Chapter 5. Adapting the international tax system to the digitalisation of the economy

This chapter considers the implications of the changes arising from digitalisation for the international tax system, in particular, with respect to the existing profit allocation and nexus rules. It identifies the different views held by members of the Inclusive Framework on BEPS on the question of whether and to what extent the changes arising from digitalisation should result in changes to the international tax rules. This chapter also describes the next steps to take forward the work of the Inclusive Framework towards a consensus-based solution by 2020.

5.1. Overview

370. The digitalisation of the economy is having a widespread impact. As described in Chapter 2, the depth of this transformation is seen nowhere so clearly as in highly digitalised business models, and it is also far reaching, with it being difficult, if not impossible to ring fence the digital economy.[1]

371. It is important to consider the implications of these changes for the international tax system. As noted in the 2015 BEPS Action 1 report, the broader tax challenges raised by digitalisation go beyond the issue of how to put an end to BEPS. In the digital age, they chiefly relate to the question of how taxing rights on income generated from cross-border activities should be allocated among countries.[2] This chapter begins with an analysis of the two of the key fundamental concepts in the international income tax system: profit allocation and nexus rules. It analyses how certain characteristics frequently observed in highly digitalised business models, scale without mass, heavy reliance on intangibles and data and user participation, may interact with those rules. In turn, it is possible to identify how it could create outcomes which do not align the location where profits are taxed with the location of the activities which are creating value for the enterprise.

372. Members of the Inclusive Framework have different views on the question of whether and to what extent these features of highly digitalised business models and digitalisation more generally should result in changes to the international tax rules. There is acknowledgement of the continuing evolution of digital technologies. Nonetheless, there is no agreement over the tax implications of scale without mass and a greater reliance on intangibles. Further, with respect to data and user participation, there is no consensus on whether, and the extent to which they should be considered as contributing to a firm's value creation, and therefore, any impact they may have on the international tax rules.

373. While acknowledging these divergences, members of the Inclusive Framework agree that they share a common interest in maintaining a single set of relevant and coherent international tax rules, to promote, inter alia, economic efficiency and global welfare. As such, they have agreed to undertake a coherent and concurrent review of the two key aspects of the existing tax framework, namely the profit allocation and nexus rules that would consider the impacts of digitalisation on the economy.

374. Further work will need to be carried out on the analysis of the value contribution of certain characteristics of highly digitalised business models as well as digitalisation more broadly, and to inform that debate, technical solutions would also be explored to test the feasibility of different options with respect to the profit allocation and nexus rules. This process will include gathering input from a broader group of stakeholders including business, civil society and academia. An update on this work will be provided in 2019, as members work towards a consensus-based solution by 2020. Throughout these stages of work, it will be important to continue to monitor the latest developments: from the evolution of new technologies and rapidly evolving business models, to the adoption and impact of countries' legislative proposals that aim to address these challenges.

5.2. Introduction

375. The rapid spread of digitalisation, coupled with the liberalisation of trade policy, has increased the pace of globalisation and induced an ongoing structural transformation of the economy. As this transformative process is having an impact across the board, it would be difficult, if not impossible, to ring-fence the digital economy from the rest of the economy.[3] The digital transformation has not changed the fundamental nature of the core activities that businesses carry out to generate profits (i.e., source and acquire inputs, create or add value, sell to customers etc.). Nonetheless, as shown in the 2015 BEPS Action 1 report and, in particular with respect to more highly digitalised business models, as described in Chapter 2 of this report, digitalisation has driven considerable changes in the way businesses operate. This has led to the emergence of new business models and to the substantial transformation of old ones. These changes have placed pressure on the basic concepts underlying the existing international tax rules, which were created almost a century ago.

376. The BEPS Project produced a substantial renovation of the international tax rules, underpinned by the principle that the location of taxable profits should be aligned with the location where economic activities and value creation take place. The 2015 BEPS package has had and will continue to have an important impact in addressing BEPS concerns, including those relevant to digitalised business models as indicated in Chapter 3. The question remains of whether they adequately address the broader direct tax challenges identified in the 2015 BEPS Action 1 report regarding nexus, data and characterisation. These broader tax challenges raised by the digitalisation of the economy go beyond the issue of how to put an end to BEPS, and chiefly relate to the question of how taxing rights on income generated from cross-border activities in the digital age should be allocated among countries.[4] Concerns about the inadequacy of the current rules to deal with the broader tax challenges is evidenced by the increasing number of uncoordinated, unilateral actions taken since 2015, as described in Chapter 4.

377. Against this background, this chapter describes the challenges that the digitalisation of the economy presents for the continuing effectiveness of the international tax system. To this end, this chapter first reviews two of the fundamental rules underlying the existing international rules for the taxation of business profits. It goes on to describe a number of outstanding issues associated with or exacerbated by digitalisation that could undermine the sustainability of these long-standing rules. Finally, with a view to advancing discussions on these complex issues and reaching consensus on a multilateral solution by 2020, this chapter also outlines the key areas of the international income tax system that the Inclusive Framework has agreed to review, and details the next steps in delivering this objective.

5.3. Fundamental rules of the international income tax system

378. The set of rules that affect the tax treatment of cross-border business activities is constituted primarily by domestic tax law, tax treaties and other international law instruments, such as the Multilateral Instrument. As indicated in the 2015 BEPS Action 1 report,[5] many of these rules originate from principles devised in the 1920s – e.g., the "origin of wealth" principle[6] – at a time when factors contributing to the value created by MNEs were relatively immobile and required intensive use of labour and tangible assets. In particular, it is possible to identify two key rules that frame the taxation of business profits from cross-border activities:

- ***The nexus rule to determine jurisdiction to tax a non-resident enterprise***. Under most tax treaties, business profits derived by an enterprise are taxable exclusively by the state of residence unless the enterprise carries on business in the other state (i.e., the source state) through a permanent establishment (PE) situated therein. This is sometimes called the "nexus" rule (e.g., Articles 7 of the OECD and United Nations (UN) Model Tax Conventions), as it identifies the profits that are taxable by a country by reference to their relationship to a PE. The latter is generally defined by reference to a threshold that determines the circumstances in which a foreign enterprise is considered to have a sufficient level of economic activity in a state to justify taxation in that state. This threshold generally requires a certain level of physical presence of the foreign enterprise in the taxing jurisdiction, either through a "fixed place of business" or through the actions of a "dependent agent" (Articles 5 of the OECD and UN Model Tax Conventions). For example, material operations in a market involving activities such as distribution, inventory management and local marketing (i.e., bricks and mortar economy) would typically be covered by this definition and thus meet the PE threshold. In contrast, the mere export of goods by a foreign enterprise that are not produced or distributed through a local facility would not be covered by this definition. Consequently, except where separate distributive rules apply (e.g., Articles 6, 10, 11, 12, 13, or 17 of the OECD and UN Model Tax Convention),[7] the determination of the jurisdiction with taxing rights depends on a nexus rule that looks at the substance of a business activity and attributes the primary right to tax to the country in which this income-producing activity physically takes place.
- ***The profit allocation rules, based on the arm's length principle***. Once it has been established that a particular country should be allowed to tax the profits of an enterprise, it is necessary to have rules for the determination of the relevant share of the profits that will be subjected to taxation. Profit allocation rules perform this function. The internationally accepted principle underlying profit allocation is the arm's length principle (ALP).[8] The ALP is broadly applied in a similar manner in two cases: when a country has taxing rights over the business profits of a resident taxpayer (e.g., Article 9 of the OECD and UN Model Tax Conventions) or when these business profits are attributable to the PE of a non-resident taxpayer (e.g., Articles 7 of the OECD and UN Model Tax Conventions).[9] Application of the ALP requires an analysis of the functions performed, assets used and risks assumed by each associated enterprise (and/or PE) – i.e., the factors deemed to materially contribute to the business profits earned from the relevant transaction(s). Such an analysis (referred to as a "functional analysis") is performed for each business entity separately, requiring the determination of the distinct contributions of each associated enterprise (and/or PE) to the creation of value reflected in the profits from the relevant transaction(s). In this exercise, establishing the exact nature and location of the functions performed by people, taking into account assets used and risks assumed, are the primary proxies used to reflect real economic activities and value creation. This is the approach taken by the OECD Transfer Pricing Guidelines[10] and the OECD report on the Attribution of Profits to Permanent Establishments[11] (e.g., "significant people functions").

379. To summarise, the taxation of a non-resident enterprise depends on rules that are strongly rooted in physical presence requirements to determine nexus and allocate profits. The principal focus of the existing tax framework has been to align the distribution of taxing rights with the location of the economic activities undertaken by the enterprise,

including the people and property that it employs in that activity. This conceptual approach was recently reinforced by the BEPS Project, which sought to realign the location where profits are taxed with the location where economic activities take place and value is created. However, the effectiveness of these rules may be challenged by the ongoing digitalisation of the economy to the extent that value creation is becoming less dependent on the physical presence of people or property.

5.4. Digitalisation, value creation and the international income tax system

380. The ongoing digitalisation of the economy raises questions regarding the relevance and effectiveness of some key concepts underlying the existing international tax rules, namely nexus and profit allocation rules. To achieve progress on these complex issues, this section of the report examines the tax challenges raised by the digitalisation of the economy and outlines the different views among countries on their potential implications for the international tax system. Finally, this section identifies the key areas of the international income tax system that the Inclusive Framework has agreed to review.

5.4.1. Digitalisation and the challenges for tax policy makers

381. The 2015 BEPS Action 1 report identified a number of broader tax challenges raising questions as to whether the current international tax framework can appropriately deal with the changes brought about by the digitalisation of the economy. With respect to direct taxes, it was recognised that the these challenges relate to the allocation of taxing rights between source and residence jurisdictions, and raised questions of whether the existing paradigm used to determine where economic activities are carried out and value is created for tax purposes continues to deliver appropriate results.[12] These challenges were classified into three broad categories, which substantially overlap:

- **Nexus**: The continual increase in the potential of digital technologies and the reduced need in many cases for extensive physical presence in order to carry on business, combined with the increasing role of network effects generated by customer interactions, can raise questions as to whether the current rules to determine nexus with a jurisdiction for tax purposes are appropriate.[13]
- **Data**: The growth and sophistication of information technologies that have accompanied the digitalisation of the economy has permitted an increasing number of companies to gather and use information across borders to an unprecedented degree. This raises the issues of how to attribute value created from the generation of data through digital products and services, and of how to characterise for tax purposes a person or entity's supply of data in a transaction (e.g., as a free supply of a good, as a barter transaction, or in some other way). Further, the fact that users of a participative networked platform contribute user-generated content, with the result that the value of the platform to existing users is enhanced as new users join and contribute, may raise other challenges.[14]
- **Characterisation**: The development of new digital products or means of delivering services creates uncertainties in relation to the proper characterisation of payments made in the context of new business models, particularly in relation to cloud computing.[15]

382. When considered together, the broader tax challenges raised by digitalisation relate directly to the operation of and interaction between two of the basic concepts that underlie the international tax rules: namely, the rules for determining nexus and the allocation of profit.

383. Extending the work on the tax challenges of digitalisation described in the 2015 BEPS Action 1 report, Chapter 2 of this report looked more specifically at highly digitalised business models, and analysed the effects of digitalisation on how these businesses operate and create value. In particular, a number of salient features were identified that are frequently observed in the business models of some highly digitalised firms: cross-jurisdictional scale without mass, heavy reliance on intangible assets, especially intellectual property (IP) and the importance of data, user participation and their synergies with IP. These characteristics are not exclusive to highly digitalised business models. They can also be found to varying degrees, in more traditional business models, and have gained greater prominence as a function of globalisation more generally. The third feature, data and user participation, is more evident in a subset of highly digitalised business models. Noting that these features, which are frequently observed in certain highly digitalised businesses, may also become more prevalent in other parts of the economy as a result of increasing integration of digital technologies, it is useful to consider their potential implications for the international tax system, as described below, recognising that Inclusive Framework members have different positions on those tax implications which are discussed in Section 5.4.2.

384. An expansion of business models as a result of the phenomenon of "scale without mass" is impacting the distribution of taxing rights over time by reducing the number of jurisdictions where a taxing right can be asserted over the business profits of an MNE. For example, in many instances, scale without mass has led to an increasing share of the profits from cross-border activities not being taxed in the market jurisdiction, including in situations where the foreign enterprise has an important economic presence in that market. These impacts may highlight issues inherent in existing tax rules, which rely predominantly on physical factors to determine a taxable presence and allocate profits, when applied in the digital age.

385. An increasingly heavy reliance on intangibles may also pose challenges to the existing tax framework. The BEPS Project has significantly contributed to realigning income from intangibles with value creation, notably by putting greater emphasis on real economic activities (e.g., Action 5, Actions 8-10), and by taking a more holistic approach to the review of cross-border transactions. Nonetheless, it may still often be very difficult to determine how to allocate income from intangible assets among different parts of an MNE group. In turn, this may increase the responsiveness of business decisions to tax competition between countries. For instance, the location of the ownership and management of some important intangibles for digitalised firms (e.g., various types of knowledge-based capital)[16] may not always be clearly discernible. In addition, intangible assets may easily be shifted around within an MNE group provided there is a correlation with a certain level of physical activity (e.g., functions that control risks, functions relating to the development, enhancement, maintenance, protection and exploitation of intangibles (DEMPE)). These concerns may potentially be exacerbated in markets of the MNE group where goods and services are being supplied, if an MNE is still able to secure a low tax base therein through a local reseller model (e.g., a distributor not performing DEMPE functions regarding intangibles who is entitled to no more than the "routine profit" otherwise expected to be earned from routine functions performed in third-party transactions).

386. Finally data and user participation, and, more generally, the ongoing and interactive relationships between digitalised businesses and their customers, may represent additional tax challenges, if and to the extent that they can be considered a source of a firm's value creation. This could be the case, for instance, if a large base of

active online users producing substantial amounts of content and data is considered a material contribution to the value creation of a business, distinct from the algorithms and other intangible assets used for analysing and processing this content and data. This may pose challenges to both the nexus and profit attribution rules, to the extent that value generated in this way by users in a particular jurisdiction is considered value created by the enterprise in the jurisdiction, as such a concept of value creation is currently not captured by the existing tax framework. In particular, it may pose challenges to existing nexus rules in situations where the highly digitalised business that exploits the data and user-generated content has little or no presence (in terms of personnel or tangible assets) in the jurisdiction where the active users generating the data are located. As indicated in Chapter 2, the impact of these challenges would depend on the degree to which those business models make intensive use of data and user participation. It should be recognised, however, that the range of businesses intensively benefitting from data and user participation is likely to increase as a result of the continued digitalisation of the economy.

5.4.2. Implications for the international tax system

387. These issues raise very complex technical questions, and there are also different views among the more than 110 members of the Inclusive Framework on the question of whether and to what extent these features of highly digitalised business models and digitalisation more generally should result in changes to the international tax rules. On the one hand, there is broad acknowledgement of the continuing evolution of digital technologies and the need for further consideration and monitoring of how these changes are impacting value creation across the economy. On the other hand, there is not yet agreement amongst countries over the tax implications of scale without mass and a greater reliance on intangibles. Further, while data and user participation are recognised as not being present in all highly digitalised business models, where they are present, there is currently no consensus on whether, and the extent to which, they should be considered as contributing to a firm’s value creation, and therefore, there is no agreement as to whether they require changes to the international tax rules.

388. The positions held by members fall across a broad spectrum, although these positions can be generally described as falling within three groups.

389. The first group of countries share the view that, taken together, some characteristics frequently observed in certain highly digitalised business models – in particular, reliance on data and user participation – may lead to misalignments between the location in which profits are taxed and the location in which value is created. In their view, this misalignment is not produced by any specific BEPS arrangement or tax planning strategy but is the result of a new and unique feature observed in some highly digitalised business models that is not captured by the existing international tax framework: the active participation of users through an online platform, and the value that this participation creates for the business (i.e., user-generated value). The failure of the tax system to recognise this contribution to the value creation process of certain highly digitalised businesses means that the existing nexus and profit allocation rules are failing to create alignment between the location in which profits are taxed and the location in which value is created. According to these countries, these challenges are currently confined to certain business models and, subject to a refined analysis of the relevant business models, may be addressed through targeted changes to the existing tax rules, including a re-consideration of the rules relating to profit allocation and nexus.

390. Beyond the challenges created by user-created value, this group of countries is generally supportive of the broad principles underpinning the existing international tax framework. They do not believe that digitalisation, and its impact on how businesses operate cross-border, undermines those principles and do not see the case for wide-ranging change. In particular, most of the countries in this group reject the idea that a country that provides the market where a foreign enterprise's goods and services are supplied on its own provides a sufficient link to create a nexus for tax purposes, regardless of the scale of these supplies. Instead, they consider that profits should continue to be taxed exclusively where the factors that produce the income are located, in accordance with long-standing principles of the existing tax system (e.g., aligning profit with value creation).

391. There is a second group of countries that take a different view regarding the nature and scale of the challenges posed by digitalisation. This group of countries take the view that the ongoing digital transformation of the economy, and more generally trends associated with globalisation, present challenges to the continued effectiveness of the existing international tax framework for business profits. Importantly, for this group of countries, these challenges are not exclusive or specific to highly digitalised business models.

392. Some of these countries are generally concerned that a growing range of enterprises can now be heavily involved in the economic life of a market jurisdiction (e.g., through a large number of sales, market-specific investments) with a taxable presence that currently only attracts a minimal taxable base, or with no taxable presence at all. According to these countries, a changing global economy presents a challenge to the adequacy of the two basic concepts that underlie the current tax framework. First, it raises a profit allocation issue, as more and more profit is dependent on non-physical and mobile value drivers (e.g., various types of knowledge-based capital). Second, it raises a nexus issue, as the limited or lesser need for physical presence to carry on economic activities challenges the extent to which the existing PE definition (e.g., a "fixed place of business") is still a relevant nexus for determining the jurisdiction in which to tax business income.

393. Some, although not all of this second group of countries, also explicitly reject the suggestion that data and user participation should be considered value creation by the business in the user's jurisdiction. According to this view, user data and user contributions should be viewed in the same way as other business inputs sourced from an independent third party in the business' supply chain.

394. Finally, there is a third group of countries that consider that the BEPS package has largely addressed the concerns of double non-taxation, although these countries also highlight that it is still too early to fully assess the impact of all the BEPS measures. These countries are generally satisfied with the existing tax system and do not currently see the need for any significant reform of the international tax rules. Some countries in this group do not agree that data and user participation contribute to value creation in the user's jurisdiction, whereas some other countries in this group believe these issues require further consideration.

5.4.3. Reviewing two key concepts of the international tax system

395. While there is a clear divergence of views among members of the Inclusive Framework on BEPS over whether, and the extent to which, changes to the international tax principles are needed, a broad group of countries support further exploration of

potential changes to the nexus and profit allocation rules, that would consider the impacts of digitalisation on the economy.

396. In addition, members agree that they share a common interest in maintaining a relevant and coherent set of international rules to address the cross-border taxation of business profits in a way that improves, inter alia, economic efficiency and global welfare, particularly where the alternative is likely to be unilateral approaches with all of their associated adverse impacts. A multilateral approach is important to reduce the distortions to investment and growth, while reducing complexity, minimising double taxation, supporting innovation and achieving a fairer, more efficient and simpler tax system for firms operating across the globe.

397. With this in mind, the members of the Inclusive Framework have agreed to undertake a coherent and concurrent review of the two key aspects of the existing tax framework, namely the profit allocation and nexus rules that would consider the impacts of digitalisation on the economy, relating to the principle of aligning profits with underlying economic activities and value creation.[17]

5.5. Next stage of work

398. Taking forward this commitment will require refining the analysis of the value contribution of certain characteristics of highly digitalised business models as described in Chapter 2 as well as digitalisation more broadly, with a view to studying its impact on any revision of the nexus and profit allocation rules. In determining the parameters of any such revision, it would be important for the Inclusive Framework to assess whether the challenges described in this report, relating to the principle of aligning profits with underlying economic activities and value creation, would be best addressed by a consensus-based solution focused on certain highly digitalised business models, or whether such a solution should be applicable to the broader economy. Meanwhile, and to inform that debate, technical solutions would be explored to test the feasibility of different options. Relevant Working Parties, including Working Party 1, Working Party 6 and the TFDE, would support the work of the Inclusive Framework which gathers more than 110 members.

399. On the basis of this further analysis, it is anticipated that the Inclusive Framework will work towards a consensus-based solution by 2020. This is a challenging objective, given the complexity and still-evolving nature of the issues involved, and will require a phased programme of work, with an update to be provided in 2019. This process will provide an opportunity for detailed discussions between members, as well as to gather input from a broader group of stakeholders including business, civil society and academia. The particular constraints and environment faced by developing countries will be taken into account in this process, through their direct participation as members of the Inclusive Framework, as well as through liaison with regional tax administration bodies such as the African Tax Administration Forum and the Inter-American Centre for Tax Administration. In this way a fuller understanding of the issues as well as possible impacts of the options can be developed.

400. In due course, consideration should also be given to the development of appropriate legal instruments to support global implementation of any changes that may be required. Such legal instruments would facilitate and accelerate the adoption of measures which are agreed.

401. Throughout these stages of work, the TFDE will also have an important role to play in the ongoing monitoring of developments: from the evolution of new technologies and rapidly-evolving business models, to the adoption and impact of countries' legislative proposals that are potentially relevant to digitalisation.

Notes

[1] (OECD, 2015[1]) , Chapters 3 and 4.

[2] (OECD, 2015[1]), Chapter 7.

[3] (OECD, 2015[1]) , Chapters 3 and 4.

[4] (OECD, 2015[1]), Chapter 7.

[5] (OECD, 2015[1]), paragraph 28-40.

[6] The "origin of wealth" principle was enunciated by a group of economists in a 1923 report mandated by the League of Nations. The purpose of this report was to study the issue of double taxation from a theoretical and scientific perspective. It rejected the argument that income should generally be taxed exclusively in the state of residence, and posited that taxation should be based on a doctrine of economic allegiance: "whose purpose was to weigh the various contributions made by different states to the production and enjoyment of income" (Graetz and O'Hear, 1997[5]). In general, the economists concluded that the most important factors (in different proportions depending on the class of income at issue) were "the origin of the wealth and the residence or domicile of the owner who consumes the wealth". For business profits, they took the view that the place where income was produced is "of preponderant weight" and "in an ideal division a preponderant share should be assigned to the place of origin". The origin or production of wealth was defined for these purposes as all the stages involved in the creation of wealth: "the original physical appearance of the wealth, its subsequent physical adaptations, its transport, its direction and its sale". As noted by the economists, "these stages up to the point where wealth reaches fruition may be shared in by different territorial authorities". This "origin of wealth" principle has remained a primary basis for taxation of business profits until today.

[7] By virtue of separate distributive rules, some categories of business profits may be taxed in a source country notwithstanding the absence of nexus therein in the form of a PE. These rules include Articles 6 and 13 of the OECD Model Tax Convention regarding income derived from immovable property and capital gains derived from the sale of such properties. These Articles allow a country to tax the income or capital gain if the immovable property is located in that country. Additionally, business profits may include certain elements of income such as dividends, interest, or royalties (or technical fees in the context of tax treaties based on the UN Model) which, depending on the domestic law and the applicable tax treaty, may be subject to a limited withholding tax in the source country even in the absence of any physical presence of the enterprise.

[8] The ALP requires that the price and other conditions in relation to controlled transactions between associated enterprises be consistent with those that would occur between unrelated enterprises for comparable transactions under comparable circumstances. Such prices are generally referred to as "arm's length prices".

[9] There are different approaches taken by countries with respect to the attribution of profits to permanent establishments. Two of the predominant approaches are reflected in the Commentary to Article 7 of the *OECD Model Tax Convention on Income and on Capital* (2017). One approach is set out in the pre-2010 version of Article 7 of the OECD Model Tax Convention (and is maintained in the UN Model Tax Convention), while the other approach is reflected in the OECD's *2010 Report on the Attribution of Profits to Permanent Establishments*, which was

incorporated in the 2010 revision of the Commentary on Article 7 of the *OECD Model Tax Convention on Income and on Capital*.

10 (OECD, 2017[2]). It incorporates the substantial revisions made in 2016 to reflect the clarifications and revisions agreed in the 2015 BEPS Reports on Actions 8-10 "Aligning Transfer Pricing Outcomes with Value Creation" and on Action 13 "Transfer Pricing Documentation and Country-by-Country Reporting". It also includes the revised guidance on safe harbours approved in 2013, which recognises that properly designed safe harbours can help to relieve some compliance burdens and provide taxpayers with greater certainty. Finally, this edition also contains consistency changes that were made to the rest of the OECD Transfer Pricing Guidelines. The original version of the OECD Transfer Pricing Guidelines was approved by the OECD Council in 1995.

11 (OECD, 2010[3]). It should be noted that regardless of whether a country adopts the approach described in this report, Article 7 of the OECD MTC has always provided for allocation of profits between a PE and the rest of the enterprise of which the PE forms a part on the basis of the hypothesis that the PE is a separate entity.

12 (OECD, 2015[1]), see among others paragraphs 249 and 376.

13 (OECD, 2015[1]), see among others paragraphs 253 to 261.

14 (OECD, 2015[1]), see among others paragraphs 262 to 267.

15 (OECD, 2015[1]), see among others paragraphs 268 to 272.

16 Knowledge-based capital (KBC) comprises a variety of non-physical assets. One widely accepted classification groups KBC into three types: computerised information (software and databases); innovative property (patents, copyrights, designs, trademarks); and economic competencies (including brand equity, firm-specific human capital, networks of people and institutions, and organisational know-how that increases enterprise efficiency) (OECD, 2013[4]).

17 The Inclusive Framework recognised that profit allocation rules and nexus rules are strongly interrelated, with the consequence that any change to existing profit allocation rules is likely to put more pressure on the nexus rules and is likely to require some consequential changes. Conversely, any change to existing nexus rules is likely to require a concurrent change to profit allocation rules (e.g., explore the extent to which profit can be allocated to a jurisdiction where an enterprise has little or no physical presence in terms of assets or employees).

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