Annex C. Examples

Box C.1. Extending the carry-forward regime to profit shortfalls

Group X is an MNE group that provides streaming services with a business model producing regular profit. It has no other business lines. In Years 1, 2 and 3, pursuant to Amount A computation rules, the group (no segmentation required) generated the following results.

In EUR million	Total Revenue	PBT	Profitability	Profit shortfalls
Year 1	100	10	10%	0
Year 2	100	10	10%	0
Year 3	100	10	10%	0
Total	300	30	10%	0

Assuming the Amount A profitability threshold is established at a 10% return on revenue, Group X has no profit in excess of that threshold in any of the three years under review, and none of the profit for Amount A purposes generated during those years would be reallocated to market jurisdictions.

Consider now a competitor, Group Y, providing similar services but with a business model producing irregular profit. In Years 1, 2 and 3, pursuant to Amount A computation rules, the group (treated as a segment) generated the following results.

In EUR million	Total Revenue	PBT	Profitability	Profit shortfalls
Year 1	100	5	5%	5
Year 2	100	5	5%	5
Year 3	100	20	20%	0
Total	300	30	10%	10

Notwithstanding the fact that this competitor has generated the same level of profit over the three-year period under review, without a carry-forward regime accommodating profit shortfalls, Group Y would have a share of its profits for Amount A purposes in excess of the profitability threshold in Year 3 reallocated to market jurisdictions, i.e. EUR 10 million.

In contrast, with a carry-forward regime accommodating profit shortfalls, the profit shortfalls generated in Year 1 (i.e. EUR 5 million) and Year 2 (i.e. EUR 5 million) would be preserved and offset against the profit in excess of the profitability threshold in Year 3 (i.e. EUR 10 million). Group Y would thus not have a share of its profit for Amount A purposes reallocated to market jurisdictions in Year 3.

Box C.2. The marketing and distribution profits safe harbour for a decentralised business model

Group X is an MNE group in scope of Amount A. Under the marketing and distribution profits safe harbour proposal, the assumption is that the Amount A profit allocated to market jurisdictions where the group does not have a physical presence is a return on sales of 1.5% (Amount A only) and the Amount A profit allocated to market jurisdictions where the group has a physical presence is a return on sales of 3.5% (Amount A plus a 2% fixed return for routine marketing and distribution activities).

IP Owner (Jurisdiction 1)

Group X has a decentralised operating model, in which an IP Owner (resident in Jurisdiction 1) develops and owns the group's trade intangibles and licenses these intangibles to full-risk distributors in market jurisdictions in exchange for a benchmarked royalty.

Full-risk distributors (Jurisdictions 2, 3, 4 and 5)

The full-risk distributors (resident in Jurisdictions 2, 3, 4 and 5 respectively) combine these licensed intangibles with their own marketing and other intangibles, in products that are then sold to third parties. The full-risk distributors realise the residual profits (or losses) from their respective markets. The group and entity-level financials for Group X are summarised below.

in EUR million	IP Owner	Distributor 2	Distributor 3	Distributor 4	Distributor 5	Total
	Jurisdiction 1	Jurisdiction 2	Jurisdiction 3	Jurisdiction 4	Jurisdiction 5	Consolidated
Revenue	1,500	1,000	800	1,200	4,000	7,000
Third party revenue	0	1,000	800	1,200	4,000	
Intragroup revenue	1,500	0	0	0	0	
Profit before tax (PBT)	450	46	256	-12	712	1,222
Profit margin (%)	30.0%	4.6%	3.2%	-1.0%	17.8%	17.5%

Application of the safe harbour

Group X would determine the safe harbour return due to each of these market jurisdictions under Amount A and the profits allocated to market jurisdictions under the existing profit allocation rules (shown in the table above). As Group X has a physical presence in each of the market jurisdictions it operates in the safe harbour return would be 3.5%.

Finally, Group X would then determine in which markets it is eligible for the safe harbour and in which market it would be required to allocate Amount A:

- In Jurisdictions 2 and 5, Group X already allocates a return in excess of 3.5%. Therefore, it would be eligible for the safe harbour and hence would not pay Amount A in these jurisdictions.
- In Jurisdiction 4, Group X incurs a loss. Therefore, it would not meet the fixed return of the safe harbour and would, therefore, be ineligible for the safe harbour.
- In Jurisdiction 3, Group X would meet the fixed return of the safe harbour but not the cap. Therefore, it would only need to allocate profit equal to an additional return of 0.3% (being the difference between the profits already allocated to Jurisdiction 3 under the existing profit allocation rules and the cap of the safe harbour return) to Jurisdiction 3 under Amount A.

Under the proposed mechanism to eliminate double taxation, the IP Owner is likely to be identified as the paying entity and hence Jurisdiction 1 would be required to provide double tax relief (through the exemption or credit method) for the Amount A profit allocated to Jurisdiction 4 and 3.

Box C.3. The netting-off effect for a centralised business model

Group A is an MNE group in scope of Amount A. The group generates EUR 20,750 million in third party revenue and earned PBT of EUR 5,323m, resulting in a profit margin of 26%. The group and entity-level financials are summarised in the table below.

Principal (Jurisdiction 1)

Group A has a centralised operating model, in which a Principal (resident in Jurisdiction 1) owns the group's trade and marketing intangibles and realises the entire residual profit of the group. Jurisdiction 1 is a large market for Group A, generating EUR 10,000 million in third party revenues that are booked by the Principal.

Other market jurisdictions (Jurisdiction 2, 3, 4 and 5)

The other entities in the group (resident in Jurisdictions 2, 3, 4 and 5 respectively) perform baseline marketing and distribution functions. Under the ALP-based profit allocation rules, these distributors are remunerated with a 3% return on sales.

in EUR million	Principal	Distributor 2	Distributor 3	Distributor 4	Distributor 5	Total
	Jurisdiction 1	Jurisdiction 2	Jurisdiction 3	Jurisdiction 4	Jurisdiction 5	Consolidated
Revenue	15,000	2,000	4,000	3,500	1,250	20,750
Third party revenue	10,000	2,000	4,000	3,500	1,250	
Intragroup revenue	5,000	0	0	0	0	
Profit before tax (PBT)	5,000	60	120	105	38	5,323
Profit margin (%)	33%	3%	3%	3%	3%	26%

Under the Pillar One solution, Jurisdictions 1, 2, 3, 4 and 5 would all (as eligible market jurisdictions where nexus is established) be allocated Amount A. Jurisdictions 2, 3, 4 and 5 would also continue to be allocated profit under the existing ALP-based profit allocation rules The results of these allocations are shown in the table below.

Prior to the elimination of double taxation, the full Amount A profit allocated to Jurisdiction 1 could be said to give rise to double counting because this market jurisdiction already exercised taxing rights over material residual profit under existing ALP-based profit allocation rules, i.e. profit amounting to EUR 5,000 million, that is, a profit margin on total sales of 33% exceeding the average return on sales of the MNE group (26%).

in EUR million	Jurisdiction 1	Jurisdiction 2	Jurisdiction 3	Jurisdiction 4	Jurisdiction 5	Total
Amount A	313	63	125	110	39	650
ALP-based allocation	5,000	60	120	105	38	5,323
Total taxable profit *	5,313	123	245	215	77	5,972
Potential double counting	313	0	0	0	0	313

* The total taxable profits exceed the taxable profits of Group A, as the double taxation arising from Amount A has not yet been eliminated.

Under the proposed mechanism to eliminate double taxation, the Principal would be identified as the paying entity[5] and hence Jurisdiction 1 would be required to provide double tax relief (through the exemption or credit method) for the EUR 650 million in profits reallocated under Amount A.

In this example, the mechanism to eliminate double taxation will entirely net-off the potential for double counting in Jurisdiction 1 (i.e. EUR 313 million), by effectively reducing the profit for which income tax will be paid in Jurisdiction 1.

in EUR million	Jurisdiction 1	Jurisdiction 2	Jurisdiction 3	Jurisdiction 4	Jurisdiction 5
Amount A	313	63	125	110	39
ALP-based allocation	5,000	60	120	105	38
Total taxable profit*	5,313	123	245	215	77
Potential double counting	313	0	0	0	0
Netting-off of profits under the mechanism to eliminate double taxation	(650)	0	0	0	0
Total taxable profits (after the elimination of double taxation)	4,664	123	245	215	77

* The total taxable profits exceed the taxable profits of Group A, as the double taxation arising from Amount A has not yet been eliminated

Box C.4. The netting-off effect for a decentralised business model

Group B is an MNE group in scope of Amount A. The group generates EUR 12,000 million in third party revenue and earned PBT of EUR 2,450 million, resulting in a profit margin of 20%. The group and entity-level financials are summarised in the table below.

IP Owner (Jurisdiction 1)

Group B has a decentralised operating model, in which an IP Owner (resident in Jurisdiction 1) owns a significant part of the group's intangibles. Under the group's transfer pricing policy, the IP Owner receives a revenue-based royalty from the distribution entities for the right to use its intangibles. Group B's products are not sold in Jurisdiction 1.

Distributors (Jurisdictions 2, 3, 4 and 5)

Each distribution entity (resident in Jurisdictions 2, 3, 4 and 5) owns the marketing intangibles relevant to their jurisdiction. Under the group's transfer pricing policy, these distribution entities realise the residual profit or loss from their activities after paying IP Owner a royalty for the right to use its intangibles.

In the year under analysis, a recession in Jurisdiction 2 means Distributor 2 only earns PBT of EUR 200 million, a profit margin of 5%. Distributors 3, 4 and 5 earn higher profits and higher profit margins, as shown in the table below. The profit margins earned by Distributor 3 exceeds those earned by Distributor 4 and 5. This could be for a number of reasons, such as the effectiveness of their local operations or the underlying economic conditions in the different markets.

	IP Owner	Distributor 2	Distributor 3	Distributor 4	Distributor 5	Total
	Jurisdiction 1	Jurisdiction 2	Jurisdiction 3	Jurisdiction 4	Jurisdiction 5	Consolidated
Revenue	2,000	4,000	2,000	3,000	3,000	12,000
Third party revenue	0	4,000	2,000	3,000	3,000	
Intragroup revenue	2,000	0	0	0	0	
Profit before tax (PBT)	750	200	650	400	450	2,450
Profit margin (%)	38%	5%	33%	13%	15%	20%

Under the new taxing right of Pillar One, Jurisdictions 2, 3, 4 and 5 would all (as eligible market jurisdiction where nexus is established) be allocated Amount A, in addition to the profit allocated under existing ALP-based profit allocation rules due to the performance of marketing and distribution activities. Jurisdiction 1 would be allocated profit under existing rules for the activities performed by the IP Owner. The results of these allocations are shown in the table below.

Prior to the elimination of double taxation, the Amount A profit allocated to Jurisdiction 3 could be said to give rise to double counting. It is more difficult to assess whether and how much of the allocation of Amount A to Jurisdictions 2, 4 or 5 constitutes double counting. These jurisdictions may have taxing rights over some residual profit derived from Group B's marketing intangibles under the existing profit allocation rules, but measuring any related double counting is more complicated due to the lower profitability of the entities in those jurisdictions.

in EUR million	Jurisdiction 1	Jurisdiction 2	Jurisdiction 3	Jurisdiction 4	Jurisdiction 5	Total
Amount A	0	83	42	63	63	250
ALP-based allocations	750	200	650	400	450	2,450
Total taxable profit *	750	283	692	463	513	2,700
Potential double counting	0	?	42	?	?	n.a.

* The total taxable profits exceed the taxable profits of Group B, as the double taxation arising from Amount A has not yet been eliminated.

Assume that under the current mechanism to eliminate double taxation, only IP Owner and Distributor 3 would be identified as potential paying entities under the activity test (step 1) and profitability test (step 2).[6] Further, assume that as a result of the market connection priority test (step 3) the IP Owner is identified as the paying entity for Jurisdiction 2, 4 and 5 and Distributor 3 is identified as the primary paying entity for Jurisdiction 3, on the basis that it has the strongest connection to this market.

In this example, the mechanism to eliminate double taxation would not entirely net-off the potential for double counting in the different jurisdictions where Group B has a distribution entity. This is because the mechanism to eliminate double taxation would not require Jurisdictions 2, 4 and 5 to provide relief for whole or part of the profits reallocated under Amount A. However, the additional profits allocated to Jurisdiction 3 under Amount A (which could give rise to double counting) would be entirely eliminated as a result of Distributor 3 being identified as the primary paying entity for this jurisdiction. It should be noted this outcome would only arise if the market connection priority test (step 3) resulted in Distributor 3 bearing Jurisdiction 3's full Amount A tax liability.

in EUR million	Jurisdiction 1	Jurisdiction 2	Jurisdiction 3	Jurisdiction 4	Jurisdiction 5
Amount A	0	83	42	63	63
ALP-based allocations	750	200	650	400	450
Total taxable profit	750	283	692	463	513
Potential double counting	0	?	42	?	?
Netting-off of profits under the mechanism to eliminate double taxation	(209)	n.a.	(42)	n.a.	n.a.
Total taxable profits (after the elimination of double taxation)	541	283	650	463	513

Notes

[1] In practice, some variances may arise for the implementation and administration of each approach. For example, using profit margins instead of profit amounts may limit the scope and relevance of some currency exchange issues (i.e. timing and determination of the appropriate conversion rate), to the extent that the locally sourced revenue is booked in the currency of the market jurisdiction (e.g. multiplying local revenue by a profit margin would not involve any currency exchange). These practical differences will be considered as part of the work on implementation and administration of Amount A, especially when designing a simplified administration system to centralise the computation and compliance of Amount A (see below Chapter 10).

[2] To facilitate the illustration, the calculation assumes that all the revenue of the MNE group (or segment where relevant) falls in the scope of Amount A (see section 2.2).

[3] As there can be no negative residual profit (W), this calculation could also be expressed as W = Max(P-R*z, 0).

[4] To facilitate the illustration, the calculation assumes that all the revenue of the MNE group (or segment where relevant) falls in the scope of Amount A (see section 2.2).

[5] In practice, the identification of the paying entity (or entities) should follow the rules articulated in the Section 7.2.

[6] The identification of the paying entity (or entities) would follow the rules articulated Section 7.2.

OECD/G20 Base Erosion and Profit Shifting Project

Tax Challenges Arising from Digitalisation – Report on Pillar One Blueprint

INCLUSIVE FRAMEWORK ON BEPS

The OECD/G20 Base Erosion and Profit Shifting (BEPS) Project aims to create a single set of consensus-based international tax rules to address BEPS, and hence to protect tax bases while offering increased certainty and predictability to taxpayers. Addressing the tax challenges raised by digitalisation has been a top priority of the OECD/G20 Inclusive Framework in BEPS since 2015 with the release of the BEPS Action 1 Report. At the request of the G20, the Inclusive Framework has continued to work on the issue, delivering an interim report in March 2018. In 2019, members of the Inclusive Framework agreed to examine proposals in two pillars, which could form the basis for a consensus solution to the tax challenges arising from digitalisation. That same year, a programme of work to be conducted on Pillar One and Pillar Two was adopted and later endorsed by the G20.

This report focuses on new nexus and profit allocation rules to ensure that, in an increasingly digital age, the allocation of taxing rights with respect to business profits is no longer exclusively circumscribed by reference to physical presence. It reflects the Inclusive Framework's views on key policy features, principles and parameters, and identifies remaining political and technical issues where differences of views remain to be bridged, and next steps.

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