
Digital Economy

Digital Economy: New Profit Allocation and Nexus Approach

> *The proposals addressed in the Programme of Work will have implications well beyond digital businesses or digital business models.*

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It is rightly said: “Taxation should seek to be neutral and equitable between forms of electronic commerce and between conventional and electronic forms of commerce.

Business decisions should be motivated by economic rather than tax considerations. Taxpayers in similar situations carrying out similar transactions should be subject to similar levels of taxation."[1]

Building on this analogy, the Organisation for Economic Co-operation and Development (OECD), under the aegis of the Inclusive Framework under the Base Erosion and Profit Shifting (BEPS) project, has time and again taken several measures to address the challenges in taxing a digital economy. Back in 2015, the OECD, as part of its BEPS project in Action Plan 1,[2] recognized that the digital economy raises broader tax challenges for policy makers relating to nexus, data and characterisation. The OECD has continued work at a breakneck speed with the release of an Interim Report[3] in 2018, followed by a policy note and a Public Consultation Document (PCD) - *Addressing the Tax Challenges of the Digitalisation of the Economy* in 2019.

The latest development in the series of work undertaken by the OECD in the field of taxing the digital economy is developing a consensus-based 'new taxing rights' for a digital economy under the Programme of Work[4] released in May 2019. The document provides an overview of the direction on the long-term consensus-based solution that the OECD aims to achieve to address the challenges of the digitalization of the economy. On June 9, 2019, the G20 finance ministers endorsed the Programme of Work that was issued by the OECD Inclusive Framework on BEPS on May 31, 2019.

While conceding the gaps that may exist in how jurisdictions approach these issues, the Programme of Work creates an aggressive timeline to develop rules and design standards to deliver a unified framework. Important anticipated milestones include a progress report in December 2019, ongoing Working Party discussions throughout 2019 and 2020, and a final report delivered to the G20 by the end of 2020.

This paper focuses on the rules of the new profit allocation as described under Pillar 1 and the digital nexus approach propounded by the OECD as the basis for taxing the digital economy. It further analyses each of the profit allocation methods in detail and the potential impact of these allocation methods on certain digital business models.

Synopsis of new profit allocation and nexus approach

The Programme of Work aims to resolve the tax challenges arising from the digitalisation of global economies and explores technical issues to be resolved through two pillars, which are discussed below:

- Pillar One: This pillar focuses on finding an agreed approach for the allocation of profits of a multinational enterprise (MNE) group among the countries in which the business is carried on, including countries in which the business does not have a physical presence, but has customers and/or users of its goods or services. Pillar One suggests the following changes:
    - Revised Nexus Rule: The Programme of Work would explore the development of the concept of remote taxable presence (i.e., taxable presence without the need to establish physical presence). Remote taxable presence can be established by 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; and creating a new and separate rule for a non-physical nexus that would operate in addition to a PE.
    - Revised Profit Allocation Rules: The new market jurisdiction taxing right requires a method to quantify the amount of profit to be reallocated to market jurisdictions, and a method to determine how that profit should be allocated among the market jurisdictions entitled to tax under the new taxing right. The programme envisages three methodologies for profit allocation: (1) Modified Residual Profit Split Method; (2) Fractional Apportionment Method; and (3) Distribution-Based Approaches.
- Pillar Two: This pillar focuses on proposing a new set of rules that would establish a global minimum tax regime for multinational groups. This proposal would apply beyond the digital economy and would ensure that multinationals pay a minimum level of tax on profits earned in low-tax countries. A global anti-base erosion (GloBE) proposal sets out the following two interrelated rules:

- Income inclusion rule: This rule operates as a minimum tax and provides tools for jurisdictions to tax low-taxed profits of foreign subsidiaries and branches at the level of related investors. It would tax the income of a foreign branch or a controlled entity if that income is subject to tax at an effective rate that is below a minimum rate.
- Tax on base eroding payments: Under this rule, the source state could deny a deduction or impose source-based taxation for payments to related entities when the payment is not subject to a minimum tax rate, and tax treaty benefits could be denied where certain income is not subject to a minimum tax rate.

Overview of profit allocation methodologies

Key characteristics of the three allocation methodologies are found in Exhibit 1. Illustrations of the practical application of each profit allocation methodology are below.[5]

Modified Residual Profit Split Method.

Step 1: Determine the MNE group's total profit. This shall require consideration of the suitability of using accounting rules for the computation of total profits, relevant measure of profit and other appropriate adjustments. Further, relative merits in determining the group-wide basis or on an entity/aggregated entity basis will need to be analyzed.[6] The profit & loss account of an MNE Group is found in Exhibit 2.

Step 2: Determine the MNE group's routine profit and remove the routine profit from the total profit determined in Step 1. The routine profit can be determined by using either current transfer pricing rules or other simplified approaches.[7]

The profits attributable to the MNE group's routine functions based on transfer pricing principles equal USD 8. Therefore, the profit left after removal of the routine profit is USD 20 [total profit (28) – routine profit (8)].

Step 3: Determine the portion of the MNE group's non-routine profit within the scope of the new taxing right. The non-routine profit can be determined by using either current transfer pricing rules or other simplified approaches.

Subtracting the routine profit from the MNE group's total profit leaves the MNE group with a residual non-routine profit of USD 20 (28-8).

Step 4: Allocate the non-routine profit to market jurisdictions based on an appropriate allocation key. This requires an evaluation of various allocation keys.

Here, we hypothesise that the intangibles have created a unique and valuable contribution in developing sales in the market jurisdictions and accordingly the cost in developing the intangibles (i.e., marketing and R&D) can be the basis of the value generated to the market jurisdiction and could be an appropriate allocation key for allocating non-routine profit to market jurisdictions. Since the cost of marketing and R&D is approximately 1:2, the allocation of non-routine profits to the market jurisdiction is depicted in Exhibit 3.

The non-routine profit arising from the marketing intangible (USD 7) should be allocated between the market jurisdictions (e.g., A and B) in pre-determined ratios based on relative contributions, such as advertising, marketing and promotion (AMP) spent in the two jurisdictions, or by sales. Assuming the AMP spent in jurisdiction A is USD 2 and the AMP spend in jurisdiction B is USD 6, the allocation of non-routine profit on account of the marketing intangible to the market jurisdictions is depicted in Exhibit 4.

Fractional apportionment method (FAM).

Step 1: Determine the MNE group's total profit to be apportioned. This step involves developing and evaluating a method to determine the profit to be apportioned. Profit can be determined by using current transfer pricing rules or by applying a global profit margin to local sales.

As in Step 1 of the MRPS example above, the total profit of the MNE Group is assumed to be USD 28.

Step 2: Select the appropriate allocation keys. This step involves determining and selecting the appropriate factors, such as employees, assets, sales, and users that can be taken into account in apportioning the relevant profit.

Step 3: Apply the selected allocation keys to allocate a fraction of the profit to each jurisdiction. This includes determining the allocation percentage to be applied to each

jurisdiction's profit to determine the taxable profits.

After identifying the appropriate allocation keys and assigning weights to them, a fraction of profit is allocated to various market jurisdictions, as depicted in Exhibit 5.

Distribution-based approaches.[8]

Step 1: Assume a baseline profit. This includes developing a baseline profit attributable to local marketing, distribution, and user-related activities in each market jurisdiction. We have assumed a baseline profit as 3% of local sales for purposes of our analysis, which should be representative of an arm's length return for these activities.

Step 2: Calculate the Adjusted Baseline Profit (ABP). This includes assessing whether and how any adjusted profits or returns could be applied if the relevant group has an established tax presence in the market jurisdiction.

To adjust the base profitability of 3% based on industrial / market factors, if the group's profitability exceeds 12%, the baseline profit could be increased by 20% of the excess, for example.[9] A corresponding calculation could also be made in cases of decreased group profitability. The group profitability in our example is 28%. Therefore, the adjustment to the baseline profit would be: 20% × (28-12) = 3.2% and the ABP would be 6.2% (i.e., 3.2% adjustment + 3% baseline profit).

Step 3: Adjust the ABP to local marketing expenditures to arrive at the profit allocation percentage. In our example, the ABP would be adjusted to local marketing expenditures by applying an increase or decrease of 20% to local marketing expenditures exceeding 10% of local revenue. See Exhibit 6 for an assumption of marketing spend.

Case studies

This section analyzes the application of the various profit allocation methods to certain existing digital business models.

Social networking

Social networking sites are the most widely used and popular digitalized business models. A social networking site is characterized by user interaction over an online platform. This user interaction provides marketing opportunities to other online businesses and corresponding advertising revenue to the social networking site. User engagement is critical in this model and the market reach is achieved with no significant tangible presence in a particular jurisdiction.

Based on user interaction on the social networking platform in a particular jurisdiction, an algorithm that is developed and owned by the IP owner (usually the headquartered company) analyzes user data to reveal patterns, trends, and associations, especially relating to human behavior and interactions, using data processing software.

From an organizational structure perspective, social networking companies typically set up a local subsidiary in a particular market jurisdiction to perform strategic or local marketing support services, such as website management and local advertising functions. Such entities receive an arm's length remuneration for the local marketing support services rendered.

A diagram of the business model is depicted in Exhibit 7. Possible value creators include the following:

- Technological platform: The technological platform is the facilitator that brings together the users and advertisers and plays a key role in monetizing the data.
- Users: Users of the social networking platform posting information and updates leads to the generation of data, which perpetuates a continuous cycle of further interaction and generation of user data.
- Data generated: The data generated by user interaction would not be of much use without analysis that reveals potential patterns, trends, and associations that, in turn, can be sold to specific advertisers. This data generated is important where advertising revenue is one of the main revenue streams for a social networking site as users may not pay a subscription or membership fee.

Applicable profit allocation method – MRPS. Let's assume local subsidiaries are provided an arm's length return commensurate with their functions. The current profit allocation rules (though at arm's length) don't factor in the value generated by the market

jurisdiction for its role in providing the user base or allocate any additional returns to the market jurisdiction. On the contrary, the residual / non-routine returns lie with the parent entity or the entity undertaking / owning the technology.

In a social networking scenario, user interaction undoubtedly generates considerable value. MRPS appears to be linked to user participation in the value chain. As discussed earlier, the MRPS methodology is intended to allocate a certain portion of the MNE group's profit to the market jurisdiction so as to reflect the value created that is not recognized by the existing profit allocation methodology.

It seems that the MRPS method could be an appropriate method to allocate non-routine profit among market jurisdictions that were not allocated any additional returns previously. The value creators in the social networking model (i.e., number of users, cost of technological development, local advertising revenue generated) can be used as allocation keys for allocating non-routine profits to market jurisdictions.

Consumer transportation and logistics. Ride hailing platforms are an example of how digitalization can be used to fulfil the public utility function of transportation and are gaining traction globally. They are representative of a “gig and sharing” business model in the digital economy. This business model operates through an application on a mobile device connecting users[10] and providers[11] of specific services.

First, a ride hailing company sets standards for service providers to use its platform, such as vehicle standards, driving skills requirements, record standards, etc. The platform monitors service providers' active hours and location details in real time on the platform. Second, the service users input their personal data through the ride hailing company's application on their mobile device before requesting services. The app matches service users request for specific services with service providers on the platform. Upon completion of the service, a fee is charged directly by the platform to the service user's bank card or credit card entered into the application.

The fee is calculated by the platform based on certain algorithms. Ride hailing applications also provide rating and review systems, allowing users to provide feedback and their interaction with the platform. This feedback acts as a mechanism for allocating future service requests between sets of users.[12]

As part of their organizational structure, local entities are responsible for providing the following:

- Platform access to the contracted drivers and customers.
- Regional marketing and sales services.
- Driver and customer support services.
- Billing management.

In most cases, a local subsidiary is compensated on an arm's length basis for marketing and support services and no additional compensation is provided absent a PE.

See Exhibit 8 for a representation of this model. Possible value creators include:

- Service users, which are the end consumers who utilize the platform and whose feedback is used to strategize pricing decisions or develop lateral business models.
- Platform, which is the technological medium that brings together a service provider and an end user to generate value for the end user.
- Service providers, which are the independent service providers, in the absence of whom, the user base and platform may not be of any value.

Applicable profit allocation method - FAM. Under the current ride hailing business model, the local subsidiary is remunerated on an arm's length basis for the services it provides. However, under this methodology, value is not attributed / accrued to the local entity that is responsible for bringing together users and service providers. These returns are essentially passed on to the headquarter entity. As a result, while the local entity is remunerated based on the functions undertaken and risks borne, the market jurisdiction is not compensated.

This imbalance can be addressed by FAM, whereby a fraction of the MNE group's total profit can be allocated to market jurisdictions based on certain selected allocation keys. By applying this method, a market jurisdiction could be attributed a fraction of the profit for the value created through local user activity and market development.

Digital media streaming. Video streaming providers allow subscribers to watch television shows, movies, documentaries and more on a wide range of Internet-connected devices.

The companies may also provide DVD rental plans. Video, on-demand streaming companies generally operate on a subscription-based model, which is also their primary source of revenue. Subscribers pay for a monthly subscription plan and are given access to stream shows, movies, documentaries and other content available on a company's platform in the format of their choice, for which they pay a fee.

Digital media streaming companies give subscribers legal access to a large movie and television database, personalized suggestions based on proprietary algorithms, and seamless streaming services without the interruption of advertisements. The streaming services are supported on a wide range of devices, such as computers, televisions, mobile devices (i.e., mobile phones and tablets), and gaming consoles. Some providers release new and exclusive series one full season at a time instead of one episode at a time, which encourages subscribers to return to the program regularly and often.

Some video streaming companies have earned millions in revenue from consumers in various jurisdictions, but such revenue is booked in a different jurisdiction. This raises questions regarding how multinational corporations classify and account for revenue locally and highlights the challenges of taxing the digital economy.

The business organization in a local jurisdiction is structured to include a local distribution entity that functions primarily as a limited risk distributor. This entity is responsible for entering into subscription contracts with end user subscribers or certain strategic partners. Another entity is responsible for the content to be streamed online. This entity is responsible for purchasing the license for particular content. Once the license is purchased, it is immediately transferred to the offshore entity. The local entity never takes ownership of the licensing rights, but it receives an arm's length remuneration for the functions that it performs.

Possible value creators include:

- Technology interface - the technology medium that brings together a service provider and end users to generate value for the end users.
- User viewing patterns - the data generated and analyzed from the viewing patterns of end users, and which assist the services provider in identifying end user preferences

and, accordingly, modifying and/or adding content to enhance customer viewing satisfaction.

- Content – different digital media streaming providers stream different content. Developing and suggesting user-specific content based on an analysis of user data helps popularize a particular streaming platform.

Applicable profit allocation method - distribution method. The base rate allocable under this method would, to some extent, take into consideration the assured return payable to the local entities in a market jurisdiction. This method adjusts the baseline profit to the level of local marketing expenses in the relevant jurisdictions to derive the rate of profit allocable to a market jurisdiction.

The distribution method may be considered a viable profit allocation method under the digital business model where marketing intangibles form an important part of the value creation process. Further, this approach would help to mitigate subjectivity and provide greater certainty.

Treatment of losses under Pillar One

In their efforts to scale rapidly, many digital companies have incurred losses. Therefore, the sharing of losses among several jurisdictions should be addressed to prevent notional profits being taxed in the absence of real profits. It is pertinent to note that not much is discussed in the Programme of Work about the need to allocate business losses based on the Pillar One approaches. However, it does state that the new proposed profit allocation rules have effective application to both profits and losses.

The Programme of Work expects to explore some of the issues related to the treatment of losses, including the practical consequences of filing tax returns in market jurisdictions, the development of an earn-out approach to losses (which could also refer to some form of a term test), and the determination of the type of loss (i.e., business / segment loss, jurisdiction loss, or carry forward loss) should be taken into account in the proposed approaches.

Nexus debate

The concept of nexus has been defined variably through significant economic presence, user participation, digital PE, or the presence of marketing intangibles. The Programme of Work highlights the fact that different technical issues need to be resolved to undertake a coherent and concurrent revision of the profit allocation and nexus rules.

The OECD Multilateral Convention to Implement Tax Treaty Related Measures to Prevent Base Erosion and Profit Shifting (the "Multilateral Instrument" or "MLI") has introduced changes to the concept of taxable nexus.[13] However, the actual source revenue effects are likely to be minimal because the MLI will modify characteristics that are not relevant to the digital economy as they are focused on physical presence.[14]

The solution for resolving the nexus debate should be simple for tax administrations to administer and easy for taxpayers to comply with. At the risk of jettisoning the arm's length principle, if the quasi-formulaic approach adopted is complex, it may lead to disputes in addition to potential double taxation.

Conclusion

While the OECD's Programme of Work includes lengthy discussions on issues related to the new profit allocation rules, it does not dwell as much on the new nexus rules. Profit allocation must be addressed first and used to influence the design of the nexus rules and determine the appropriate nexus threshold that excludes incidental activities and those that would attract significant profit allocation in any event. This is unlike the traditional model where profit allocation plays a role after nexus is created in another jurisdiction.

The Work Programme notes that further work will be done to determine how to minimize compliance costs and disputes, and to investigate scoping limitations based on the nature or size of a business. The feasibility of segmentation – per business line or region – will also be considered, as well as potential limitations on scope (by nature or size of a given business) and the treatment of losses.

The residual profit split method[15] aligns with existing tax principles, but modifies them to adapt to changes in the digital era. On the other hand, fractional apportionment is a departure from generally accepted tax principles and the transfer pricing arm's length standard. The distribution approach is a hybrid of sorts that could lead to tax certainty

demanded by tax authorities and taxpayers in the current OECD negotiations. Implementing a business line approach would present opportunities for taxpayers and tax authorities to entertain subjectivity in the allocation of corporate profits.

Fractional apportionment is a simpler method for the allocation of income, and when based on simple objective criteria, can provide an objective and predictable way of attributing profits in a consistent manner. For developing countries that include the provision of fractional apportionment in their tax treaties, it would be a preferred approach. From an Indian tax perspective, a report highlighting the 'fractional apportionment approach' as one of the methods being considered is particularly important. It is pertinent to note that the Indian Revenue Administration Board's recently released discussion paper on profit attribution also highlights the fractional apportionment approach as a profit attribution mechanism.

The proposals addressed in the OECD Programme of Work will have implications well beyond digital businesses or digital business models. These proposals could lead to significant changes to the overall international tax rules under which multinational businesses currently operate. It is important for businesses to monitor these developments closely as they unfold in the coming months. Finally, any proposals should provide for double tax relief and multilateral dispute resolution, as well as a combined reporting approach to minimize administrative burdens.

Though the program aims to set out a process to reach a new global consensus on the future taxation of multinational enterprises, it remains to be seen how the proposal will be adopted over time. Any number of obstacles to finding consensus could arise in this process, especially in achieving a unified approach. A future solution could lie in a more frequent use of certain formulary methods. This scenario will likely elicit further opposition since it implies a further departure from the traditional arm's length principle. The aim should be to tax corporate profits without distorting corporate decisions and also paving the way for digital innovations. Such an approach could make the difference between addressing and meeting the tax challenges of the digital economy. Corporations and countries are equal stakeholders who must reach a consensus on the allocation and nexus rules to find a fair and equitable solution for taxing the digital economy.

Exhibit 1. Key characteristics of profit allocation methodologies

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Exhibit 2. Profit and Loss Account of MNE Group

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Exhibit 3. Allocation of Non-Routine Profits to Market Jurisdiction

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Exhibit 4. Allocation of Non-Routine Profit for Marketing Intangible

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Exhibit 5. Fractional Apportionment Method

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Exhibit 6. Assumption of Marketing Spend in Distribution-Based Approach

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Exhibit 7. Digital Business Models

Exhibit 8. User Contribution to Digital Business Model

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[1] https://www.oecd.org/tax/consumption/1923256.pdf

[2] *Addressing the Tax Challenges of the Digital Economy*, Final Report (2015)

[3] *Tax Challenges Arising from Digitalisation: Interim Report* (2018)

[4] OECD/G20 Inclusive Framework on BEPS - *Programme of Work to Develop a Consensus Solution to the Tax Challenges Arising from the Digitalisation of the Economy* (2019)

[5] It should be noted that with all the allocation methodologies, it is the profits of the MNE group that are allocated to market jurisdictions, as opposed to the profits of the group's local entities. The local entity will continue to be allocated profit based on Functions, Assets and Risk, and taxed accordingly.

[6] We have used global (i.e., group) profits for purposes of our analysis.

[7] This includes the use of proxies (i.e., based on capitalized expenditure, projections of future income, or fixed percentages of total non-routine income).

[8] Martin A. Sullivan, *Economic Analysis: Distribution Based Profit Allocation Proposal Catches OECD's Attention*, Tax Notes Int'l, June 10, 2019, p.1047

[9] *Id.*

[10] The term "service users" refers to the group of platform users who seek services, such as cab rides, delivery of food and groceries, and courier services.

[11] The term "service providers" refers to the group of platform providers who render services, such as cab rides, delivery of food and groceries, and courier services.

[12] Lakshmi Narayanan, University of Amsterdam, *UBER: A Test Case Analysis of Nexus in the Digital Economy*, IBFD, p.12 (July 2018).

[13] MLI Explanatory Statement, available at: https://www.oecd.org/tax/treaties/explanatory-statementmultilateralconvention-to-implement-tax-treaty-related-measures-to-prevent-BEPS.pdf

[14] Daniel W. Blum, *Permanent Establishments and Action 1 on the Digital Economy of the OECD Base Erosion and Profit Shifting Initiative: The Nexus Criterion Redefined*, Bulletin for International Taxation, 69 (June/July 2015), pp.314-317.

15 It is well believed that the residual profit split method - as outlined by the recent *Revised Guidance on the Application of the Transactional Profit Split Method 2018* - is the most suitable method to establish remuneration in line with the actual value created, especially in situations where that value comes from dematerialized activities.

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