

November 11, 2019

## Osler submission to OECD on Public Consultation Document for ‘Unified Approach’ under Pillar One

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Tax Policy and Statistics Division  
OECD Centre for Tax Policy and Administration

Dear Sirs/Mdms

**Re: Secretariat Proposal for a “Unified Approach” under Pillar One**

### Executive Summary

1. We are writing in response to the request of the Centre for Tax Policy and Administration of the OECD for comments on the October 9, 2019 *Public Consultation Document Secretariat Proposal for a “Unified Approach” under Pillar One* (the “**Unified Approach**”). Our comments are principally directed to:
  - (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 arising under the Unified Approach such as differences in tax base and the application of losses, which highlight the importance of effective dispute resolution procedures.
2. We are also providing comments on the need for the OECD to develop a clear set of consensus rules for dispute resolution to be adopted by all participating countries that goes beyond the statement of a general principle that such rules are intended to provide relief from double taxation. Our comments also address issues relating to the scope of the Unified Approach, but are not limited to the specific questions asked by the OECD in its publication of the Unified Approach.
3. The Unified Approach was released under Pillar One of 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**”). The Program of Work contains two principal measures: Pillar One, which would allocate additional taxing rights to user/market jurisdictions, and Pillar Two, which would introduce a global minimum tax to prevent the shifting of profits to low-tax jurisdictions.

## Background to the Unified Approach and Prior Comments

4. The final package of BEPS measures included Action 1 *Addressing the Tax Challenges of the Digital Economy*. The Report on Action 1 acknowledged that it would be difficult, if not impossible, to “ring-fence” the digital economy from the rest of the economy for tax purposes, further concluding that digitalisation presents no unique BEPS issues, but that some highly digitalised business models may exacerbate certain BEPS concerns.
5. The OECD’s Task Force on the Digital Economy (“**TFDE**”) was tasked with studying tax challenges in this context, with a final report due on the topic in 2020.
6. The TFDE delivered an Interim Report on the *Tax Challenges Arising from Digitalisation* on March 16, 2018 and signalled that the OECD was looking at fundamental changes to the existing international tax framework in the context of the digital economy. The January 29, 2019 Policy Note approved by the OECD/G20 Inclusive Framework on BEPS noted that the proposals go beyond the arm’s length principle and expand taxing rights in source or market jurisdictions where there is no physical presence.
7. The Policy Note also indicated that this work would be expanded to two “pillars” that will form the basis of the OECD’s final year of work in this area:
  - (a) **Pillar One** – taxing the digital economy, initially focussing on the allocation of taxing rights among countries through three separate proposals – user participation, marketing intangibles and significant economic presence; and
  - (b) **Pillar Two** – unresolved BEPS issues (including the introduction of a global minimum tax to prevent the shifting of profits to low-tax jurisdictions).
8. The February 13, 2019 *Public Consultation Document Addressing the Tax Challenges of the Digitalisation of the Economy* (the “**Initial Public Consultation Document**”) explored three proposals under Pillar One, all of which called for the reallocation of taxing rights in favour of user/market jurisdictions: the “user participation” proposal, the “marketing intangibles” proposal and the “significant economic presence” proposal.
9. Our firm previously submitted comments on the Pillar One proposals set out in the Initial Public Consultation Document. In a letter dated March 7, 2019, we identified certain practical issues with the three proposals. Many of these issues remain outstanding in the Unified Approach, including how the OECD will account for different taxation periods and functional currencies between multinational enterprise (“**MNE**”) group members, the manner in which losses will be applied, and the manner in which revenues and expenses are to be calculated and allocated across jurisdictions (including with respect to both timing and quantum).
10. In our March 7, 2019 comments, we stressed that the OECD should not proceed with the proposals under either of the two pillars without a strong consensus from a clear majority of stakeholders and that in order for the proposals to work effectively, countries must, as a minimum standard, agree to abandon any unilateral measures targeting similar activities that may have been proposed or adopted prior to the development of a consensus view. The OECD has stated that it is seeking a coordinated approach to prevent the chaos that would arise from multiple countries adopting unilateral measures. However, the OECD’s current proposal simply adds to the chaos by proposing a new and complicated taxing right without taking any specific and enforceable action to eliminate the many unilateral measures that have been proposed or adopted by its members and other countries that are part of the OECD/G20 Inclusive Framework on BEPS.

# Unified Approach

11. In releasing the Unified Approach, the OECD appears to have acknowledged that none of the three prior proposals were likely to form a consensus view. In order to encourage consensus, the Unified Approach incorporates aspects of each of the prior proposals relating to scope, nexus, and profit allocation. Many important details remain outstanding, including with respect to administration, enforcement, dispute resolution, and the elimination of double taxation.

## ***Scope of the Unified Approach***

12. The Unified Approach would apply to large consumer-facing businesses, broadly defined as “businesses that generate revenue from supplying consumer products or providing digital services that have a consumer-facing element,” provided that they exceed a certain global revenue threshold. We understand that carve-outs are contemplated for certain sectors (such as extractive industries, commodities and possibly financial services).

13. The OECD should provide clear guidance that defines and identifies businesses in scope under the Unified Approach and in our view, a high global revenue threshold would be appropriate considering the administrative compliance burden that will inevitably be created by the proposals under the Unified Approach. A high revenue threshold would also be in line with the policy rationale underlying the OECD’s Program of Work. In our view the threshold should not be less than (but could be higher than) the threshold used for relevant country-by-country reporting purposes. This way, MNE groups would know that if they are not subject to country-by-country reporting requirements, they would also not be subject to the new Unified Approach.

14. We agree with the OECD’s decision to carve-out certain industries – particularly the resource sector, commodities, and financial services. In addition, in our view, the OECD should also consider excluding any other industries that trade in fungible property (such as commodities or cash) on the basis that they should not be considered to derive value from marketing intangibles in a manner consistent with businesses trading in unique properties. In addition, if a MNE group carries on both carved-out and non-carved out businesses, the OECD should ensure that only the non-carved out profits are eligible for reallocation under the Unified Approach. This could be done, for example, by excluding entities or lines of business where a significant portion of the underlying economic activity is derived from a carved-out business, or by applying the relevant revenue threshold only to revenue derived from businesses not subject to any carve-out.

15. We also agree that the scope of the Unified Approach under Pillar One should not apply to pure business-to-business transactions (i.e., transactions that are not consumer facing). In that regard, the OECD could clarify that the Unified Approach is not intended to apply to businesses that sell to arm’s length intermediaries (rather than customers) – on the basis that, in those cases, the user/market jurisdictions would be entitled to tax the local intermediaries’ profits.

## ***Introducing a New Nexus Rule that does not Depend on Physical Presence***

16. The Unified Approach introduces a new nexus rule for businesses in scope that does not depend on physical presence in the user/market jurisdiction. Instead, nexus will be determined based on a revenue threshold (which can vary based on the size of the market), which is assumed to indicate sustained and significant involvement in the user/market jurisdiction. The revenue threshold may be combined with a time threshold, and other activities (such as online advertising targeted at a jurisdiction) may also be relevant. This new nexus rule would be introduced through a standalone rule – layered on top of the existing permanent establishment rule. In our view, this mix of fundamentally different approaches to allocating profits (e.g., the arm’s length principle combined with formulary

apportionment) has a significant risk of creating additional tax disputes and double taxation. While the OECD has repeatedly cautioned countries that country-by-country reports should only be used as a risk-assessment tool, the Unified Approach's use of differing methods to allocate income could increase the risk of those reports being used as a proxy for allocating income.

### ***Profit Allocation Beyond Arm's Length Principle***

17. The Unified Approach creates a new profit allocation rule for businesses in scope that, in part, ignores the arm's length principle. The proposal begins with identifying a MNE group's profits, which may be based on consolidated financial statements and may be separated on a business line and/or regional/market basis. The OECD notes that separating the MNE group by business line and/or region/market could appropriately target the application of the Unified Approach to marketing intangibles. We agree that restricting reallocation to revenues derived from the same business line or the same region/market would be consistent with the intent of the Unified Approach, although we note that there may be complexities with respect to how such a separation will be applied as an administrative matter.
18. Under the Unified Approach, a market jurisdiction may be entitled to tax the following three types of amounts intended to give market jurisdictions greater taxing rights over residual profits based on a formulaic system, while the arm's length principle would continue to apply to routine profits:
  - (a) **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.
  - (b) **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.
  - (c) **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.
19. In our view, the OECD should more clearly identify the manner in which profits will be allocated to market jurisdictions, with a clear indication that the total amount of income taxed in different jurisdictions should not exceed 100%. Specifically, it is not clear how the OECD intends for Amounts A, B, and C to be allocated to specific entities in a MNE group (particularly in jurisdictions, such as Canada, that do not have a consolidated tax regime), and to ensure that (i) specific entities in the MNE group are not taxed on the same profits more than once, and (ii) double taxation is eliminated through the appropriate use of foreign tax credits. As drafted, it is very difficult to determine which entities in a group will be required to pay tax under Amounts A and B (or the manner in which any income allocated to a market jurisdiction under the new taxing rights may be offset by losses or other income allocated to a member of the MNE group in the same jurisdiction under the arm's length principle). Each country could argue, particularly based on a selective interpretation of the relevant country-by-country reporting statistics, that they should be entitled to tax a larger portion of income under Amount C. In our view, the OECD must adopt more specific measures to avoid double taxation. For example, if the starting point for allocating profits is the current arm's length standard, the Unified Approach should then clearly set out which jurisdictions and entities should reduce their income allocations by any amounts allocated to other jurisdictions under Amounts A and B.
20. Under the Unified Approach, an appropriate return for "routine" activities would be excluded from overall profit, and the remainder would be deemed to be "non-routine" profits, a portion of which would be allocated amongst different eligible market jurisdictions based on variables such as sales. Although the OECD has indicated that they will ensure that "routine" and "non-routine" activities are well understood and clearly defined – that is not

yet the case. In our view, the OECD should include specific and binding rules (together with examples) setting out specifically the circumstances in which activities will be considered routine, including the associated risks assumed, with a specific and limited amount of related income. To assist in that process, the OECD could use work previously done to clarify the application of the profit split method<sup>1</sup> in the transfer pricing context. In our view, any ambiguity in the application of the Unified Approach should be resolved in favour of taxpayers and not revenue authorities.

21. The OECD should also carefully study the interaction between the arm's length principle and the proposal to allocate residual profit under the Unified Approach. In our view, embedding tax avoidance principles into transfer pricing or otherwise layering them on top of the existing profit allocation rules will conflate the arm's length principle (which is cited in the Commentary to both the OECD and United Nations Model Tax Conventions) and anti-avoidance, and will further undermine reliance by courts and others on the OECD Transfer Pricing Guidelines.

## Unilateral Measures Targeting Similar Activities

22. The Unified Approach is intended to respond to unilateral tax measures targeting non-resident multinational corporations operating highly digitized business models – many of which are based in the United States. Such unilateral measures include proposed measures for taxing the digital economy (including the 3% digital services tax announced by the French government earlier this year) as well as measures to address unresolved BEPS concerns (including the United Kingdom's Diverted Profits Tax and the GILTI (Global Intangible Low-taxed Income) and BEAT (Base Erosion and Anti-Abuse Tax) regimes in the United States).
23. In our view, the Program of Work set an appropriately high bar of having the proposals approved by all 130+ members of the OECD/G20 Inclusive Framework on BEPS. Yet, there is no discussion in the Unified Approach of having countries abandon their unilateral measures targeting similar activities that may have been adopted prior to the development of a consensus view.
24. The OECD should require participating countries to agree to abandon any unilateral measures as a minimum standard and pre-condition to their participation in any new global standards. (For example, the recently re-elected Liberal Party in Canada announced that it intends to introduce a new 3% value-added tax on the income of businesses engaged in targeted advertising and digital intermediation services if they have world-wide revenues of at least C\$1 billion and Canadian revenue of more than C\$40 million – but, if the Unified Approach comes into effect, the Liberal Party plans to lift the tax and replace it with the consensus view.) Otherwise, there is the potential to have aspects of the existing international tax framework overlay the Unified Approach in addition to the patchwork of unilateral digital services taxes – which, in our view, would compound the complexity involved, would increase the risk of double taxation, and would inevitably result in additional tax disputes.

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<sup>1</sup> For transfer pricing purposes, the profit split method determines the arm's length allocation of total profit or loss attributable to transactions between related parties by evaluating the relative value of each non-arm's length person's contribution to that profit or loss. In a "residual profit split", each party is first allocated an arm's length profit for its routine contributions, such as manufacturing or distribution. The remaining or residual profit or loss (for non-routine contributions) is then allocated amongst parties based on an assessment of each non-arm's length party's contribution to the residual profit or loss. Non-routine contributions are those that cannot be accounted for by reference to market returns, or that are so integrated with other transactions that contributions cannot be reliably evaluated on a separate basis.

## Practical Issues with Unified Approach Highlighting the Importance of Dispute Resolution

25. While the OECD appears committed to ensuring that the Unified Approach under Pillar One does not result in double taxation, there are a number of remaining issues (including those that we identified in our submission of March 7, 2019), which highlight the importance of effective dispute resolution procedures. These issues include:
- (a) Differences in taxation periods and functional currencies between MNE group members (including across multiple jurisdictions and including having regard to minority investors).
  - (b) The application of losses: as a minimum standard, countries should agree to allow losses to be imputed into their jurisdiction based on similar allocation principles as the allocation of income – and allow such losses to shelter other income earned by the MNE group in that jurisdiction. There could also be an agreed minimum standard for the time limits within which losses could be carried forward or backward and used to offset other income in a jurisdiction.
  - (c) The manner in which revenues and expenses are to be calculated and allocated across jurisdictions (including with respect to both timing and quantum).
26. We commend recent comments from Pascal Saint-Amans, Director of the Centre for Tax Policy and Administration at the OECD that, “[i]f you want to benefit from the reallocation of taxing rights, you must have an effective binding dispute-resolution mechanism in place...It doesn’t have to be arbitration, but it must be equivalent to it.” Echoing these comments, if a country wishes to benefit from the additional taxing rights provided under Pillar One (which depart from established international tax norms), it must also be willing to share in the burden of any losses incurred in respect of the same business activity, particularly those which may arise in the early stages of business development.
27. By way of an example, consider the case of an enterprise that incurs significant initial start-up costs in one country, say the United States. Over time, the enterprise expands its business into different markets. The enterprise ultimately recognizes revenues in those additional markets, but, at the time that losses were incurred, was not operating in the user or market jurisdictions. In our view, if the market jurisdictions were to tax the enterprise’s income earned without a physical presence in their jurisdiction, they should also be prepared to recognize a proportionate amount of losses incurred by that enterprise – even if such losses were incurred outside of the particular jurisdiction. This underscores the importance of sharing losses prospectively as well as retrospectively. In the above example, start-up losses should not be confined to the United States if other jurisdictions will seek to tax the income of the enterprise – particularly in the absence of a physical presence. The “Unified Approach” simply states that the new rules will apply to both profits and losses and that the OECD is considering a claw-back or “earn-out” mechanism for losses under Amount A, without specifying the applicable timing or manner in which profits and losses may be recognized across different entities and jurisdictions – particularly for countries like Canada that do not have a consolidated tax regime. Such allocations of losses must be a minimum standard – without leaving countries with the discretion to tax MNE’s on their income without providing adequate relief for losses.
28. How the MNE group is defined will impact the scope of the proposals under the Unified Approach. In Canada, for example, there are a number of different group concepts in our domestic legislation, including non-arm’s length, related, associated, affiliated, and connected. There are also two “control” concepts that are relevant – *de jure* (legal) control and *de facto* (factual) control. Navigating the various group concepts in each of the 130+ members

of the OECD/G20 Inclusive Framework on BEPS, and consistently defining the MNE group so that the definition works in all jurisdictions, will be very difficult. In our view, a narrower interpretation of control (i.e., *de jure* control) may be most appropriate and the OECD should consider whether defining the MNE group should be informed by the same threshold as country-by-country reporting.

29. In our view, the Unified Approach appropriately recognizes that the lack of common tax base amongst the 130+ members of the OECD/G20 Inclusive Framework on BEPS is an issue. The OECD may need to rely on standardized accounting results to measure a MNE group's profit, which we note will generally be different than any country's definition of taxable income. However, as noted in the OECD's work on Pillar Two, accounting standards are not uniform across the globe, and significant permanent and temporary timing differences may arise when compared to income computed for relevant tax purposes. In our view, the Unified Approach should be restricted to reallocating income between different jurisdictions – and should not be used to seek to increase or duplicate the amount of income that is subject to tax. As a result, the Unified Approach should be modified to clarify that income allocated under Amounts A, B, and C, together with any income allocated in the relevant residence jurisdiction, should never exceed the amount of income that would have been earned and allocated to a taxpayer under the existing arm's length principle. In other words, the Unified Approach should only result in a reallocation of income to market jurisdictions, and should not increase the amount of income otherwise subject to tax.
30. In addition, while formulary apportionment is used domestically within certain countries, like Canada, to allocate profit to local taxing jurisdictions, it has not been used on a broad international scale. Examining the domestic use of formulary apportionment identifies certain practical, administrative, and compliance issues for the OECD to consider. In Canada, a single currency is used. There are also similar tax systems between provinces, generally conforming to a common tax base. The OECD should carefully study and provide a mechanism to address foreign exchange differences, possibly by adopting the currency and fiscal period used for purposes of determining the consolidated groups' financial results, and should also carefully consider the potential impact of the use of potentially significant variances in the tax bases in different countries – as well as potentially significant timing differences for when various amounts of income or expenses are recognized.

## Importance of Mandatory Binding Arbitration

31. We agree with comments in the Unified Approach that impartial dispute resolution procedures will be critical if the Unified Approach is adopted, especially considering differences in countries' legal and political systems. As an example, consider differences between transfer pricing in Canada (which has a principle-based system based on the arm's length principle) and the United States (where the relevant rules have been largely codified).
32. In our view, the OECD should develop rules for mandatory-binding arbitration (or equivalent) under the Unified Approach and consider how best to provide assistance to countries with respect to competent authority proceedings and arbitration in order to facilitate resolution of disputes and address potential mismatches in experience. While the Report on Action 14 *Dispute Resolution* readily admits the OECD's failure to achieve consensus on binding arbitration, and not all countries have signed on to mandatory binding arbitration in the *Multilateral Convention to Implement Tax Treaty Related Measures to Prevent Base Erosion and Profit Shifting* ("**MLI**"), the OECD should nonetheless commit participating countries to binding arbitration (or equivalent) as a pre-condition to their participation in the new global standards. In addition, even where countries have agreed to binding arbitration under the MLI, there remains disagreement between various countries on the manner in which arbitrations should be conducted. These differences must be resolved prior to countries participating in the Unified Approach.

33. In addition, in order to promote transparency and to assess countries' efforts to implement the minimum standards under the Unified Approach, the OECD should consider implementing a robust peer review process to evaluate the implementation of the minimum standards similar to the Mutual Agreement Procedure peer review and monitor processing under Action 14 of the BEPS Action Plan, placing all 130+ members of the OECD/G20 Inclusive Framework on BEPS on an equal footing.
34. There should be a mechanism to efficiently bring finality to treaty disputes under the Unified Approach. However, most treaty disputes are currently resolved on a bilateral basis. What is the OECD proposing in terms of resolving disputes regarding Amount A, Amount B or Amount C under the Unified Approach? If a challenge arises under the Unified Approach, does the OECD envision each country that was allocated profit to have a seat at the table?
35. Lastly, while advanced pricing agreements ("**APA**") and the International Compliance Assurance Programme may reduce disputes, they are not alternatives to mandatory binding arbitration when it comes to effective dispute resolution. The OECD could look at adopting such preventative measures in addition to mandatory binding arbitration. For example, the OECD should consider adopting a minimum standard that before applying the Unified Approach to a particular MNE, each relevant jurisdiction that may seek to tax a portion of the MNE's income must either (i) agree in advance to a form of standardized multilateral APA in which the specific manner of allocating income and losses will be understood and agreed, or (ii) agree to a common form of binding arbitration.
36. Regardless of the forum, there should be a detailed set of rules for dispute resolution that participating countries sign on to that go beyond a statement of a general principle that such rules are intended to provide relief from double taxation. In addition, the OECD should look at providing procedural protections so that the process remains objective and independent, and also consider whether decisions will be precedential and/or publicly available.

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