The proposal endorses the use of a “deemed” amount for non-routine profit subject to the new taxing right (Amount A). Yet, it obliquely acknowledges the possibility that this could lead to double-counting of taxable income. If, for example, countries seek to tax high-intensity marketing efforts (Amount C), to what extent should Amount A be viewed as already rewarding those efforts? Similarly, could there be conflicts between the deemed benchmark returns used to determine Amount A and the actual routine returns compensated through Amounts B and C, and how would such differences be reconciled (e.g., would arbitration be available to reconcile all such differences)? Lastly, given that Amount C will continue to be determined under the arm’s length principle, what if the whole resulting from the Three Tier Mechanism exceeds the sum of its parts—i.e., the sum of a taxpayer’s worldwide Amounts A, B, and C exceeds its actual worldwide profit?
- **Treatment of losses:** Although the proposal acknowledges the need for incorporating rules to address losses, it does not present a clear solution on how losses—particularly common among early-stage digital companies—would be taken into account in computing income subject to the new taxing right and the related income allocations, how losses might be carried forward or back, whether expanded statutes of limitations would need to be provided, or other, similar issues.⁵
- **Identifying the “losers”:** From where would the profit newly allocated to market jurisdictions be drawn, i.e., which jurisdictions (and companies within the MNE group) would lose out? Would it be in proportion to the level of in-country profitability above a threshold? Would it incorporate global supply chain profit allocations? Will source countries accept a model that gives back some of their perceived DEMPE gains?
- **Unforeseen consequences:** What are the implications of the Unified Approach, and future refinements thereof, under non-tax laws and regulations, such as international trade law and treaties? Will market jurisdictions try to enforce privacy and telecommunications related regulations on entities present only under the new nexus standard?
- **Alignment with value creation:** To the extent a refined Unified Approach applies a uniform, “rough justice” allocation methodology to a broad range of business models and circumstances—e.g.,

multi-sided platforms, for which a substantial portion of the “market” factors are already compensated and taxed in local jurisdictions through the tax returns of independent participants such as app developers and “gig economy” participants—will it be consistent with the principle that profit should be taxed where value is created?

- **Coordination with the existing rules:** Considering that the new profit allocation rule goes beyond the arm’s length principle, coordination between the two set of rules is necessary. The new proposal may also need to be harmonized with the existing customs rules.

Perhaps the biggest open question is whether the Unified Approach will gain momentum. Notably, many Inclusive Framework member countries have developed “unilateral measures” related to the tax challenges of digitalization that differ in both scope and methodology from the Unified Approach.

For example, digital service taxes (DSTs) proposed in the UK and implemented in France generally align to the “User Participation” approach. The French tax, which was enacted July 24, 2019, imposes a 3% levy on the French revenue of a small group of large multinational technology companies.⁶ According to a policy paper published in July 2019⁷, the UK plans to impose a 2% levy on revenues of search engines, social media platforms, and online marketplaces that derive value from UK users. Spain⁸ and New Zealand⁹ have also introduced their own unilateral DST regimes.

Other countries have adopted unilateral measures that align to the “Significant Economic Presence” approach. India¹⁰ and Italy¹¹ introduced their own versions of a significant economic presence. Israel’s Significant Digital Presence Nexus, Saudi Arabia and Kuwait’s Virtual Service PEs, Taiwan’s Economic Nexus for E-Commerce Services, and Slovakia’s Intermediation PE all illustrate the efforts of countries trying to expand their taxing rights to the income of highly digitalized multinational companies derived from local activities.¹²

Amid this complicated landscape, the OECD expects its newly narrowed proposal may advance its objective of arriving at a consensus solution by 2020. Nevertheless, it is far from clear that the Unified Approach will gain a critical mass of support among Inclusive Framework members. Implementation of the approach could have complicated fiscal impacts for each country, and the OECD’s empirical analyses are ongoing.

If the Unified Approach gains consensus among the member states, all large multinational companies within the applicable scope would have to allocate a portion of their taxable income to the jurisdictions in which they make sales. This may, in many cases, increase the overall group-wide tax burden and would almost surely lead to double-taxation, at least in the short-term. Equally important, for companies with diversified geographic markets and multiple business lines, complying with the new rule may be cumbersome and costly.

With all that said, companies—operating in an environment of extreme uncertainty—have the opportunity to make their voices heard. Public comments on the Unified Approach are due November 12, with a public consultation to follow on November 21-22. Ideas submitted by participants in response to the February 2019

consultation heavily influenced the OECD's May 2019 Work Programme, and elements of the Unified Approach echo those proposals. Companies with a stake in the stability and predictability of the international tax system should take advantage of this historic opportunity to engage with and help to shape the coming changes.

For more information on this Alert, please contact a member of [Caplin & Drysdale](#).

[H. David Rosenbloom](#)
drosenbloom@capdale.com
202.862.5037

[J. Clark Armitage](#)
carmitage@capdale.com
202.862.5078

[Kirsten Burmester](#)
kburmester@capdale.com
202.862.7826

[Elizabeth J. Stevens](#)
estevens@capdale.com
202.862.5039

Jaehong Lee
jlee@capdale.com
202.862.7844

[Appendix] Genesis of the Unified Approach

If approved, the Unified Approach would replace the three Pillar I proposals identified in the February 2019 public consultation document.¹³

- **User Participation Approach:** Proposed by the UK, this approach would apply a residual profit split approach to allocate taxable income of social media platforms, search engines, and online marketplaces to jurisdictions where their users are located.¹⁴ The user jurisdiction would have the right to tax the allocated income even in the absence of a local PE.
- **Marketing Intangible Approach:** Proposed by the US, this approach would apply a residual profit split approach notionally predicated on the presence of local marketing intangibles to allocate MNE income to market jurisdictions, which would have the right to tax the allocated income even in absence of a local PE. Unlike the User Participation Approach, this approach would not have focused on specific digitalized business models.
- **Significant Economic Presence Approach:** Proposed by India, this approach would apply a new PE standard (“significant economic presence”) divorced from physical nexus and allocate income to the new PEs based on a fractional apportionment method.

Again, if approved, the Unified Approach would also replace—and, as noted, incorporate elements of—the three profit allocation methods detailed in the OECD's May 2019 Work Programme.¹⁵

- **Modified Residual Profit Split Method:** This method would rely primarily on existing transfer pricing principles, possibly with certain simplifications to enhance administrability. Unlike traditional transactional profit split methods, it would be applied at some level of aggregation (e.g., business

line, region, or group). The recently introduced IRS APMA Functional Cost Diagnostic model¹⁶ reflects some similar characteristics.

- **Fractional Apportionment Method:** Originally part of the “Substantial Economic Presence” approach, this method is analogous to the formulary apportionment methods found in the US state tax system and in the EU’s proposed Common Consolidated Corporate Tax Base frameworks.
- **Distribution-based Method:** Aimed at simplicity and administrability, this method would ascribe to market jurisdictions a baseline profit loosely linked to arm’s length returns to distribution activities, with levers to increase or reduce profit relative to the baseline by reference to local marketing spend, global non-routine returns, or other factors.¹⁷ This method could be a good fit for consumer goods companies, for which localized marketing activities are heavily emphasized, but would be less reflective of the underlying economic dynamics of highly digitalized companies, for which user participation and synergies with technology and other intangible assets are a key source of value.



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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

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¹ *Secretariat Proposal for a “Unified Approach” under Pillar One, Public consultation document, OECD (October 9)*

² The OECD views “ring-fencing”—applying the new rules only to highly digitalized companies—as not feasible. Today’s proposal, however, suggests that sectoral carve-outs, e.g., for extractive industries, commodities, and financial services, should be considered.

³ The proposal is a significant step toward the OECD’s mandate from the G20 to finalize a consensus solution by 2020 in that it synthesizes elements of the three Pillar I proposals described in the OECD’s February 2019 consultation document and May 2019 Work Programme. Please refer to the Appendix for more details about the previous Pillar I proposals.

⁴ On October 9, 2019, the OECD – through an OECD Tax Talks, a webcast from the Centre for Tax Policy and Administration – mentioned that although the proposal’s focus is mostly in the B2C businesses, some B2B models could also fall within the scope. As an example, it cited Google’s sale of advertisements to companies as a ‘consumer-facing business’.

⁵ The proposal, in its appendix, addresses the ‘claw-back or “earn out” mechanism’ as examples for the treatment of losses, but does not elaborate any further specifics in connection therewith. para 51.

⁶ The French DST applies to two categories of digital services—(i) interfacing services and (ii) advertising services.

⁷ *Introduction of the new Digital Services Tax, Policy Paper, HMRC (July 11, 2019)*

⁸ In general, if enacted as currently proposed, the Spanish DST would impose a 3% indirect tax on digital services, including (i) online advertising services, (ii) online intermediary services, and (iii) data transfer services.

⁹ On April 3, 2019, New Zealand announced, in a discussion document on *Options for taxing the digital economy*, plans to implement its own version of a DST that is to target “highly digitalized companies,” such as those offering social media networks, trading platforms, and online advertising, that earn income in New Zealand.

¹⁰ In its Finance Act of 2018, India amended the concept of “business connection” to include a “significant economic presence,” allowing for the imposition of a 40% tax on any foreign company rendering digital goods or services to India.

¹¹ Italy’s 2018 Budget Law (Law No. 205/2017) revised its domestic law PE definition so that “a significant and continuous economic presence in the Italian territory, built in such a way that it will not result in a physical presence in Italy” may satisfy the PE requirements.

¹² Most recently, on October 3, the Russian Finance Ministry also announced that it is considering its own digital tax measures.

¹³ *Addressing the Tax Challenges of the Digitalisation of the Economy, Public Consultation Document, OECD (February 13, 2019)*.

¹⁴ More detailed position of the UK HM Treasury could be found in: *HM Treasury, Corporate tax and the digital economy: position paper update (March. 2018)*.

¹⁵ *Program of Work to Develop a Consensus Solution to the Tax Challenges Arising from the Digitalization of the Economy, OECD (May 2019)*

¹⁶ On March 1, 2019, the IRS Advance Pricing and Mutual Agreement (APMA) program announced the introduction of a new spreadsheet model, referred to as the Functional Cost Diagnostic (FCD) model.

¹⁷ A detailed illustration of the application of this method could be found in Johnson & Johnson’s response to the February 2019 OECD public consultation paper.