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TALKINGPOINT March 2020

Tax challenges arising from digitalisation – global anti-base erosion mechanism

FW discusses tax challenges arising from digitalisation and the global anti-base erosion mechanism with Matthew Gillespie, Boris Nemirov, Martin Rabenort and Bob Stack at Deloitte Tax.

THE PANELLISTS

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FW: In what ways does the continued digitalisation of the economy require changes to tax policies and procedures?

Stack: Because the continued digitalisation of the economy does not manifest itself uniformly across industries, business models and regions, it remains unclear what changes are needed globally to tax policies. In some areas, like value added and consumption taxes, there has been broad recognition of the need to update the rules to take into account the digital delivery of goods and services, and that work has progressed around the world. In other areas, such as whether and how to change the global income tax architecture, there is less consensus, in part because the issues are quite complex and there are likely to be countries that gain taxing rights and others that lose taxing rights. The 'inclusive framework', a group of over 130 countries, including Organisation for Economic Co-operation and Development (OECD) and G20 members, are engaged in an ongoing project to examine what changes to the international income tax architecture might be able to garner a multilateral consensus. That work continues and hopes to show significant progress in 2020.

Gillespie: To address the potential impact on tax procedures, it is important to keep in mind that digitalisation also brings a fundamental shift in how an organisation should think about tax overall. Gone are the days of tax teams being able to use retrospective analysis and transaction sampling. Governments will likely be able to access transactional data and identify proper taxability in near real-time. Gaps in current procedures, for instance a lack of proper legal entity based books and records, could manifest as tax exposure for multinational entities (MNEs) as tax policies evolve in response to the digitalisation of the economy.

Rabenort: MNEs will also likely need to include new taxes within the global tax mandate and tax operating model. In view of that fact alone, tax processes and procedures are likely to be affected, with the degree of impact depending to an extent on the company's inherent industry and jurisdiction footprint.

Nemirov: The digitalisation of the economy will also require certain changes to transfer pricing policies and procedures of MNEs. However, there are several perspectives that MNEs are considering, whether the digitalisation of their own organisations and the manner in which they deliver products and services will require such changes to transfer pricing policies

and the manner of their implementation and monitoring or whether the work being done by the OECD on digital would force companies to make changes in order to mitigate the impact on their businesses. Digitalisation presents a slew of new challenges that most MNEs have not had to deal with previously and the facts and circumstances of each company's business dynamics and digital value chains will be critical to consider.

FW: Could you provide an overview of the Organisation for Economic Co-operation and Development (OECD)'s global anti-base erosion proposals? To what extent do they involve substantial changes to the international tax architecture?

Stack: The inclusive framework process is pursuing a 'two pillar' approach to dealing with international tax issues arising from the digitalisation of the economy. The work under pillar one seeks to change the current rules concerning how much profit of certain large MNEs is allocated to market countries, as well as the current rules that preclude income taxation in a country in the absence of a physical presence. Pillar two seeks to minimise MNEs' ability to shift profit to low- or no-tax jurisdictions by imposing a 'minimum tax' rate on corporations, loosely based on the US global intangible low taxed income (GILTI) regime that was enacted in 2017 as part of US tax reform. This 'global anti-base erosion proposal' (GloBE), which is still in early stages of technical development, would subject an MNE to a so-called 'top-up' minimum tax in the event the MNE is not subject to a sufficient level of tax on its activities outside its home country. Broadly speaking, if a country does not impose such a minimum tax, then other countries would be permitted to deny deductions or potentially impose withholding taxes on payments to low-tax countries in situations in which that income is not otherwise subject to a minimum tax. There are many technical issues still to be worked out, however.

Gillespie: This is one of the top agenda and discussion items for most MNEs, as each tries to gain a deeper understanding of how the OECD digital proposals will impact their business and attempts to model out such impact. However, given the uncertainty around where consensus will be reached in the future, many MNEs have taken a 'wait and see' approach before implementing any changes to their transfer pricing and international tax structures.

FW: What are some of the key issues that arise in connection with determining an appropriate, consistent tax base?

Stack: To be meaningful a minimum tax rate should be based on a common tax base. For example, if a company has 100 of income, but only 10 of depreciation expense in year one, it pays tax on 90 of income. Another country might allow immediate expensing of capital investment, so that on the very same facts as the previous example, there is 100 of income and 50 of deduction. The search for a consistent base seeks to minimise distortions that complicate efforts to determine whether the minimum tax rate has been paid. One key question is whether a 'good enough' solution would permit reasonable variations among countries in determining the appropriate tax base. If policymakers are seeking a high level of consistency, then they might want to use a common accounting standard, such as US generally accepted accounting principles (GAAP), Japan GAAP or international financial reporting standards (IFRS) as the base, because these standards are commonly used beyond a single country or region and are less sensitive to differences in local country tax rules. But this 'book income' approach also has distortions related to issues such as timing, and so the question becomes how to adjust book income to produce a more reliable tax base than taxable income for purposes of a minimum tax, and whether it is possible to harmonise differences among the most common accounting standards. All of this is technically complex and challenging, and the OECD secretariat, in connection with the inclusive framework process, has engaged in extensive consultation and analysis on these issues.

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Rabenort: Apart from the adoption of a global approach, one of the challenges going forward is that, where tax authorities have full visibility to tax relevant data at a granular level, such as Brazil, for instance, and can deploy technology solutions to interrogate and analyse the data to determine the tax base that in their view is appropriate, it is likely that in cross-border situations the same economic tax base may be included in the tax base of multiple countries from their individual perspectives. That could lead to many more mutual agreement procedures under tax treaties or other multilateral instruments, and ultimately to double taxation. It is therefore key that the tax authorities globally determine how to consistently interpret and apply tax rules to prevent this outcome. The digitalisation of taxing authorities can have additional impacts. For non-cross-border situations, within a single country, the type of real-time, data-driven tax environment we are describing could also lead to an increased tax base, as the tax authority could apply a continuous monitoring system, including exception reporting, which would be expected to

lead to a stream of queries and suggested corrections. It may then be difficult for taxpayers to respond to or counter those queries and corrections within the period imposed by law, hence the potential for increased tax liabilities.

Gillespie: A key issue related to a real-time data environment is proper intercompany accounting. We have seen situations where well over 50 percent of an MNE's transactions may be intercompany in nature, and such transactions are often not processed with the same level of rigour or detail, compared to transactions with third parties.

Nemirov: From a transfer pricing point of view, there are often significant differences in how intercompany transactions are implemented in various countries for the purposes of compliance with the local regulations and requirements, as well as how these are ultimately captured in the companies' books and records. In some cases, even reconciliation of the intercompany transactions in the books of the counterparties to the same transactions can prove to be difficult. GAAP, timing, foreign exchange, enterprise resource planning (ERP) systems and level of consolidation, naming conventions and other differences can play a major role as well.

> WE EXPECT THE TRANSFORMATION TOWARD A REAL-TIME, DATA-DRIVEN ENVIRONMENT TO CONTINUE, AND EVEN ACCELERATE.
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FW: What potential problems are likely when it comes to allocating income among entities within a group, based in different jurisdictions, for tax purposes?

Stack: There needs to be global agreement around the sources of income, as well as the allocation of expense to that income, even in situations in which some expense is incurred outside the jurisdiction that is being given the right to tax it. Failure to achieve a sound agreement around these key issues can result in double taxation of the same items of income, which can dampen investment.

Gillespie: There are significant differences in transfer pricing rules across countries, which today create inconsistencies in terms of income and expense allocation, and at times lead to double taxation of the same income. As examples, countries may have different views on what comprises stewardship, which expenses can be allocated and deducted locally, arm's length levels of profits for various activities, differentiating between routine and non-routine activities and so on. Access to usable and relevant data is also at times a limiting factor, especially with companies that grew through acquisitions and where numerous ERP systems may exist across the organisation and which do not fully share data.

FW: What practical challenges do you anticipate with rolling out the OECD's proposed rules internationally?

Stack: The biggest practical challenge is to get over 130 countries involved in the inclusive framework to agree first at a political level on an agreed solution, and then on the technical details of any agreed solution. This is a time consuming and complicated process. Once the technical details have been agreed, the solution needs to be adopted by national legislatures around the world and embodied in income tax treaties. Every country has its own unique challenges when it comes to enacting legislation and agreeing to treaty changes.

Rabenort: As this global effort proceeds there could be a number of practical challenges, such as countries may have a variety of practical interpretations of the proposed rules, countries may not implement all of the proposed rules but instead may be selective and countries may use the proposed rules to implement additional measures that were initially not considered.

Gillespie: Depending on the ultimate proposal, I can also foresee a period of challenge meeting compliance requirements, as many large MNEs do not currently have the financial systems to provide near real-time legal entity reporting, especially at the transaction level of detail.

Nemirov: The timing of each country's implementation of the OECD proposals may also create complications, as was seen with the implementation of the country-by-country reporting (CbCR) and notification requirements.

FW: To what extent would the OECD's proposals add new layers of complexity to tax planning for multinational entities (MNEs) that operate highly digitalised businesses?

Stack: It is important to note that the approaches being considered at the OECD, including pillar one, as well as the GloBE, are actually not limited to highly digitalised businesses. There is potential for shifting to an entirely new generation of tax rules for all cross-border businesses, and that will necessarily entail new layers of complexity.

Rabenort: If the world moves toward formulaic approaches, the possibilities for tax planning may be reduced.

Gillespie: There will certainly be complexities in developing sustainable processes for compliance. Many companies will need to consider completely revamping their underlying financial systems, and the

new cloud-based systems prominent today may need to adapt configuration to meet these evolving tax needs.

FW: How have MNEs responded to the rules proposed to address global anti-base erosion? What criticisms have been raised?

Stack: Most large MNEs are paying close attention to the inclusive framework and OECD process, but have perhaps expended more energy on pillar one – which may be seen as farther reaching and more impactful – than on the pillar two GloBE proposal. This may be due, in part, to the fact that some US MNEs might be assuming the US GILTI regime would 'immunise' them from the new income inclusion rule being contemplated. However, that is far from clear at this stage.

Rabenort: Many MNEs have simply adjusted their processes to remain compliant with tax laws and regulations in the countries in which they operate, which can often lead to a higher tax burden.

Gillespie: With respect to the real-time, data-driven environment and the digitalisation of tax authorities, there is apprehension in the marketplace given that many companies have financial platforms built to meet the needs primarily of management reporting rather than regulatory reporting. The criticisms that many MNEs raise centres around the work and cost required to comply with digital reporting requirements. However, accounting records should already be handled in a way that would easily allow for this compliance – digitalisation is starting to drive what is already a much-needed change.

FW: Looking ahead, how do you expect tax challenges and solutions arising from digitalisation to unfold in the months and years ahead? Are there any steps MNEs should be taking now to prepare and plan accordingly?

Stack: When the OECD first considered these issues in a 2015 report, it concluded that it is not possible to 'ringfence' the digital economy and write special rules for it. Rather, the entire economy is becoming digitalised, so that new rules would likely apply broadly across industries. While the inclusive framework is hoping to show concrete progress to the G20 in 2020, there is still significant work to be done before an agreed approach emerges, assuming one does. This will probably be a long term, ongoing process, cutting across a variety of tax policy areas, from consumption taxes through income taxes.

Rabenort: We expect the transformation toward a real-time, data-driven environment to continue, and even accelerate. MNEs should ideally prepare themselves by tackling that transformation just ahead of, or at least in cadence with, the tax authorities – to remain compliant while maintaining effective control of tax positions. MNEs should be progressing the necessary data and reporting transformations now.

Gillespie: In the near term, there could also be significant negotiating between individual companies and governments, as most MNEs are not prepared for the onslaught of various digitalisation initiatives that countries globally are rapidly enacting. ■

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