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# The OECD/Inclusive Framework's Program of Work on Revised Nexus and Profit Allocation Rules (Pillar One): Where Will It Lead?

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On June 9, 2019 the G20 finance ministers endorsed the program of work that was issued by the OECD's Inclusive Framework on BEPS on May 31, 2019 in relation to tax challenges arising from the digitalization of the economy. As expected, the program of work has two parts. The first part, called Pillar One, aims to find an agreed approach to the allocation of the profits of a multinational business among the countries in which the business is carried on, including countries in which the business has no physical presence but does have customers and/or users of its goods or services. Thus Pillar One contemplates new rules on tax jurisdiction (often called nexus), in addition to a new allocation rule, since the existing rules do not allow a country to impose net income tax on a non-resident business that has customers and/or users in a country but has no agents or assets in the country.

The second part of the program of work, Pillar Two, deals with a proposed set of new rules that would establish a global minimum tax regime for multinational groups. The remainder of this article will discuss Pillar One only.

It is worth noting at the outset that the program of work is written in a way that clearly suggests that the proposals are not just proposals to be considered on a 'without prejudice' basis, as stated in the OECD/Inclusive Framework Policy Note of late January 2019. Rather, the introductory chapter of the program document notes, first, that "for some commentators and members of the Inclusive Framework the work on the tax challenges of digitalization has revealed some more fundamental issues of the existing international tax framework, which have remained after the delivery of the BEPS package", and then states that "if the Inclusive Framework does not deliver a comprehensive consensus-based solution within the agreed G20 time frame [i.e., by the end of 2020], there is a risk that more jurisdictions will adopt uncoordinated unilateral tax measures."

Regarding Pillar One in particular, the introductory chapter first says, in paragraph 7, that the aim is "to undertake a coherent and concurrent review of the profit allocation and nexus rules". However, in paragraph 18, the wording, although similar, is different, saying that the discussion of Pillar One "describes the different technical issues that need to be resolved to undertake a coherent and concurrent revision of the profit allocation and nexus rules." Note the change from "review" to "revision". Keeping the current rules in place does not appear to be within the realm of possibility, at least for those cases that are within the scope of the new rules (however that scope is ultimately defined).

Exactly what the new taxing right will look like and how it will work has not been determined. A number of different options remain for both the profit allocation and the nexus component parts of Pillar One.

### Revised Profit Allocation Rules

The new rules will prescribe a new method for determining the amount of profit (or loss) subject to the new taxing right and for allocating those profits or losses among different jurisdictions.

The possible methods considered in the program of work include:

1. Modified Residual Profit Split (MRPS) – that is, identifying the non-routine profits of a business and allocating a portion of them to market jurisdictions, using a combination of existing transfer pricing rules and a new allocation key (which is yet to be determined).
2. Fractional Apportionment – that is, “formulary apportionment”. Fractional apportionment avoids the complexity of MPRS by eliminating the need to identify routine and non-routine profits. It would apply to the total global profits of a group or business line and allocate them between jurisdictions according to a set “allocation key” or formula. Traditionally eschewed by the OECD as overly simplistic and inconsistent with the arm’s length principle of transfer pricing, “fractional apportionment” would represent a momentous transformation of the principles upon which the international tax system is built.
3. Distribution-based “simplified methods”. This contemplates using fixed baseline profit margins for “marketing, distribution, and user-related activities” taking place in market jurisdictions, and adjusting the margin “based on a group’s overall profitability and other relevant factors to effectively allocate a proportion of routing and non-routine profits to market jurisdictions.”

In any case, it seems highly likely that some sort of formulaic allocation method will be adopted.

The program document notes that it will be necessary to “explore the possibility of determining the profits subject to the new taxing right on a business line and/or regional basis.” With respect to the scope of the new rules, the Inclusive Framework “will explore different limitations that could operate either by reference to the nature (e.g., through negative exclusions, safe harbours, and/or other screening criteria) or the size (e.g., thresholds based on revenue or other relevant factors) of a given business.” Businesses involving commodities and other primary products, and financial instruments, are mentioned as possibly being subject to special rules (or an exclusion).

### Nexus

The new rules for establishing taxing rights will also include a new concept in international taxation: that of a remote, non-physical, taxable presence.

The program of work contemplates the recognition of non-physical taxable presence through either:

- Expanding the current definition of what constitutes a “permanent establishment” (PE) in the OECD Model Tax Convention by deeming a PE to exist where an MNE has “a remote yet sustained and significant involvement in the economy”; or
- Creating an entirely new and separate rule for a non-physical nexus that would operate in addition to the concept of PE.

In either case, the key consideration in determining nexus will be determining the indicators that demonstrate that an MNE is participating in the economy of a jurisdiction (beyond mere sales to customers located there from a remote location).

The program of work also recognizes the need to ensure the new taxing right does not lead to double taxation, adversely impact existing tax treaties, or cause administrative complication. All of this is, of course, more easily said than done.

**How did it come to this?**

It was not foreseeable, when the BEPS Project final reports were published in October 2015, that the OECD Centre for Tax Policy and Administration's top priority project in mid-2019 would be the potentially revolutionary program of work that was approved by the G20 finance ministers in early June. The final report on Action 1 of the BEPS Action Plan, dealing with the tax challenges of the digital economy, had simply deferred any further work on the topic until after an evaluation had been made, in 2020, regarding the effect of the implementation of the other 14 items in the plan. What led us to where we now find ourselves, and where are we headed?

There have been several forces at work since late 2015. First, in mid-2016 the OECD created the Inclusive Framework on BEPS Implementation, opening up the OECD's tax policy work to any country that was willing to commit to the four minimum standards established by the BEPS final reports (namely, anti-abuse provisions in tax treaties, transfer pricing documentation and country-by-country reporting, ending harmful tax practices, and improving mutual agreement procedures). The Inclusive Framework invitation attracted a large number of countries to the table. There are now 129 members.

Second, the scope of the policy work discussed by the Inclusive Framework expanded beyond implementation of the BEPS Project recommendations. The deferred BEPS Action 1 work provided the opportunity for countries such as India to advocate for reform of well-established features of the international tax system, such as the OECD's transfer pricing guidelines and the permanent establishment concept. Once Pandora's box had been opened in this way, other countries—France and Germany, specifically—came forward with a global minimum tax proposal dealing explicitly with an issue that had been explicitly excluded from the BEPS Project, i.e. tax rate arbitrage.

Third, a number of countries, plus the European Commission, put pressure on the OECD/Inclusive Framework by enacting, or proposing to enact, digital services taxes on a unilateral basis. India got the ball rolling in 2016 with its equalization levy, and a number of countries followed suit, with variations on the theme, in subsequent years. This led the United States, whose resident technology giants were the targets of these taxes, to take the lead in encouraging the OECD/Inclusive Framework to find a global, consensus-based "solution" to the "problems" of taxing multinational corporations in the age of digitalization, in return for a commitment by all countries to refrain from imposing unilateral digital services taxes not in compliance with the agreed approach. Oddly, the digitalization-related tax problems that the program of work is meant to be solving through proposals applicable to all types of businesses have not been as clearly defined as the political problem posed by the likelihood of a large number of uncoordinated unilateral tax measures aimed at large global multinationals with highly digitalized business models.

**Where are we headed?**

The program of work is fairly candid about the fact that a political agreement is needed on the main issues in Pillar One—i.e., new rules on allocating profits to market countries and on jurisdiction to tax remote sellers. Allocation is the most difficult issue, because re-allocation will create winners and losers from a pure revenue perspective. The size of a given multinational's global taxable profit pie will not change; rather, the size of the pieces that go to the countries that are able to tax the multinational will change. Some countries that currently get no piece at all will get a piece of the pie in the future. And some countries will get a smaller piece than they currently get.

Why would the losers agree to be losers? Advocates for change hope that the countries that would lose revenue under new allocation rules will be persuaded that it is in their interest to pay that price in exchange for a new international tax framework that is stable, clear, and relatively friction-free. This is plausible in relation to relatively wealthy countries whose economies are heavily dependent on international trade, such as Germany and the Netherlands, since the political calculation involves the idea that the deal will indirectly provide economic aid to developing countries with large populations, such as India. But for smaller developing countries that depend on multinational corporate income tax revenues from production or extraction activities within their borders, it is hard to see any incentive to agree to new tax rules that reallocate income toward the marketing and sales end of the value chain.

By the end of 2019, it should be possible to tell whether a political agreement on profit allocation and taxing jurisdiction is going to be achieved or not. Most longtime observers of the OECD's tax policy work feel that some sort of agreement will be hammered out. It might not be supported by 100% of the Inclusive Framework members, and more likely than not it will be worded in a way that allows for somewhat differing interpretations. It will almost certainly involve a formulaic approach to dividing the global profits of a multinational business and a certain level of commitment to enhanced dispute resolution measures. It is hard to predict more than that at this stage.

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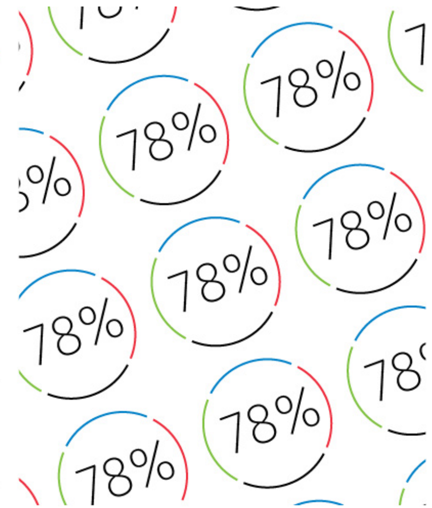

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