# Byrnes' Comments on the OECD's "Unified Approach" to Allocation of Profits of Digital Business

**Kluwer International Tax Blog**
October 10, 2019

William Byrnes (Texas A&M University Law)

*Please refer to this post as: William Byrnes, 'Byrnes' Comments on the OECD's "Unified Approach" to Allocation of Profits of Digital Business', Kluwer International Tax Blog, October 10 2019, http://kluwertaxblog.com/2019/10/10/byrnes-comments-on-the-oecds-unified-approach-to-allocation-of-profits-of-digital-business/*

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In my International Taxation class tomorrow (October 10th) we are going to discuss the OECD's "Unified Approach" released a day earlier on October 9, 2019. Given the keen interest generated by digital taxation and the allocation of profits/losses generated therefrom, I thought it of interest to the Kluwer International Tax readers that I share my notes and thoughts. If you are familiar with the previous OECD digital tax reports, then skip to section 2 below.

1. **February 2019 OECD Consultation *Addressing the Tax Challenges of the Digitalisation of the Economy***

Following a mandate by G20 Finance Ministers in March 2017, the Inclusive Framework on BEPS, working through its Task Force on the Digital Economy (TFDE), delivered an Interim Report in March 2018: *Tax Challenges Arising from Digitalization*.[1] Since the delivery of this 2018 Interim Report, the Inclusive Framework further intensified its work and several proposals emerged that could form part of a long-term solution to the broader challenges arising from the digitalization of the economy and the remaining BEPS issues. A February 2019 consultation document was issued describing the proposals discussed by the Inclusive Framework.[2] The February 2019 OECD Consultation considers alternatives that would allow authorities to impose taxes on online revenue generated within their destination-sourced jurisdictions but which are not captured by traditional international tax rules dependent on physical presence and nexus. The February 2019 Consultation deals specifically with the taxation challenges of attaching tax jurisdiction to the activities of digital multinational tech companies.

The OECD proposals focus on three potential solutions to establish tax jurisdiction: (I) user participation, (II) linking marketing intangibles such as a company's trademark to where the customers are resident, and (III) a new "significant economic presence" that links digital activity in a country to local activities such as billing and revenue collection in a local currency. This OECD Consultation document argues that there is an important difference between trade intangibles and marketing intangibles involving an intrinsic functional link with market jurisdictions because of the importance of marketing intangibles to digital business models. According to the Public Consultation Document, the marketing intangible proposal addresses a situation where an MNE group can essentially "reach into" a jurisdiction, either remotely or through a limited local presence, such as a limited risk distributor, to develop a user/customer base and other marketing intangibles. It sees an intrinsic functional link between marketing intangibles and the market jurisdiction.

This intrinsic functional link is seen as manifested in two different ways. First, some marketing intangibles, such as brand and trade name, are reflected in the favorable attitudes in the minds of customers and so can be seen to have been created in the market jurisdiction. Second, other marketing intangibles, such as customer data, customer relationships and customer lists are derived from activities targeted at customers and users in the market jurisdiction, supporting the treatment of such intangibles as being created in the market jurisdiction. Taking into account this link between marketing intangibles and the market jurisdiction, the proposal would modify current transfer pricing and treaty rules to require marketing intangibles and risks associated with such intangibles to be allocated to the market jurisdiction.

The proposal considers that the market jurisdiction would be entitled to tax some or all of the non-routine income properly associated with such intangibles and their attendant risks, while all other income would be allocated among members of the group based on existing transfer pricing principles. One consequence of this proposal is that market jurisdictions would be given a right to tax highly digitalized businesses—even in the absence of a taxable presence—given the importance of marketing intangibles for such business models. The proposal is intended to be consistent with the principle of allocating profit based on the value creation by firms in that this positive attitude in the minds of customers is created by, and the customer information and data is acquired through, the active intervention of the firm in the market. Unlike marketing intangibles, trade intangibles are seen as not similarly possessing an intrinsic functional link with market jurisdictions.

Given the importance of the tax issue and administrative challenges arising from the digitalization of the economy, the OECD intensified its work after the delivery of the Interim Report in March of 2018.[3] Seeking a "consensus" based solution, consistent with the analysis included in the Action 1 Report as well as the Interim Report, various proposals were put forward to achieve this result.[4] Some proposals focused on the allocation of taxing rights by suggesting modifications to the rules on profit allocation and nexus, other proposals focused more on unresolved BEPS issues. The OECD grouped these proposals into two pillars which could form the basis for consensus.

Pillar One focuses on the allocation of taxing rights, and seeks to undertake a coherent and concurrent review of the profit allocation and nexus rules; whereas Pillar Two focuses on the remaining BEPS issues and seeks to develop rules that would provide jurisdictions with a right to "tax back" where other jurisdictions have not exercised their primary taxing rights or the payment is otherwise subject to low levels of effective taxation. While these two groups of proposals, Pillar One and Two, are distinct, the issues overlap. Thus, within the OECD BEPS Inclusive Framework of nearly 130 country and jurisdiction tax authorities, there is agreement that both issues will be explored in parallel working toward a consensus solution that addresses both pillars.

Under Pillar One, three proposals have been articulated to develop a consensus-based solution on how taxing rights on income generated from cross-border activities in the digital age should be allocated among countries, namely, the "user participation" proposal, the "marketing intangibles" proposal and the "significant economic presence" proposal. These proposals have important differences, including the objective and scope of the reallocation of taxing rights, i.e., the "new taxing right". At the same time, all allocate more taxing rights to the jurisdiction of the customer or user which is called the "market jurisdiction" meaning jurisdiction of the economic market being sold into.

Countries that have been on the losing end of digital economy global parent corporations have strongly pushed for a new think of how value is generated by a remote business activity because active commercial participation in a local market interacting with local market users is not recognized in the current tax regime framework for allocating profits.[5] The uphill struggle has been the century of international tax law jurisprudence focusing on the division of business income taxing rights based on a connecting factor of physical presence with a jurisdiction, and the arm's length standard to allocate income where that connecting factor materializes.

The OECD identified the following technical issues that require resolution for the Pillar One group of proposals:

- Different approaches to determine the amount of profits subject to the new taxing right and the allocation of those profits among all jurisdictions of a business' value chain;
- The design of a new nexus rule that will capture the digital concept of business activity and presence; and
- International instruments to ensure implementation and efficient administration of newly obtained taxing rights, including the effective elimination of double taxation and resolution of tax disputes arising as a result.

The two prevalent proposed profit allocation rules to apply to a business' digital value chain are a modified residual profit split ("MRPS") method and a fractional apportionment method which is a modified formulary apportionment used among the U.S. states.

The MRPS method is proposed to allocate to market jurisdictions a portion of an MNE group's non-routine, i.e. intangibles, profit that reflects the value created in markets that are not recognized under the existing profit allocation rules. The MRPS will require four steps, being: (1) determine the total profit to be split; (2) remove the routine profits, using either current transfer pricing rules or simplified conventions; (3) determine the portion of the non-routine profit that is within the scope of the new digital taxing rights, using either current transfer pricing rules or simplified conventions; and (4) allocate the in-scope non-routine profits among the relevant market jurisdictions using a consensus-based allocation key. The MPRS method opens a pandora box of challenging issues for which consensus among the approximate 130 countries must be identified. The five primary issues for which a consensus will need to evolve for the MPRS method to provide a workable solution are:

1. The development of rules to govern how total profits should be computed for purposes of applying the Modified Residual Profit Split ("MRPS")
2. The development of rules to bifurcate total profit into routine and non-routine
3. The development of rules to quantify the portion of non-routine profit subject to the new taxing
4. The development of rules to allocate the identified profit subject to the new taxing rights among the relevant market jurisdictions.
5. The integration of the MRPS method with the existing transfer pricing rules without giving rise to double taxation or double non-taxation.

The fractional apportionment method is proposed to allocate to market jurisdictions a portion of an MNE group's total profits, that is without making any distinction between routine and non-routine profit. One approach posited looks to a non-resident enterprise's overall profitability of either the relevant group members involved in the digital business' value chain or isolates profitability to a specific business line's digital business' value chain. The alternative approach for determining the profit pool of a specific business line as opposed to relevant group members may gain traction to address large global MNEs that are not considered digital businesses in the sense of FAANG but leverage digital business within the value chain.[6]

This fractional apportionment method will require three steps, being: (1) determine the pool of profit to be divided (by group or business line); (2) select an allocation key; and (3) apply this formula of the allocation key to allocate fractions of the profit among the market jurisdictions. The four primary issues for which a consensus will need to evolve for the fractional apportionment method to provide a workable solution are:

1. Developing the method to determine the profits of a non-resident entity or its group that will be subject to the fractional apportionment mechanism.
2. Choosing a financial accounting regime and measures upon which the profit determination will be based.
3. Identifying the allocation key factors, including employees, assets, sales, and users, to be taken into account for constructing the formula to be employed to apportion the profits among the market jurisdictions.
4. Designing the coordination rules of the fractional apportionment method and the current transfer pricing system without giving rise to double taxation or double non-taxation.

The OECD includes the possible use of proxies based upon capitalized expenditures; projections of future income; fixed percentage of total non-routine income, including the possibility of using different fixed percentages for different lines of business; or other proxies yet to be proposed. Moreover, the OECD contemplates possible allocation keys, such as revenues. The fractional apportionment method involves the determination of the amount of profits subject to economic presence without making any distinction between routine and non-routine profit.

A third proposal presented a distribution-based approach that focuses on dual considerations of allocating profit to the market jurisdictions and the proper pricing of marketing and distribution activities. In contrast to the MRPS method, the distribution-based approach focuses on the profit related to routine activities associated with marketing and distribution. The proposal seeks consensus for a specified baseline profit for a market jurisdiction based upon a pool of the marketing, distribution, and user-related activities. The baseline profit may be increased based on the MNE group's overall profitability. This mechanism can also allow, in order to attract a consensus for it, a portion of an MNE group's non-routine profit from, by example, to be reallocated to market jurisdictions.

If this proposal gains traction, then consensus-building discussions about the baseline profit may consider additional variables to accommodate competing countries' perspectives, by example, industry and market differences. The five issues for which a consensus will need to evolve for a distribution-based approach method to provide a workable solution are:

1. Developing rules that provide a universal baseline amount of profit attributable to marketing, distribution, and user-related activities.
2. Choosing factors for potential adjustment of the baseline profit, such as a group's profitability as well as potentially its losses, that effectively allocate a proportion of routine and non-routine profits to market jurisdictions.
3. Selecting a minimum or maximum return for the baseline.
4. Assessment of how the adjusted profits may be allocated to market jurisdictions wherein the relevant group has no established tax presence.
5. Integrating the distribution approach into the current transfer pricing system without giving rise to double taxation or double non-taxation.

The OECD, in recognition that countries are unilaterally imposing tax on the digital business of foreign corporations regardless of physical presence, has set a deadline of 2020 to generate the consensus necessary for a proposal or set of proposals to percolate into a workable global solution to be published.[7] By example, France imposed a three percent tax as a withholding on the gross digital services income sourced from French users when the threshold of French sourced digital income reaches 25 million Euros. The tax only applies to corporations that employ a digital services business model and generate more than 750 million euro in profits.[8]

The OECD developed a road map with nine actions to assist OECD member countries to develop and implement new rules to monitor digital transformation and its international impact.[9] The nine actions developed to manage the challenges of digital transformation includes:

1. Make the digital transformation visible in economic statistics.
2. Understand the economic impact of digital transformation.
3. Measure well-being in the digital age.
4. Design new approaches to data collection.
5. Monitor transformative technologies (i.e. AI, Blockchain, Internet of Things).
6. Make sense of data and data flows.
7. Define and measure the skills need in digital era.
8. Measure trust in online environments.
9. Assess governments digital strengths.

**2. October 9, 2019 OECD *Secretariat Proposal for a "Unified Approach" under Pillar One***

On October 9, 2019 the OECD released its *Secretariat Proposal for a "Unified Approach" under Pillar One, Public Consultation Document*.[10] The Unified Approach is intended to include four elements: (I) scope, (ii) economic nexus, (iii) formulary apportionment profit allocation, and (iv) binding dispute resolution.[11] Regarding the element of scope, the OECD intends the new approach to capture more than just highly digital business models, but with carve-outs for certain industries such as the extractive industry. The expanded scope will rope in consumer-facing businesses.

The element of economic nexus dispenses with the dependency on physical presence to claim jurisdiction over a foreign taxpayer's digital activities. Thus, nexus may also be based on economic presence, such as a sales threshold based on the size of a jurisdiction. The OECD proposes that the revenue threshold would also take into account digital activities, such as online advertising services, that target users in locations that are different from the locations wherein the relevant revenues are booked. Economic nexus will be incorporated within a new standalone OECD Model tax treaty provision.

The new profit allocation will be based upon an approximation formulaic approach without the need for precise arm's length benchmarking, and irrespective of in-country marketing or distribution presence (permanent establishment or separate subsidiary) or selling via unrelated distributors. The final fourth element is a new three-tier profit allocation mechanism that in turn requires a binding dispute resolution mechanism. The new profit allocation mechanism is proposed as follows:

> **Amount A**: a share of deemed residual profit of a MNE group allocated to market jurisdictions using an approximation formulaic approach without the need of precise arm's length benchmarking;
>
> **Amount B**: a fixed remuneration for baseline marketing and distribution functions that take place in the market jurisdiction; and
>
> **Amount C**: Binding and effective dispute resolution mechanisms including any additional profit where in-country functions exceed baseline activities.

The Unified Approach rejects the application of the current Articles 7 and 9 arm's length approach of the OECD (and UN) Model Tax Treaty to determine the allocation of the profits to enterprises that fall within the scope of the new economic nexus article.[12] The Unified Approach states that it is "impossible" to use an arm's length approach to allocate profit based on an economic-based whereby no functions are performed, no assets are used, and no risks are assumed in the market jurisdictions. The approximation formulaic approach will be established "to deliver an agreed quantum of profit to market jurisdictions".

The deemed residual profit method will determine the remaining profit after a deemed routine profit for activities to the countries where the activities are performed.[13] Yet, the OECD recognizes that the non-routine profit generated by MNE groups is attributable to more than just the sales in the source country, to the activities such as trade intangibles, capital and risk, customers' data, valuable brand, innovative algorithms, and software.[14] The OECD envisions the global adoption of an approach that determines the level of the deemed routine profit and then the proportion of the deemed residual profit that will be allocated to the markets of economic presence through a formula based on sales.[15] Losses may also be allocable, but potentially subject to a claw-back or an "earn out" mechanism.[16]

The Unified Approach contemplates that profit attribution for distribution and other routine functions may continue to be allocated by a transfer pricing analysis based upon the arm's length principle or permanent establishment allocation under Article 7. Yet, the Unified Approach proposes that fixed remunerations be explored that reflect an assumed baseline activity, possibly with variances by industry. The justification is that fixed returns may provide certainty for taxpayers and tax administrations. Ironic that the OECD has pushed during the membership negotiations for Brazil, which employs fixed percentages, to move to an arm's length approach. The routine return amount for the routine activities will be excluded from the calculation of the pool of profits from which the allocation to market jurisdictions would be made.[17]

The OECD proposes that the starting point for the determination of the non-routine residual will be the identification of the MNE group's profits based upon the consolidated financial statements under the accounting standards of the headquarters jurisdiction prepared in accordance with the Generally Accepted Accounting Principles (GAAP) or the International Financial Reporting Standards (IFRS).[18] However, the OECD contemplates that a relevant measure of profits may be isolated to a business line, regional, or market basis. The example provided is of a potential distortion caused by a low-margin retail business that offers a high-margin cloud-computing business line. The jurisdictions wherein the high volume, though low margin, retail sales are concentrated may have a proportional advantage for the allocation of a group's profits over jurisdictions wherein high margin cloud-computing sales occur. The jurisdictions with the high margin digital activities will want a formulaic approach that limits the allocation based on the retail sales of the group. The OECD contemplates that the proposed approach assumes that a share of the deemed non-routine profit attributable to the market jurisdiction would be determined in accordance with a simplifying convention, such as non-routine profit multiplied by an internationally-agreed fixed percentage, perhaps different percentages for different industries or business lines.[19]

**3. New Profit Attribution Approach Example**.

The OECD provides the following example of the new profit attribution approach.[20] Group X is an MNE group that provides streaming services. It has no other business lines. The group is highly profitable, earning non-routine profits, significantly above both the market average and those of its competitors. P Co (resident in Country 1) is the parent company of Group X. P Co owns all the intangible assets exploited in the group's streaming services business. Hence, P Co is entitled to all the non-routine profit earned by Group X. Q Co, a subsidiary of P Co, resident in Country 2, is responsible for marketing and distributing Group X's streaming services. Q Co sells streaming services directly to customers in Country 2. Q Co has also recently started selling streaming services remotely to customers in Country 3, where it does not have any form of taxable presence under current rules.

Regarding Country 2 Group X has a taxable presence in the form of Q Co. Under the new economic nexus concept, Country 2 must determine whether Group X has a new non-physical taxable presence. If Q Co generates sufficient sales in Country 2 to meet the revenue threshold, then Country 2 has a new right to tax a portion of the deemed non-routine profits of Group X. Country 2 may tax that income directly from the entity that is treated as owning the deemed non-routine profit (in this example, P Co), with the possibility of Q Co held jointly liable for the tax due to facilitate administration.[21] Country 1 must grant relief from double taxation via P Co claiming a foreign tax credit or an exemption. Q Co is a relevant taxpayer only for an applicable fixed return for baseline marketing and distribution activities. Transfer pricing adjustments must be made to transactions between P Co and Q Co to eliminate double taxation. Finally, if Country 2 allocates additional profits under the arm's length determines to Q Co because its activities go beyond the baseline activity assumed in the fixed return arrangement for marketing and distribution activities, then Country 2 should be subject to robust measures to resolve disputes over double taxation with Country 1.[22] Group X does not have a physical presence in this example in Country 3. However, Q Co executes remote sales in country 3. If the remote sales breach the revenue threshold, then Q Co has an economic presence in Country 3 for which a portion of the deemed non-routine profits of Group X will be allocated.[23]

**4. Is Data the New Oil?**

I have oft heard that "data is the new oil" the past year.[24] On behalf of the analogy, I have heard that data like oil has grades and qualities. Data like oil is merely a potential value that cannot be realized without processing/refining.

But my thought that is if data is the new oil, then isn't data part of the national patrimony (except in the USA)? If it is part of the national patrimony, then its exploitation must be for the benefit of the national public under most countries' laws and even constitutions. And if so, then by example, an equivalent of an extractive industry royalty may be imposed by a country, as well as 'production' sharing agreements. Under a continental European approach to the communal society, I can envision an argument that data extracted from the public is akin to extracting natural resources. Anyway, data is not exclusive to one extractor, whereas oil becomes exclusive via the extraction process. Data does not deplete by its extraction and use but rather becomes more valuable. So I do not think "data is the new oil" is a good analogy. But if data is the new oil, then perhaps data should be subject to a similar tax regime.

If you are interested in how to determine and then allocate a residual, download my article" Boiling Starbucks' Roasting Down to the Essence of its Residual In the Netherlands State Aid case"

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[1] OECD (2018), Tax Challenges Arising from Digitalisation – Interim Report 2018: Inclusive Framework on BEPS, OECD/G20 Base Erosion and Profit Shifting Project, OECD Publishing, Paris, https://doi.org/10.1787/9789264293083-en (accessed Oct. 9, 2019).

[2] Public Consultation Document, Addressing the Tax Challenges of the Digitalisation of the Economy, 13 February – 6 March 2019. Available at https://www.oecd.org/tax/beps/public-consultation-document-addressing-the-tax-challenges-of-the-digitalisati

on-of-the-economy.pdf (accessed Oct. 9, 2019).

[3] OECD (2018), Tax Challenges Arising from Digitalisation – Interim Report 2018: Inclusive Framework on BEPS, OECD/G20 Base Erosion and Profit Shifting Project, OECD Publishing, Paris. Available at https://doi.org/10.1787/9789264293083-en (last visited Oct. 9, 2019).

[4] OECD (2019), Addressing the Tax Challenges of the Digitalisation of the Economy – Policy Note, as approved by the Inclusive Framework on BEPS on 23 January 2019, OECD, Paris. Available at https://www.oecd.org/tax/beps/policy-note-beps-inclusive-framework-addressing-tax-challenges-digitalisation.pdf (last visited Aug 23, 2019).

[5] As a general perception, the globalized digital multinationals are U.S. headquartered, epitomized by the acronym FAANG that includes Facebook, Apple, Amazon, Netflix and Google. China's digital multinationals are also drawing attention as these become global household names, especially throughout Asia, epitomized by the acronym BAT that includes Baidu, Alibaba, and Tencent.

[6] The acronym FAANG that includes Facebook, Apple, Amazon, Netflix and Google.

[7] OECD (2019), "Tax and Digitalisation", OECD Going Digital Policy Note, OECD, Paris. Available at www.oecd.org/going-digital/tax-and-digitalisation.pdf (last visited Oct. 9, 2019). Countries that have enacted or proposed a tax on the digital business of foreign corporations, by example, include India, France, the U.K., Italy, Spain, Poland, Hungary, and Belgium.

[8] France's digital services tax targets primarily U.S. digital companies. The tax is referred to by France's policy makers as the GAFA tax, which stands for Google, Apple, Facebook, and Amazon, and that it has been written so as not to apply to European companies. *See* Transcript of § 301 France Digital Services Tax (DST) at p. 22 Public Hearing of the Office Of The United States Trade Representative (Aug 19, 2019). Available https://ustr.gov/sites/default/files/enforcement/301Investigations/0819USTR.pdf (accessed Oct. 9, 2019).

[9] OECD (2019), Measuring the Digital Transformation: A Roadmap for the Future, OECD Publishing, Paris, Available at https://doi.org/10.1787/9789264311992-en (accessed Oct. 9, 2019).

[10] *Secretariat Proposal for a "Unified Approach" under Pillar One*, Public Consultation Document, OECD (Oct. 9, 2019) (hereafter "Unified Approach"). Available at https://www.oecd.org/tax/beps/public-consultation-document-secretariat-proposal-unified-approach-pillar-one.pdf (accessed Oct. 9, 2019).

[11] Unified Approach ¶ 15.

[12] Unified Approach ¶ 27.

[13] Unified Approach ¶¶ 30, 52.

[14] Unified Approach ¶ 57.

[15] Unified Approach ¶ 35.

[16] Unified Approach ¶ 51.

[17] Unified Approach ¶ 54.

[18] Unified Approach ¶ 53.

[19] Unified Approach ¶ 58.

[20] Unified Approach ¶ 41.

[21] Unified Approach ¶ 43.

[22] Unified Approach ¶ 45.

[23] Unified Approach ¶ 48.

[24] "Data is the new oil. It's valuable, but if unrefined it cannot really be used. It has to be changed into gas, plastic, chemicals, etc to create a valuable entity that drives profitable activity; so must data be broken down, analyzed for it to have value." Clive Humby, Address at the ANA Senior Marketer's Summit at the Kellogg School. (2006). Michael Palmer, Data is the New Oil, ANA MKTG. MAESTROS (Nov. 3, 2006) http://ana.blogs.com/maestros/2006/11/data_is_the_new.html (accessed Oct. 10, 2019). See The world's most valuable resource is no longer oil, but data (Economist May 6, 2017). Available at https://www.economist.com/leaders/2017/05/06/the-worlds-most-valuable-resource-is-no-longer-oil-but-data (accessed Oct. 10, 2019).