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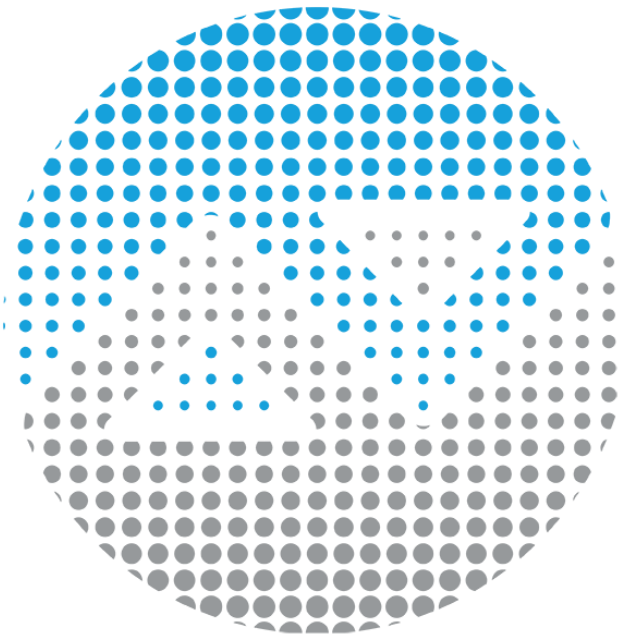

Tax Insights

Pillar One blueprint on nexus, profit allocation challenges of digitalisation issued

Snapshot

On 12 October 2020, the G20/OECD inclusive framework on base erosion and profit shifting (inclusive framework) released two detailed ”blueprints” in relation to its ongoing work to address the tax challenges arising from the digitalisation of the economy. The Pillar One blueprint sets out “building blocks” for potential future international agreement on rules for taxable presence (nexus) in countries and profit allocation between countries to address tax challenges arising from digitalisation. Comments on the blueprint are invited by 14 December 2020 and a virtual public consultation meeting will be held in January 2021.

Work to address the political and remaining technical issues will continue after the blueprints have been presented to the G20 finance ministers on 14 October 2020. The OECD’s aim is to bring the process to a conclusion by mid-2021.

The blueprint sets out proposals, that do not yet have the political agreement of the inclusive framework countries, to reallocate taxing rights in favour of user/market countries:

- **Amount A:** A new taxing right allocating a share of global residual profit to market countries using a formulaic approach applied at a group (or segment) level, irrespective of local physical presence;
- **Amount B:** A fixed return for defined "baseline marketing and distribution functions;" and
- **Tax certainty:** Through effective dispute prevention and resolution mechanisms.

Amount A: New taxing right for digital services and consumer-facing businesses

Scope

Two broad groups of businesses have been identified as having the ability to participate in an **active and sustained manner** in the economic life of a market country, with or without local physical operations, such that they are in scope of Amount A.

Automated digital services generate revenue from services provided remotely on a standardised basis to a large and global customer or user base:

- Activities on the **positive list** are in scope and include: online advertising services, sale of user data, online search engines, social media platforms, online intermediation platforms, digital content services, online gaming, standardised online teaching services, and cloud computing services;
- Activities on the **negative list** are out of scope and include: customised professional services, customised online teaching services, online sale of goods or services other than automated digital services, revenue from the sale of physical goods, and services providing access to the internet or other electronic networks; and
- Other activities are in scope if they meet a **general definition** by being **both automated** (i.e. once the system is set up the provision of the service requires minimal human involvement on the part of the service provider) **and digital** (i.e. performed over the internet or an electronic network).

Consumer-facing businesses are defined as those that generate revenue from the sale of goods or services **of a type commonly sold to individual consumers** (whether or not the consumer is the direct purchaser) and/or businesses that **license or otherwise exploit intangible property connected to such goods or services**. Businesses operating through third party intermediaries, via franchise models, and/or by way of licensing arrangements in respect of consumer goods or services are **included** within the scope of Amount A.

If a business sells finished products of a type commonly sold to consumers to both businesses and consumers (**dual use** finished goods/services) **all** of the revenues are in scope of Amount A. The sale of **intermediate** products/components that are incorporated into a finished consumer product sold to consumers are **out of scope**. The sale of **dual use intermediate** products/components are **in scope** of Amount A in relation to actual sales to consumers only.

Exclusions are anticipated in respect of: extractives and natural resources, including commodity traders, but excluding businesses that incorporate natural resources in their products (e.g. jewellery and chocolate), consumer-facing businesses in the financial services sector (including banking, insurance and asset management), construction, sale and letting of residential property, and international air and shipping businesses.

Thresholds

A multinational group must meet two thresholds for Amount A to apply:

- An annual consolidated group revenue threshold (potentially EUR 750 million); and
- A de minimis threshold for foreign in-scope revenue.

The thresholds could initially be set at a higher level and gradually reduced over time.

New nexus (taxable presence)

A market country will only be entitled to an allocation of Amount A if in-scope revenues are generated in that country as follows:

- Automated digital services: In-scope revenues above a threshold; and
- Consumer-facing businesses: In-scope revenues above a threshold, potentially together with a "plus factor" indicating significant and sustained engagement, e.g. a subsidiary or Permanent Establishment (PE) in the market country. Other plus factors may be considered, including local revenues in excess of an agreed higher level.

Consideration is being given to using a higher threshold for large markets and a lower threshold for small developing economies. The new nexus is exclusively applicable to the new Amount A taxing right and does not create a nexus for any other purpose, e.g. customs duties or other taxes.

Revenue sourcing

The Amount A rules are supported by detailed rules to source revenue to market countries, including sourcing principles and defined hierarchies of indicators reflective of specific types of in-scope activities. For example, for the direct sale of consumer goods the principle is the place of final delivery of the goods, and the preferred indicator is the jurisdiction of the shop or shipping address. A balance is sought between the need for accuracy and proportionate compliance costs.

Tax base determination

The calculation of Amount A will be based on **profit before tax derived from consolidated group financial accounts** prepared under an eligible accounting standard. Minimal book-to-tax adjustments will be applied, and could be limited to excluding income tax expenses, dividend income, gains or losses in connection with shares, and expenses typically not deductible for tax purposes for public policy reasons (e.g. penalties).

Consideration is being given to the computation of Amount A on a segmented basis for businesses which display segmentation hallmarks – mandatory for larger groups with global revenues in excess of an agreed threshold, with smaller groups potentially able to opt in by election. Segmentation may also be required, subject to further work, where potentially material distortions could otherwise arise, e.g. where a group has highly profitable out of scope activities.

Losses will be pooled, either at the group or segment level, with a carry-forward/earn-out mechanism so that no Amount A profits will arise (and be reallocated to markets) for the group/segment until historical losses have been fully absorbed. Consideration is being given to the potential inclusion of losses incurred prior to the introduction of an Amount A regime, and whether "profit shortfalls" below the level for Amount A allocation should also be taken into account.

Profit allocation

Quantum of Amount A: Formulaic approach

- Step 1: Profitability threshold - determine the residual profit of the group in excess of an agreed profitability threshold, i.e. where the threshold is set as a percentage of profit before tax to revenue;
- Step 2: Reallocation percentage - an agreed fixed percentage of the residual profit identified at Step 1 may be allocated to the market jurisdiction (the remaining residual profits are assumed to be attributable to activities not targeted by the new taxing right); and
- Step 3: Allocate the relevant portion of residual profit to market countries based on locally sourced in-scope revenues.

Inclusive framework members have different views on whether differentiation is needed in the Amount A formula, i.e. whether the same formulae apply to all in-scope businesses in the same way in all circumstances, or whether differences in the degrees of digitalisation and/or profitability should be reflected in the percentages used.

A marketing and distribution profits safe harbour may be included to limit the Amount A allocation to any market countries where residual profits are already taxed locally, e.g. if a business has a sufficiently-taxed entity or PE conducting marketing and distribution activities connected to locally sourced in-scope revenue.

A domestic business exemption also may apply to exclude from the scope of Amount A profits from the sale of goods that are developed, manufactured and sold in a single country.

Elimination of double taxation

Amount A is an overlay to the system of allocating profits on the basis of the arm’s length principle. The new taxing right and existing profit allocation rules will be reconciled by identifying the relevant jurisdictions where double taxation arising from Amount A should be relieved.

Firstly, the Amount A liability will be allocated between **paying entities**:

- Step 1: A qualitative activities test to identify group entities that make “material and sustained contributions” to a group’s residual profits (based largely on existing transfer pricing functional analyses);
- Step 2: A quantitative profitability test to ensure that the potential paying entity has the capacity to bear the Amount A tax liability;
- Step 3: As a priority, the Amount A tax liability will be allocated to paying entities that have a market connection; and
- Step 4: Any remaining Amount A tax liability will be apportioned between other entities in the group (or segment) on a formulaic pro-rata basis.

Secondly, the Amount A liability allocated to paying entities will be relieved via either exemption or credit by the paying entity.

Amount B

Amount B seeks to standardise the remuneration of related party distributors that perform **baseline marketing and distribution activities** with the objective of simplifying the administration of transfer pricing in particular for smaller developing countries. Amount B applies to potentially all business sectors and is **not subject to scope limitations**.

A fixed return that is intended to approximate the return under the arm's length principle is proposed. The quantum of the fixed return is likely to be based on comparable company benchmarking analyses under the transactional net margin method, potentially varying by industry and/or region. Under one proposal, it would be possible to rebut the application of Amount B by providing evidence that another transfer pricing method (e.g. a strong comparable uncontrolled price) under the arm’s length principle would be the most appropriate. Amount B would not supersede previously agreed Advance Pricing Arrangements (APAs), or Mutual Agreement Procedure (MAP) settlements.

The blueprint assumes that Amount B would apply to a **narrow scope** of baseline in-scope activities as defined in a **positive list** of typical functions performed, assets owned and risks assumed at arm’s length by routine distributors. A corresponding **negative list** would suggest typical factors that would indicate a distributor is outside the scope of Amount B. Quantitative indicators would further support the identification of in-scope activities. Some inclusive framework members have expressed interest in broadening the scope.

Increased tax certainty, dispute prevention and resolution

The proposals seek to increase tax certainty for businesses and tax authorities, with **enhanced dispute resolution** considered a key component.

In respect of Amount A, a binding dispute prevention process would be made available to businesses. Early certainty could be provided, before tax adjustments are made by tax authorities, in respect of whether a group is within the scope of Amount A, and if so, whether its determination and allocation of Amount A is agreed (including the identification of the paying entities). The process will include a review panel made up of members of relevant tax authorities as the first step, as well as where necessary, a determination panel providing a mandatory and binding outcome for Amount A.

For businesses in the scope of Amount A, a new mandatory and binding resolution process is also being developed for disputes related to transfer pricing and PEs.

Enhancements and improvements to existing dispute prevention tools will be explored including in relation to the International Compliance Assurance Programme, joint audits, and bilateral and multilateral APAs.

Amount B rules will be designed to limit the potential for disputes, but mandatory binding dispute resolution will be available where disputes do arise. For developing countries with no or low levels of MAP disputes, an elective binding dispute resolution mechanism is being considered for issues not related to Amount A.

Implementation and administration

Under a simplified administrative process, a single **coordinating entity** could file a **single standardised Amount A self-assessment return** and documentation package with the tax authority where the ultimate parent entity of the group is resident (or a surrogate lead tax authority), who would then exchange the return with other affected tax authorities (i.e. where the group has a constituent entity/market). Market jurisdictions could be paid their share of Amount A tax through the co-ordinating entity as agent.

The proposals would require changes to both domestic law and changes to double tax treaties. A new multilateral convention will be developed to facilitate treaty changes.

It is expected that any consensus-based agreement must include a commitment to withdraw relevant unilateral actions, including digital services taxes, and not adopt such unilateral actions in the future.

Comments

The blueprint does not have the political agreement that the G20 had originally hoped for when setting the ambitious target of completing work on the tax challenges of the digitalised economy by the end of 2020. As a result, the blueprint identifies areas where inclusive framework countries are not yet aligned, and options that countries might consider in their continued efforts to reach consensus. The blueprint sets out the technical work that has continued, conducted by the OECD Secretariat with significant input from inclusive framework representatives, despite the lack of political progress. It identifies a number of specific policy matters (e.g. reallocation percentages and thresholds, whether Amount A could be an optional safe harbour) and technical areas (the requirements for segmentation) where differences of view remain.

The proposed new taxing right, Amount A, remains focused on two broad sectors: automated digital services and consumer-facing businesses. Key scope issues remain undecided, such as the application of the rules to the pharmaceutical sector. Financial services businesses will be pleased to see proposals for broad exclusions for banking, insurance and asset management businesses, subject to political agreement. Extractive industries, natural resources, and commodities also are excluded, alongside airlines, shipping and residential property businesses.

The blueprint does not compromise on the complexity of the proposed rules, in particular as regards the determination of paying entities that will give up taxing rights over profits in favour of the market countries. Consideration is being given to the phasing in of the Amount A rules starting with the very largest multinationals (possibly those with annual consolidated revenues in excess of EUR 10 billion or EUR 5 billion) to help tax authorities provide certainty to in-scope businesses.

Businesses will be concerned that there is little detail on the interaction of Amount A and existing taxing rights in market countries, in particular withholding taxes on royalties, and also that countries have the option of specifying credit relief for double taxation rather than exemption. It is expected that credit relief and the interaction with existing complex domestic regimes will prevent effective relief from double taxation. There is reference to some countries preferring credit relief where the residual profits country has a higher tax rate than the market country, which appears to be out of line with the rationale for reallocation of taxing rights. Businesses will be keen to understand the potential availability of pre-regime losses for offset against Amount A profits, particularly given the economic downturn caused by COVID-19.

The commitment to an innovative solution to deliver early certainty alongside effective dispute prevention and resolution for Amount A is essential to ensuring that a new international framework does not hinder economic growth. Businesses will be pleased with the efforts made in this area by inclusive framework countries, even though there continues to be differences of view on the scope of mandatory binding dispute resolution beyond Amount A. Businesses will also be pleased to see that simplified compliance processes are under consideration, including a central filing option.

Work on Amount B (a baseline return for marketing and distribution activities) continues, but it is clear that political and technical challenges remain.

The aim of bringing the process to a conclusion by mid-2021 remains ambitious, in particular in light of the US election and the continuing challenges posed by COVID-19, but OECD Secretary-General Angel Gurría stressed the risk of further uncoordinated, unilateral measures, and that failure to reach agreement "would risk tax wars turning into trade wars at a time when the global economy is already suffering enormously." Even if agreement is reached by mid-2021, it is clear that implementation, through a multilateral instrument or amendments to bilateral treaties, will take years. It would appear that the earliest implementation of Amount A could be 2024 given the work that remains, and may be delayed further.

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