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OECD provides additional detail on Pillar One proposal in update on international tax reform – Seeking consensus-based solution in 2020

FEBRUARY 3, 2020 18 MIN READ

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In this Update

- The OECD has been working on a two-pillar approach to international tax reform: (a) Pillar One – which would allocate additional taxing rights to market jurisdictions (for example, by creating a new nexus test for establishing source country taxing rights, which diverges from the traditional "permanent establishment" concept), and (b) Pillar Two – which would introduce a global minimum tax and certain other measures to prevent the shifting of profits to low-tax jurisdictions. These proposals are expected to have a significant impact on multinationals, particularly those in digital-oriented and intangible-intensive sectors. Osler's summary of global efforts towards international tax reform are set out in prior Updates.
- On January 31, 2020, Canada and the other 136 countries comprising the OECD/G20 Inclusive Framework on BEPS (the Inclusive Framework) released a statement (the January Statement) expressing strong support for reaching a multilateral agreement with respect to Pillar One and Pillar Two, and affirming their commitment to reach a consensus-based solution by the end of 2020.
- Annexes in the January Statement set out the currently agreed upon "architecture" or "outline" for Pillar One (reflecting a "new" approach), and Pillar Two (with a high-level progress report).
- Significant new, or clarified items, in the January Statement include:
  - Considering the U.S. proposal that Pillar One be made an elective "safe harbour."
  - A more definitive statement carving out extractive industries, most financial services (including insurance), airline and shipping businesses.
  - Clarifying that businesses selling intermediate products and components are largely out of scope.
  - Indicating that the new nexus rule should not apply to an entity only selling consumer tangible goods into a market jurisdiction, absent certain, to be developed, criteria that would indicate a significant and sustained presence.

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  - Acceptance that a "one-stop shop" approach limiting filing to the ultimate parent jurisdiction (rather than all market jurisdictions) is likely the only practical way forward.
  - Acknowledgement that group-consolidated financial statements are likely the best basis for measurement and that loss carryforward rules will have to be developed.
- Several countries have proposed unilateral measures to impose new taxes on digital services providers without waiting for a broader consensus on the OECD's proposals. The OECD acknowledged that the aggressive timeline for a consensus-based approach is largely due to the looming potential for a trade war (citing the example of the U.S. response to France's digital services tax). Separately, Canada's Liberal Party election platform included a 3% digital services tax modelled after France's tax.
- Many important details and policy issues under Pillar One and Pillar Two remain unresolved – with very little time for the OECD to accomplish its objectives in 2020.

Introduction

On January 31, 2020, the OECD/G20 Inclusive Framework on BEPS released the *Statement by the OECD/G20 Inclusive Framework on BEPS on the Two-Pillar Approach to Address the Tax Challenges Arising from the Digitalisation of the Economy – January 2020* (January Statement) outlining what is currently the agreed upon "architecture" or "outline" of Pillar One and Pillar Two.

The OECD's *Programme of Work to Develop a Consensus Solution to the Tax Challenges Arising from the Digitalization of the Economy* (Program of Work) published in May 2019 proposed two principal measures: (a) Pillar One, which would allocate additional taxing rights to market jurisdictions (for example, by creating a new nexus for establishing source country taxing rights and revising the "arm's length" standard for allocating profits) and (b) Pillar Two, which would introduce a global minimum tax and certain other measures to prevent the shifting of profits to low-tax jurisdictions.

The January Statement provides an update on the content, status and intended policy objectives of the two-pillar approach. The discussion on Pillar One is comprehensive and sets out, in some respects, a new approach to various items previously included in public consultation documents, including consideration of the U.S. request for Pillar One to take the form of an elective "safe harbour."

The Pillar One outline in the January Statement was drafted taking into account comments received through the public consultation process which Osler actively participated in (described below) and input from the nearly 140 members of the Inclusive Framework.

In contrast, the Pillar Two outline in the January Statement provides a high-level progress report on the OECD's work under this pillar and does not offer a new approach to address remaining BEPS issues.

An OECD Press Conference and an OECD Webcast were also held on January 31, 2020, and further discussed the contents of the January Statement as well as anticipated next steps.

Pillar One

Background to Unified Approach on Pillar One

The OECD proposals under Pillar One in the Program of Work originally focused on highly digitized businesses, and explored three separate proposals based on "user participation," "marketing intangibles" and "significant economic presence." However, after consultations, it was apparent that a consensus on any of the three proposals was unlikely to be reached, particularly since they appeared to disproportionately impact U.S.-based multinational enterprises operating highly digitized businesses.

In October 2019, the OECD Secretariat released a proposal for a "Unified Approach" under Pillar One. The Unified Approach introduced a revised profit allocation rule applicable to all multinational enterprises that are "in scope" with potential carve-outs for certain industries. For taxpayers in scope with a sufficient nexus to particular jurisdiction(s) (based on revenue or other thresholds), an appropriate return for routine activities will be excluded from overall profit. The remainder will be deemed to be non-routine profits, a portion of which will be allocated amongst different eligible market jurisdictions based on variables such as sales.

More particularly, under the Unified Approach, a market jurisdiction may be entitled to tax the following three types of amounts:

- **Amount A:** The portion of deemed residual profit (i.e., a group's overall profit less a return for routine activities) that is allocated to a market jurisdiction.
- **Amount B:** A fixed return (which may vary by industry or region) for certain routine marketing and distribution activities taking place in a market jurisdiction.
- **Amount C:** Any profit attributable to activities in a market jurisdiction that go beyond routine marketing and distribution activities, to be calculated based on the arm's length principle, which should not duplicate Amount A above.

Osler made a submission [PDF] to the OECD in response to the October 9, 2019, public consultation document on the Unified Approach under Pillar One highlighting some of our concerns with the Unified Approach – including (a) the need for participating countries to agree to abandon any unilateral measures as a pre-condition to their participation in the Unified Approach; and (b) practical issues and complexity arising under the Unified Approach which highlight the critical need for effective dispute resolution procedures, discussed in more detail below.

Outline of the architecture of a Unified Approach on Pillar One in the January Statement

The OECD provided an update in the January Statement regarding the new taxing right represented by Amount A. The January Statement clarified that the scope of Amount A is intended to apply to two types of large businesses: (a) automated digital services, and (b) consumer-facing businesses. Business models in scope for Pillar One include retail companies, franchise business models and "automated digital services," which are expected to include the following:

- online search engines
- social media platforms
- online marketplaces
- digital content streaming

- online gaming
- cloud computing services
- online advertising services

Compared to prior consultation documents, which generally described the scope of Pillar One proposals as applying to "large consumer-facing businesses," the January Statement described the intended scope of Pillar One more specifically. The January Statement distinguished between "automated digitalized businesses" and other in-scope businesses. For "automated digitalized businesses," a revenue threshold would be sufficient to create a nexus in a market jurisdiction. However, for other in-scope consumer-facing businesses, the January Statement recognized that the mere cross-border sale of tangible goods into a market jurisdiction does not in itself amount to a significant and sustained engagement in that jurisdiction. The January Statement suggested that additional or "plus" factors, such as the physical presence in, or targeted advertising towards, a market jurisdiction may also be required to satisfy the nexus threshold to apply Pillar One proposals to such consumer-facing businesses.

The January Statement acknowledges the compliance and administrative burden associated with the proposals, suggesting that the application of Pillar One will operate with a number of thresholds:

- a gross revenue threshold, which could be the same €750-million revenue threshold used for country-by-country reporting;
- a carve-out where the total aggregated in-scope revenue is less than a yet to be determined threshold;
- a carve-out for situations where the total profit allocated to a particular jurisdiction would not meet a certain *de minimis* amount; and
- additional thresholds regarding the computation of Amount A and the application of the new nexus rule (such as additional or "plus" factors to establish a sufficient nexus).

In terms of carve-outs, the consultation document on the Unified Approach published in October 2019 assumed that extractive industries would be carved out from the scope of Pillar One, and also raised the possibility of a carve-out for financial services. The January Statement includes more definite and specific references about carving out extractive industries and (most) financial services (including insurance), as well as airline and shipping businesses, and provided more specific rationale regarding such carve-outs. For example, the January Statement noted the wide-spread application of prudential regulation and licensing requirements to financial services as a justification for excluding most forms of regulated financial services from the scope of Pillar One.

The January Statement reflects an evolution in the OECD's thinking regarding intermediate products and components. According to the January Statement, businesses selling such item that are incorporated into a finished product sold to consumers will largely be out of scope with possible exceptions for items that are branded and commonly acquired by consumers for personal use.

While the basic approach to calculating Amount A remains the same as in prior consultation documents, the January Statement provides more detail regarding the measures for determining the amount. For example, the January Statement endorses the measurement of profit using consolidated group financial accounts. The OECD is inclined to use pre-tax profit for purposes of calculating Amount A. The OECD also indicated that loss carryforward rules will be developed for purposes of calculating Amount A, and that losses incurred both before and after the inception of Amount A taxing right in a jurisdiction should be considered. The OECD is still considering the merits of applying different percentages for different types of businesses, although there is still no indication on the tax rate to be applied to Amount A by market jurisdictions).

The OECD also provided an update on the fixed return based on the arm's length principle for certain routine marketing and distribution activities taking place in market jurisdictions represented by Amount B. The January Statement states that Amount B is intended to standardize the remuneration of distributors that purchase products from related parties for resale and performed functions described as "baseline marketing and distribution activities," although the recommended return for such functions was not disclosed).

Dispute resolution

The January Statement affirms that the Inclusive Framework is committed to ensuring that the new rules do not result in double taxation, and the OECD appears to have listened to concerns and past comments on the importance of dispute resolution in this regard. However, if the Pillar One proposals move forward, much more work needs to be done to assist in preventing instances of double taxation.

The trend in the Pillar One proposals towards strengthening taxing rights in source jurisdictions means that the resident jurisdiction where a multinational enterprise is headquartered would need to provide relief from double taxation. In our view, this would be best achieved through mandatory binding arbitration or advance allocation agreements (analogous to advanced pricing agreements) which would be binding on the relevant countries. However, the January Statement suggests that there is currently no consensus on the binding nature of dispute prevention and resolution procedures as well as the scope of potential dispute resolution mechanisms under Amount C.

The January Statement notes the conceptual importance of avoiding complexity and ensuring robust and effective dispute prevention and resolution mechanisms. However, it does not offer much in the way of practical measures to achieve those objectives. Detailed practical measures will be critical to ensuring the Pillar One (and Pillar Two) proposals do not lead to "tax chaos" – with potential instances of double taxation and potential tax disputes. At a minimum, the OECD should provide specific details and examples on how Pillar One (and Pillar Two) would apply to a sample multinational group. In particular, the members of the Inclusive Framework should be agreeing to specific measures – rather than just conceptual ideas that can be interpreted and applied in different ways. Preventing tax disputes will require clarity among countries on the intended application and administration of the proposed measures, which will necessarily be extremely complicated.

By way of example, implementing Pillar One could require the following multi-step process (with significant incremental measures that would be required to implement Pillar Two):

- Calculate income/loss under domestic income tax rules (which, for countries like Canada, must be done on a non-consolidated basis).
- Determine whether Pillar One will apply to a multi-national group (e.g., whether the group satisfies the applicable size threshold and carries on a targeted automated digital services or consumer-facing business that is not otherwise carved out.
- Determine Amount A – income or loss based on a portion of consolidated profit before taxes (presumably adjusted to eliminate revenue/activities from out of scope businesses, and possibly adjusted to account for certain differences in accounting treatment), together with agreed amounts (including relevant currencies) to be allocated to particular market

jurisdictions.
- Determine potential impact of losses in calculating Amount A, including potential carryforward or carryback of losses of the consolidated group – allocated on a country-by-country basis.
- New domestic supporting rules may be required to prevent double taxation – such as (i) rules to allocate the Amount A amounts to particular entities within a MNE group, (ii) resourcing rules to deem such amounts to be “foreign sourced” in the resident country – which will likely be required under domestic rules to allow foreign tax credits to apply, and (iii) rules to allow any Amount A taxes to be creditable against taxes attributable to businesses carried on through a permanent establishment in the relevant market jurisdiction.
- Calculate Amount B amounts for each relevant jurisdiction.
- Potentially apply additional domestic rules to ensure an equivalent amount of income to the Amount B amounts is allocated to each relevant jurisdiction – which may require correlative transfer pricing adjustments (and the potential for income to be allocated to an entity in a multi-national group even if the group has consolidated losses).
- Calculate any Amount C amounts to be allocated to each relevant jurisdiction – including processes for efficiently resolving disputes (such as advanced pricing agreements, binding international arbitration or other mechanics), which presumably must also be linked with domestic transfer pricing rules and any relevant domestic anti-abuse rules.

Alternative elective approach to Pillar One and Unilateral Measures

Perhaps the biggest update to the Unified Approach under Pillar One is the possibility that a form of elective “safe harbour” will be considered by the Inclusive Framework. This proposal originated from a request by the U.S.

On December 3, 2019, the U.S. Treasury Secretary wrote to the OECD stating that while the U.S. was supportive of a long-term solution to prevent the proliferation of unilateral measures, the U.S. had serious concerns regarding potential mandatory departures from arm’s length transfer pricing and taxable nexus standards. In that letter, the U.S. Treasury Secretary indicated that it believed the goals of the Pillar One regime could be substantially achieved by making Pillar One an elective safe-harbour regime, by allowing companies to elect for Pillar One to apply, or to otherwise stay in the old system of transfer pricing. In response, the OECD noted in the January Statement that a form of safe harbour as suggested by the U.S. will be considered by the Inclusive Framework as the architecture of Pillar One is further considered.

In the Webcast, Pascal Saint-Amans, Director of the Centre for Tax Policy and Administration at the OECD, clarified that a safe harbour would likely not be a part of the “architecture” of Pillar One but would rather be an item discussed in the implementation stage of Pillar One and only decided once the OECD has developed all of the key features of Pillar One. Mr. Saint-Amans did not show great optimism that an option for a safe harbour would reach the level of consensus as a “very large spectrum” of countries have expressed serious concerns with this approach.

The OECD noted that several countries have proceeded with “unilateral” digital services taxes

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– rather than waiting for a consensus-based multi-lateral approach. Such unilateral measures include France's 3% tax on revenue generated by companies from certain digital businesses, if such companies supplied €750 million of taxable digital services worldwide and €25 million of taxable digital services in France. In response, the United States has threatened to impose retaliatory tariffs against those countries – particularly since many of the affected digital services companies are based in the U. S. The OECD noted during the Webcast that the aggressive timeline for a finalized proposal is largely due to the looming potential for a trade war (either between U.S./France over France's digital tax, or more broadly between the U.S. and jurisdictions who consider/introduce a digital services tax). This could potentially include Canada as the Liberal Party's election platform included a new 3% value-added tax on the income of businesses engaged in targeted advertising and digital intermediation services applicable to businesses with global revenues of at least C$1 billion and Canadian revenue of at least C$40 million, which would be eliminated once an international consensus is reached on the OECD's Pillar One proposals.

If Pillar One were to take the form of an elective "safe harbour," the relevant countries may well decide to continue to levy their digital services taxes on multinationals that do not "opt-in" to the Pillar One regime. As a result, it is quite possible that Pillar One will simply add additional complexity to the international tax system – rather than replacing such unilateral measures.

Pillar Two

While Pillar One is intended to allocate new taxing rights to market jurisdictions based on a new nexus rule, Pillar Two is intended to ensure that businesses which operate internationally are subject to a minimum global rate of tax. In the Webcast, Mr. Saint-Amans indicated that several countries have said that they would prefer to move forward with a plan that does not include Pillar Two and that other countries have expressed a desire to move forward with both Pillar One and Pillar Two.

The GloBE Proposal under Pillar Two calls for the development of:

1. an income-inclusion rule, which would impose current taxation on the income of a foreign-controlled entity (or foreign branch) if that income was otherwise subject to an effective tax rate that is below a certain minimum rate (which is to be set at a later date);
2. an "undertaxed payments" rule (for source countries), which would either deny a deduction or impose a possible withholding tax on base eroding payments unless that payment was subject to tax at or above a specified minimum rate in the recipient's jurisdiction;
3. a switch-over rule, which would be introduced into tax treaties to permit a residence jurisdiction to switch from an exemption to a credit method for relieving double taxation where the profits attributable to a permanent establishment or derived from immovable property are subject to an effective tax rate below the minimum rate; and
4. a "subject to tax" rule, which would ensure that treaty benefits (particularly with respect to interest and royalties) are granted only in circumstances where an item of income is subject to tax at a minimum rate in the recipient jurisdiction.

Osler made a submission [PDF] to the OECD in response to the November 2019 public consultation document on the GloBE Proposal. Our comments on the GloBE Proposal were principally directed at a need to:

1. carefully define the scope of the Pillar Two proposals such that they are focused on the intended policy objectives; and
2. ensure that the GloBE Proposal is designed in a co-ordinated manner that prevents double (or multiple) taxation and minimizes administrative complexity and compliance costs.

In our submission, we noted that the GloBE Proposal should focus its application on passive forms of income earned in jurisdictions that are not compliant with the standards of BEPS Action 5 – consistent with the OECD's stated policy objectives of discouraging artificial profit-shifting and harmful tax competition under Pillar Two. The January Statement acknowledges that some jurisdictions have pushed for similar substance-based carve-outs in order to focus the application of the GloBE Proposal on remaining BEPS issues.

While the January Statement does not address the GloBE Proposal under Pillar Two in detail, Mr. Saint-Amans indicated in the press conference that continued work is being done to address blending, carve-outs, and the ultimate rate imposed. There are upcoming meetings scheduled in March and April 2020 where Pillar Two will be discussed further.

Next Steps

The OECD intends to complete its technical work on Pillar One and Pillar Two throughout 2020. The Members of the Inclusive Framework will meet July 1-2, 2020, in Berlin in order to see whether they can reach a consensus on the architecture of the two-pillar approach. If a consensus is reached in 2020, this could then start a years-long process of adopting new rules through domestic legislation and changes to tax treaties.

As the OECD continues its work on Pillar One and Pillar Two throughout 2020, detailed practical measures will be critical to ensuring that the proposals do not lead to additional tax uncertainty and tax conflict. At a minimum, the OECD should provide specific and detailed examples of how Pillar One and Pillar Two would apply. In particular, members of the Inclusive Framework should have the requisite information in front of them in order to agree to specific measures and outcomes rather than broad conceptual ideas that have the potential to be interpreted in diverging ways.

We will continue to monitor the OECD's proposals and other international tax developments. For further information on international tax or other tax matters, please contact any member of our National Tax Group.