

G7 announcement – What lies ahead in transfer pricing?

Almost two years ago, in its inclusive framework with G20 nations, the Organisation for Economic Co-operation and Development (“OECD”) proposed a two-pillar, consensus-based solution, to tackle two of the most prominent tax issues relating to – (i) taxing the digital economy and (ii) base erosion due to shifting of profits to low or no tax jurisdictions.

The previous discussions on these issues slowed down much like economic growth and everything else, as the

world grappled with the challenges posed by COVID-19. Moreover, the erstwhile US government appeared reluctant to the OECD proposal, especially on Pillar 1. However, the Biden-led government demonstrated its commitment to the OECD proposal, set out an alternative proposal for Pillar 1, and expressed support to minimum global tax rate. Further, at a recent meeting, the finance ministers of G7 countries – the United States, Japan, Germany, Britain, France, Italy, and Canada – agreed on the following:

Pillar 1

Re-allocate taxing rights. Market countries to be awarded taxing rights on **at least 20 percent of the profit exceeding a 10 percent margin** for the largest and most profitable multinational enterprises (as against the OECD proposal that included automated digital services and the consumer-facing business only). No physical presence in a market country is required to create a new nexus (i.e., taxable presence).

Pillar 2

Set the minimum global tax rate at 15 percent to avoid countries undercutting each other to attract more investments (by lowering tax rates).

The G7 communiqué also committed to withdraw unilateral measures implemented to tax the digital economy.

Further to the above, 130 of the 139 OECD's Inclusive framework countries have given their consent to global minimum tax at a recently concluded meeting in Paris. This includes major economies, such as China, India, Brazil, the UK, Germany, France, and Russia. Notably, most of the tax havens, such as the Cayman Islands, Bermuda, Mauritius, and Cyprus, have also given their consent, which was indeed historic. However, Ireland, a home to tech giants, such as Facebook, Google, and Apple, have not given its consent.

While countries have agreed to the "big pieces", a detail implementational plan tying loose ends is expected to be finalised by October 2021. Although, this timeline seems ambitious, an honest strive to achieve the timeline is imperative to ensure relevance of the progress made so far.

Future of MNE operations and the role of transfer pricing

Changes to digital tax policies and implementation of global minimum tax, coupled with the ongoing pandemic, are bound to trigger a paradigm shift in the way business is conducted.

Once minimum tax is put in place and tax arbitrage opportunities turn negligible, the focus would be on the taxable base of profits where most future disputes would potentially lie. Transfer pricing has a pivotal role to play in preventing and resolving these disputes. Further, supply chain decisions would no longer be based on tax rates, but on other factors. For example, in the future, India may continue to attract investments due to factors such as its large consumption economy, availability of low-cost skilled labour, strategic geographic location for exports, and non-tax fiscal incentives for strategic sectors. Needless to say, the pandemic has significantly accelerated digital transformations, leading to strategic changes in the way businesses operate; many of these changes could be permanent.

There is a dire need to transform transfer pricing models, as a response to the change in the tax landscape or COVID-19 or the shift from physical to software and people to technology. This transformation will help ensure correct allocation of taxable income across jurisdictions.

The role of transfer pricing is two-fold – 1) help create a tax optimum supply chain model and 2) defend remuneration for each MNE group entity in line with its value in realigned supply chain.



As an extension to the above, most consumer companies look for more data to make business models as predictive as possible. The tax authorities can contend that value is created within their borders as the data is collected from within their borders. However, the real question is which jurisdictions use the data to derive insights, thereby becoming centres of excellence in data mining. These jurisdictions may ultimately deserve a larger share of return than the jurisdiction that is collecting the data.

Transfer pricing is often an afterthought while taking supply chain related business decisions. However, enterprises may need to understand that when we talk about key business functions, such as location of valuable intangibles, location of people function, and centralisation of activities (such as R&D, procurement, and compliances), transfer pricing should be at the heart of the analysis. One pertinent question that businesses must be prepared to answer while realigning the supply chain is - whether the entity that has been stripped down from its functions, compensated adequately and vice versa.

Transfer pricing's interplay with indirect taxes should be considered for a tax efficient and holistic solution. The future of transfer pricing planning and policymaking may lie in a multi-dimensional approach which also takes into account the impact of other taxes, incentives, geographical factors, etc., and is able to achieve cash flow and tax optimisation goals of businesses.

Primarily, at the heart of the Pillar 1 proposal is the need to earn a return for market/customer intangibles related functions. The proposal is also intrinsically connected with transfer pricing analysis, when it comes to calculation of Amount A (a share of deemed residual profit allocated to market jurisdictions) or Amount B (baseline return to entities for marketing-related functions) or determining the residual profits entitlement amongst entities, controlling important Development, Enhancement, Maintenance, Protection, and Exploitation (DEMPE) functions.

However, there are many hurdles or unanswered questions, such as:

-  What will be the mechanism for allocating income to a market jurisdiction where there are no inter-company transactions?
-  Which entity/jurisdiction will give up its share of profits for other jurisdictions and would it be protected?
-  Are transfer pricing issues likely to increase in an attempt by each jurisdiction to increase the taxable base of profits?
-  Can transfer pricing positions still be defended? Are they supported with sufficient documentation?
-  What are the mechanics of tax payment in the absence of physical or taxable presence?

Closing remarks

“Done is better than perfect.” Although there are challenges ranging from reaching a consensus to amicably resolving inherent issues of these proposals, a global common ground is the need of the hour. There is undeniably a vast base of rising digital presence that is not getting taxed or getting taxed incorrectly (by way of unilateral levies with no corresponding deduction). To add to this, there is a need to tackle mischievous acts of profit shifting by taxpayers at a time when governments across the world see dwindling coffers.

The G7 proposal represents a fundamental departure from current global tax policies. Therefore, companies that are likely to be affected should start reviewing their business models and be prepared to respond when the OECD proposal is eventually implemented. If everything goes well, the proposal is expected to be implemented by FY 2022 and enforced as law by FY 2023.



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