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Tax Insights

OECD Pillar One and Two: 31 January 2020 update

Snapshot

On 31 January 2020, the OECD/G20 Inclusive Framework on Base Erosion & Profit Shifting released a Statement on its ongoing work, on a without prejudice basis, to address the tax challenges arising from the digitalisation of the economy. The work comprises a "unified approach" to addressing nexus and profit allocation rules (Pillar One), and the development of a global anti-base erosion (GloBE) proposal (Pillar Two). The statement follows public consultations in November and December 2019.

The Inclusive Framework has endorsed an outline of the architecture of a unified approach as the basis for negotiations of a consensus-based solution under Pillar One. The proposal of the US for implementing Pillar One on a safe harbour basis has been noted as a crucial issue, with a final decision to be taken after other elements of the consensus-based solution have been agreed. In addition, there are a number of other issues where significant divergences will have to be resolved.

The Inclusive Framework reaffirmed its commitment to reach agreement on a consensus-based solution by the end of 2020.

Pillar One – nexus and profit allocation

The Inclusive Framework has endorsed an outline of the architecture of a unified approach. The unified approach is designed to adapt countries' taxing rights to take into account new business models and reallocate taxing rights in favour of the user/market country. Three possible types of taxable profit may be allocated to a market country:

- **Amount A:** New taxing right to give a share of residual profit allocated to market countries using a formulaic approach applied at a group (or business line) level, irrespective of local physical presence;

- **Amount B:** Fixed return for defined "baseline" marketing and distribution functions; and

- **Amount C:** Additional return based on transfer pricing analysis where marketing and distribution activities in a country go beyond the baseline level, along with improved dispute resolution procedures.

Amount A - new taxing right

Scope

Two broad groups of business have been identified as having the ability to participate in a "sustained and significant manner" in the economic life of a market country, with or without local physical operations, such that they are in scope for the new taxing right:

Automated digital services provided on a standardised basis to a large user base across multiple jurisdictions:

- These include online search engines; social media platforms; online intermediation platforms (including online marketplaces used by businesses or consumers); digital content streaming; online gaming; cloud computing services; and online advertising services.

- Professional services requiring significant human input despite digital delivery, such as legal, accounting, architectural, engineering, and consulting services, are not in scope.

Consumer-facing businesses that generate revenue from the sale of goods and services of a type commonly sold to consumers:

- Consumer products sold indirectly through third-party resellers and by intermediaries that perform routine tasks (e.g., minor assembly or packaging) are in scope.

- Businesses that generate revenue from licensing rights over trademarked consumer products and those that generate revenue through licensing a consumer brand (and commercial know-how) such as under a franchise model also are in scope.

- Examples of in-scope consumer-facing businesses include: personal computing products (e.g., software, home appliances, mobile phones); clothes, toiletries, cosmetics, and luxury goods; branded foods and refreshments; franchise models, such as licensing arrangements involving the restaurant and hotel sector; and automobiles.

- The sale of intermediate products/components that are incorporated into a finished consumer product sold to consumers will be out of scope, with a possible exception if the item is branded and commonly acquired by consumers for personal use.

- Extractive industries and other producers/sellers of raw materials and commodities are excluded, even if those materials/commodities are incorporated into consumer products further down the supply chain.

- It is suggested that regulated consumer-facing business lines in the financial services sector, such as retail banks and insurance, may be broadly excluded from scope.

- Airline and shipping businesses will not be in scope.

Activities may need to be segmented to separate in-scope from out-of-scope segments. Where a business sells to both businesses and consumers, the revenues are in scope if the product is of a type that is commonly sold to consumers.

Thresholds

A number of thresholds are being considered but are not yet agreed:

- Group gross revenue threshold – possibly in line with the EUR 750 million revenue threshold used for country-by-country (CbC) reporting;

- De minimis test on the total aggregated group in-scope revenue from consumer-facing activities and/or automated digital services; or

- A carve-out where the total profit to be allocated under Amount A (i.e., the aggregate deemed residual profit) does not meet a de minimis amount.

New nexus (taxable presence)

The new rules will create a nexus for in-scope businesses with a significant and sustained engagement with a market country, based on the generation of in-scope revenue in a market country over a period of years. For consumer goods businesses only, a new nexus will not arise if the group is selling consumer goods into a market jurisdiction without a sustained interaction with the market (e.g., the existence of a physical presence in, or targeted advertising directed at, the market country).

A liability will arise in the market country if a country-specific sales threshold is exceeded. The threshold will be commensurate with the size of the market to ensure countries with smaller economies are included, but with an absolute minimum amount. Further work will be undertaken to design rules that will source revenues to markets, e.g., to allocate revenue from online advertising services to the location of the user and to determine how revenues are sourced when sales of goods are via intermediaries.

This measure will require a new self-standing tax treaty provision (in addition to the existing permanent establishment and business profits articles). Filing and other tax related obligations will be minimised where possible. Simplified reporting and registration-based mechanisms (e.g., a "one stop shop") and exclusive filing in the ultimate parent country (in line with the approach for CbC reporting) will be explored. The new nexus is exclusively applicable to the new taxing right under Amount A and cannot be used as a basis for creating a nexus for any other purpose including VAT and customs duties.

Quantum of Amount A – formulaic approach

Step 1: Determine total profit of the group

- The calculation of Amount A will be based on a measure of profit derived from the consolidated group financial accounts, with profit before tax as the preferred profit measure. It is anticipated that this will be broadly consistent across countries, and that only minimum material adjustments are likely to be needed. The rules will apply to both profits and losses and will include loss carry-forward rules.

- Segmented accounts may be required to identify in-scope business segments. Further segmentation by in-scope business lines (where profitability varies) and/or region will be explored in the context of balancing the need for simplicity and accuracy, and to take account of compliance burdens.

Step 2: Determine residual profit of the group by excluding deemed routine profit

- A simplified approach based on agreed fixed percentage(s), with possible variances by industry, is being considered, to approximate the profit from routine activities

Step 3: Allocate a portion of deemed residual profit

- Nonroutine profits may be attributable to many activities, including those not targeted by the new taxing right (e.g., intangibles, capital and risk).
- For simplicity, an agreed fixed percentage could be used to identify the amount of routine profits to be attributed to the market country under the new taxing right.
- The portion of deemed residual profit could be weighted to account for different degrees of digitalisation between in-scope business activities ("digital differentiation").

Step 4: Allocate the relevant portion of deemed residual profit to market countries

- The allocation will be based on in-scope sales.

Elimination of double taxation

Amount A is an overlay to the system of allocating profits on the basis of the arm's length principle. As the arm's length principle already allocates all of the group profit, it is recognised that it is essential that there are appropriate mechanisms to eliminate double taxation and further work will be undertaken on this area.

Interaction and potential for double counting

A business would first apply arm's length principle based profit allocation rules, including Amounts B and C, followed by the application of Amount A rules.

Further consideration will be given to possible instances of double counting under Amounts A and C, including in respect of: marketing intangibles in the local country, comparability adjustments under the arm's length principle, and uncommon interpretations of the arm's length principle. No significant interaction is expected between Amounts A and B.

Amount B – Fixed return for defined baseline and marketing activities

Amount B aims to standardise the remuneration of "baseline marketing and distribution activities" to increase simplification in the administration of transfer pricing and to enhance certainty. A fixed return for in-scope activities based on the arm's length principle is proposed, and Amount B rules would not be optional nor a safe-harbour.

Further work will explore how to take account of different functionality levels, and differentiation in treatment between industries and regions, in determining the fixed return. A key consideration will be determination of an appropriate profit level indicator. The definitions of baseline activities are to be examined further but will likely include distribution arrangements with routine levels of functionality, no ownership of intangibles, and no-or-limited risks.

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 of Pillar One.

For Amount A, work will be undertaken to develop an innovative approach, supported by a clear, administrable and binding process, to provide early dispute prevention. This could include reviews by representative panels made up of members of tax authorities. Options will be developed for appropriate mandatory binding dispute resolution for Amount A where a business has not opted into the early certainty process.

Amount B rules will be designed to limit the potential for disputes and will be further limited by the provision of clear and detailed guidance on its scope. For Amounts B and C, there are currently differing positions within the Inclusive Framework on the breadth of application of enhanced dispute resolution mechanisms, and the adoption of mandatory binding arbitration may not be possible in all countries. It may therefore be necessary to consider other mechanisms. The importance of enhancing mutual agreement procedures (MAP) and ongoing work to improve the effectiveness of multilateral MAP is recognised.

Implementation and administration

A new multilateral convention will implement changes to tax treaties consistently and substantially at the same time. This would supersede the relevant provisions of existing treaties or create a framework between countries without a current treaty.

Appropriate infrastructure will be put in place to support consistent administration of the new taxing right, whilst keeping compliance and administrative costs at a minimum. Due to the number of new requirements associated with the new taxing right, certain elements may be introduced on a phased basis and/or initially on a simplified transitional basis.

The US Treasury Secretary's proposal for an alternative safe harbour basis, whereby an electing group would agree, on a global basis, to be subject to Pillar One, is to be considered in further detail. A final decision will be taken after the other elements of the consensus-based solution have been agreed upon.

Commitment to withdraw relevant unilateral actions

It is expected that any consensus-based agreement must include a commitment by Inclusive Framework members to withdraw relevant unilateral actions, such as digital services taxes.

Pillar Two – Global anti-base erosion proposal

The document includes a Progress Note on Pillar Two – the global anti-base erosion proposal. This will enable countries to tax profits which would otherwise be taxed at an effective rate below a "minimum rate." The progress note sets outs that significant work on key issues is advancing at a fast pace, with technical progress on many aspects of the proposal, but that significant work still remains.

Next steps

A revised program of work is published in respect of Pillar One, with remaining issues divided into 11 separate work streams. An OECD webcast on the economic analysis and impact assessment of the proposals is scheduled for 13 February 2020.

The Inclusive Framework intends to reach agreement on the key policy features of Pillar One by early July 2020. Remaining technical work is to be completed by November 2020 with a view to agreeing and publishing a final report, setting out the technical details, by the end of 2020.

Comments

The OECD/G20 Inclusive Framework participating countries (more than 130) have reaffirmed their commitment to reaching a multilateral solution by the end of 2020. At the same time the statement acknowledges that there remain political differences (including on the US Treasury Secretary's proposal for Pillar One to be on a safe-harbour basis) and technical challenges.

The statement is focussed on the agreed outline of the architecture of Pillar One for new nexus (taxable presence) and profit allocation rules, based on the unified approach proposal put forward by the OECD Secretariat in October 2019. The statement includes only a brief update on Pillar Two in relation to the global minimum tax proposals.

Businesses will be pleased to see that elimination of double taxation and mandatory dispute resolution mechanisms under Pillar One have become more prominent, essential to ensuring that a new international framework does not hinder economic growth. This remains an important part of the work that the OECD will continue with during the remainder of 2020.

Businesses will be pleased to see that consideration will be given to simplified compliance processes, including a central filing option (one stop shop).

Importantly, any new taxing right (Amount A) will be ring-fenced so as not to have implications for other taxes such as VAT or customs duties.

The scope of the new taxing right (Amount A) under Pillar One has been clarified, focussing on

(i) digital businesses, including those that provide cloud computing services, and

(ii) consumer businesses including franchise models.

At this stage there remains no indication of the amount of residual profit to be reallocated to the market or user countries. Extractive and other commodity businesses, and regulated financial services businesses appear to be broadly excluded, alongside international air and shipping businesses. The statement also clarifies that Amount B (a baseline return for marketing and distribution activities), and Amount C (full transfer pricing under the arm's length principle for additional marketing and distribution activities) under Pillar One will apply to all businesses regardless of whether they are in-scope for the new taxing right under Amount A.

The proposals contain some complex areas for further work, particularly in terms of nexus for Amount A where selling tangible goods into a market may or may not create an active non-physical presence, and where the threshold may vary according to the size of the market. In addition, the amount of residual profit to be allocated to market countries under Amount A may be weighted according to the degree of digitalisation of the business. These concepts are likely to be challenging to apply in practice and may run counter to the desire for simplicity.

The brief Pillar Two update mentions the issues raised by a regime that might require a minimum level of tax regardless of substance, and it is clear that policy differences remain amongst countries in respect of the scope and intentions of the proposals.

The statement confirms that changes, particularly in respect of the new taxing right under Amount A, will be implemented by way of a new multilateral instrument, so that countries adopt the new rules at broadly the same time. This is nonetheless expected to take some years to implement by way of countries' domestic procedures, and therefore the best estimates would suggest that the changes will apply, at the earliest, from 2023. Pascal Saint-Amans, speaking on the OECD's Tax Talks webcast on 31 January 2020, confirmed that there is no Plan B for a multilateral solution. The alternative, if governments cannot agree, is expected to be more unilateral action and fragmentation of the international tax system, increasing double tax and complexity, and challenges to international trade.

Contacts

David Watkins

Partner
Tel: +61 2 9322 7251
dwatkins@deloitte.com.au

Vik Khanna

Partner
Tel: +61 3 9671 6666
vkhanna@deloitte.com.au

Mark Hadassin

Partner
Tel: +61 2 9322 5807
mhadassin@deloitte.com.au

Claudio Cimetta

Partner
Tel: +61 3 9671 7601
ccimetta@deloitte.com.au

Cam Smith

Partner
Tel: +61 3 9671 7440
camsmith@deloitte.com.au

Manu Sriskantharajah

Partner
Tel: +61 3 9671 7310
msriskantharajah@deloitte.com.au

Jonathan Hill

Australian desk, NY
Tel: +1 718 508 6805
jonhill@deloitte.com

Adam Hounsell

Account Director
Tel: +61 3 9671 6106
ahounsell@deloitte.com.au

Liam O’Brien

Account Director
Tel: +61 3 9671 7905
liobrien@deloitte.com.au

Amelia Teng

Partner
Tel: +61 3 9671 7335
amteng@deloitte.com.au