Work programme for reaching consensus on tax challenges from digitalisation sets ambitious targets according to stakeholders

11 June 2019

In brief

The OECD released on 31 May 2019 the *Programme of Work to Develop a Consensus Solution to the Tax Challenges Arising from the Digitalisation of the Economy*, agreed by the OECD/G20 Inclusive Framework (IF). The aims are broadly to have a political agreement on a unified approach by the end of 2019 and to be prepared to implement that solution by the end of 2020. Stakeholders at the US Council for International Business (USCIB) 2019 OECD International Tax Conference on 3-4 June had a first opportunity to react, amid presentations from OECD and members of the IF involved in agreeing the programme.

The G20 countries formally approved the plan on 9 June 2019 and will help steer political engagement and endorsement. The Steering Group of the IF, supported by its Task Force on the Digital Economy (TFDE), will focus on reaching agreement on a unified approach. OECD Working Parties (particularly WP1, 6, 10 and 11) and the Forum on Tax Administration (FTA) Mutual Agreement Procedure (MAP) Forum will provide technical inputs. The OECD Secretariat will undertake an economic analysis and impact assessment through its WP2.

The OECD will hold public consultations for external feedback if necessary, although given the tight time frame of the project consultation periods may be short. There will be a progress report and a final report, in line with the above aims, in December 2019 and December 2020 respectively.

The work programme stipulates a large number of fundamental issues to consider in the short time frame available. In this Bulletin, we seek to provide insight on the potential impact of the programme, starting with the February/ March 2019 consultation on the project then discussing the Pillar 1 considerations, Pillar 2 considerations and impact assessment to be. Stakeholders may wish to consider whether to engage unsolicitedly with the OECD and member countries in order to make their views known.

In detail

The framework following consultation

The proposals that the work programme addresses are largely unchanged from the 13 February 2019 consultation paper, responses received and the 13/14 March public meeting (see OECD public meeting documents). Our views on a large number of issues are as set out in our response of 6 March 2019.

In this Bulletin, we address more specifically the matters directly raised by the work programme, in [particular in relation to:

- Pillar 1 - the reallocation of taxing rights involving profit allocation and nexus rules (introducing a 'new taxing right'), and
- Pillar 2 - remaining BEPS issues involving rules that would provide jurisdictions with a right to 'tax back' where a payment is subject to low levels of effective taxation.

The interaction between the two pillars is recognised and there is a stated intention to deal with them together. Because the objectives of the two pillars differ (i.e. reallocation of taxing rights vs common rules to limit the impact of tax competition), it is imperative that these two objectives are addressed together. Absent tight coordination, the two workstreams could undercut each other, for example a reallocation of taxing rights under Pillar 1 could impact the effective tax rates suffered, and the need for a Pillar 2 adjustment. This would be particularly challenging where the reallocations are not transactional (i.e., if they reallocate percentages of fungible residual profits). It seems apparent that Pillar 1 needs full consensus; under Pillar 2, a broad network of adopting countries agreeing best practice domestic rules would suffice.

The background broadly refers to the fact that the solution(s) sought should:

balance precision and administrability for jurisdictions at different levels of development

be underpinned by sound economic principles and conceptual basis

ensure a level playing field between all jurisdictions - large or small, developed or developing

not result in taxation where there is no economic profit

not result in double taxation

PwC comments: The potential for double or multiple taxation exists if a clear and principled consensus isn't reached, if it doesn't sufficiently deal with ordering rules, or if it fails to be uniformly adopted and implemented. However, we welcome the statement in the work plan that the IF is:

"… concerned that a proliferation of uncoordinated and unilateral actions would not only undermine the relevance and sustainability of the international framework for the taxation of cross-border business activities, but will also more broadly adversely impact global investments and growth".

Pillar 1 considerations

Wider recognition of issues

The programme generally describes the three different proposals set out in the March 2019 consultation paper: user participation, marketing intangibles and significant economic presence.. There is reference to 'routine' and 'non-routine' returns in different approaches, but any further work to more clearly define them appears yet to be done. Drawing together commonalities about the programme describes a business presence in a market jurisdiction reflecting the transformation of the economy and not constrained by physical presence requirements. It also refers to indicators of a multinational enterprise's (MNE's) remote but sustained and significant involvement in the economy of a market jurisdiction, including things like language and currency and product or service adaptations for a particular market.

The alternative attribution methods covered are:

- modified residual profit split
- fractional apportionment (i.e., a formulary apportionment), and
- distribution-based approaches (i.e., income would be allocated on the basis of a specific return on sales).

The matters needing to be addressed in relation to the new taxing right of market jurisdictions cover implementation issues as well as the actual rules for profit allocation and nexus.

Some commentators at the USCIB Conference stated that for an outcome to be in place by the end of 2020 to increase certainty and stability, it would have to be formulaic. Further comments indicated that the solution would have to be broad based (i.e., not focus on specific business models) and decisions would have to be taken on whether every business line or just selected lines should be in scope.

PwC comments: The plan covers profit allocation first which is consistent with our views on the order of priorities, but at the end both nexus and profit attribution need to be considered together. We welcome the identification of some of the practical matters that may arise but suggest that more will arise in the course of the discussions. Where there is a minimal established tax presence in a market jurisdiction, it is unclear what revenues or entity would fund the tax payment. Would companies be well-advised, for example, to adapt their transfer pricing system to report income in the market jurisdiction with potential impact throughout the value chain?

Commonalities

The programme recognises the continuing viability of the arm's length principle (ALP) and the transfer pricing system for many cross-border transactions. However, the programme also recognises the demands of market jurisdictions for the allocation of a share or greater share of global profits.

In addressing that, commonalities among the three proposed options are listed as:

- existence of nexus absent physical presence
- use of total business profit
- use of simplifying conventions to reduce compliance costs/disputes (which may diverge from the ALP, and
- operation alongside current profit allocation rules.

These commonalities will be the foundation of any solution that could achieve consensus among the participating countries, and accordingly the Pillar I workplan will focus on three 'building blocks' that seek to bring these foundational commonalities together into a coherent framework. The building blocks are (broadly):

I. Profit determination and allocation
II. New nexus rules
III. Implementation and administration

PwC comments: It is perhaps an oversimplification to suggest that any new rules would operate alongside current profit allocation rules. There would have to be an allowance for situations in which a business has a physical presence in a market jurisdiction and the new taxing right also applies. This may mean that certain functions, such as distribution activity, will be subject to safe harbours or formulas to simplify and remove disputes but that will lead to an increased profit allocation/ attribution to market jurisdictions and an increase in their overall tax take.

I - Profit determination and allocation

Three main alternatives, and a range of additional scoping considerations, are put forward as areas to be developed under the first building block. These methods all seek to identify both the profits in scope of potential reallocation, and how that reallocation may be achieved.

Modified residual profit split

The modified residual profit split (MRPS) alternative proposed involves four steps:

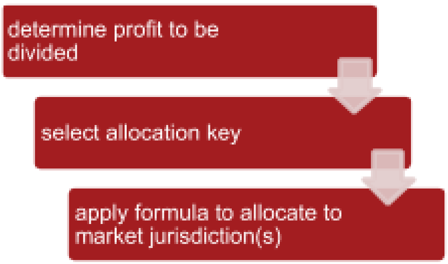
The work programme identifies a number of technical issues for consideration, including:

- suitability of accounting rules for computing total profits
- how to measure profits (group-wide vs. entity/aggregate basis),
- bifurcating total profit into routine/ non-routine buckets (e.g., adapting current transfer pricing rules, capitalized expenditures, future income proxies, fixed percentages for business lines), and
- evaluating possible allocation keys (e.g., revenues).

PwC comments: Given its complexity, it is difficult to see how the MRPS will gather consensus among the developing and emerging economies~~.~~. The bridge between the determination of total profit and the allocation of that amount will need to span any differences between the importance of user participation and marketing intangibles (where the definitions also become critical and can apply for other purposes) , and determine whether, and how, 'routine' profits are to be calculated and attributed (an area which is already extremely complex and can result in disputes). Discussion of elements put forward by particular jurisdictions about customer data and non-marketing intangibles may also be required.

Fractional apportionment method

The fractional apportionment (FA) method alternative proposed has three steps:



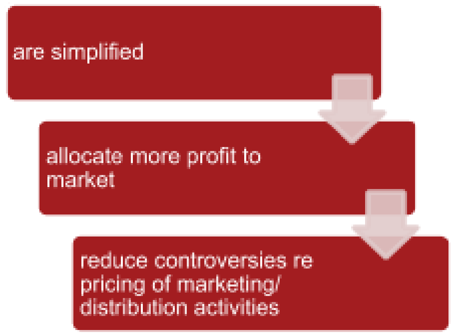
The work programme includes consideration of the following technical issues:

- developing the method to determine profits of the non-resident (e.g. overall profitability?)
- determining the financial accounting regime to measure profit, and
- considering relevant factors for the formula (e.g. employees, assets, sales, and potentially users).

PwC comments: FA would apply to both routine and non-routine profits. Integrating FA into existing transfer pricing rules would be the most challenging because this does not take existing profit allocations under the ALP into account. Determining the formula factors involves similar issues to those mentioned in relation to the MRPS. The FA increases the incentive to move factor resources to lower tax jurisdictions, distorting economic decisions, unless limited to a sales factor (as US states have done) or to the extent offset by the proposals of Pillar 2. With the likelihood of a multiple factor formula, it will be all the more important to have clearly defined but future-flexible terms (e.g., turnover, assets, employees, users). It is also likely to be even more important here to reconcile the agreed-upon accounting method under the framework and applicable accounting methods normally used for local tax purposes. We call for more economic research into allocation factors.

Distribution-based approaches

Other, but as yet unspecified approaches, are to be considered that:



Technical issues for the work programme to consider include:

- determining whether a baseline profit amount attributable to marketing/ distribution/ user-related activities can function as a minimum/ maximum return
- assessing baseline adjustments based on overall group profitability, and
- dealing with groups with no established tax presence in a market.

PwC comments: There are no references in the programme to limited risk distributors (LRDs), contrary to the earlier consultation paper. However, it seems clear that LRDs, as well as other scenarios where no or limited taxable scale exists in the market jurisdiction, are regarded as a problem and will be allocated more profit under any chosen method. Tax rules should be founded on economic reality to ensure a stable system. Distortions in re-allocation are more likely where group-wide distribution/ marketing costs are used as they are often not aligned with revenue (or other potential factors).

Business line/ regional segmentation

Technical issues for the work programme to consider alongside the three methods outlined above include:

- defining/ delineating business line approaches
- evaluating administrability, and
- assessing information MNE groups already prepare and whether it can be used to segment MNE groups

PwC comments: It may be appropriate to apply a degree of flexibility here. For businesses that report using business line or region, it may be appropriate to allow calculations that reflect the differences that exist between diverse product/ service lines or geographically. However, to compel all businesses to do so would create significant burdens, so striking an appropriate balance will be a significant challenge.

Design scope limitations

The programme recognises that, while looking to provide a level playing field, there will be businesses that, for sound economic reasons, might be excluded. These could be based on numerical thresholds as well as qualitative in terms of the nature of activities.

Technical issues for the work programme to consider include:

- limiting the scope of the new taxing right to targeted circumstances, and
- considering legal constraints imposed by other international obligations

PwC comments: The extent to which thresholds and other carve-outs are appropriate to address global policy objectives versus individual jurisdiction or regional issues may be key. These will have to be set out objectively in clear language. They could, for example, relate to the maturity of business, certain business models or characteristics within an industry sector. Beyond any issues with existing bilateral treaties, etc. (below), the legal compatibility with other rules may also need to be carefully considered (e.g., World Trade Organisation or EU rules, although both could potentially be changed with differing degrees of ease).

Loss treatment

A fundamental feature of the underlying principles of taxation (including the OECD Transfer Pricing Guidelines) is that losses are identified in the same way as profits,. The programme seeks to recognise losses as attributable where an enterprise's relevant activities generate them (or on a formulaic or other basis if that is the agreed consensus approach).

Technical issues for the work programme to consider include:

- allocation rules that apply symmetrically to profits and losses
- whether a loss-making MNE group should file a tax return in the market jurisdiction
- an earn-out approach, with cumulative loss accounts maintained so that the new taxing right only kicks in once losses have been zeroed out, and
- whether a defined subset of losses should be taken into account (e.g. carry-forward losses, particular business line losses, regional losses).

PwC comments: It is equitable that both local market losses and share of cumulative global residual losses should be taken into account. This would include recognising a market jurisdiction entity's ability to amortise the fair market value of any marketing intangible allocated to it out of an innovation entity suffering an exit charge as a result of that allocation.

II - New nexus rules

New nexus rules would need to capture business presence in a market jurisdiction without physical presence to allow it to exercise the new taxing right. Two options are set out to develop the concept of this remote taxable presence (RTP) that is not constrained by physical presence in a jurisdiction, based on amending existing rules under OECD Model Tax Convention Articles 5 (PE threshold) and 7 (attribution of business profits) or introducing a new concept (including non-discrimination provisions).
Commentators at the USCIB Conference suggested that not touching the existing PE could be better as there may be many spillovers if it were amended. Some questioned whether a nexus may be formed of multiple companies.

PwC comments: The decision will be influenced by how easy it is – either through amended guidance or amended treaty language – for the allocation standard to be made consistent with the Model (and jurisdictions' implementations thereof, particularly since many are not adopting recommended BEPS changes). The threshold would ideally include 'bright line' tests that are principles-based and clear (with guidance and consistent application). Whichever option is selected should coherently sit alongside the existing PE thresholds on an entity-by-entity basis, and coherently tax the activities of different entities (potentially related or unrelated enterprises). These challenges relate both to the thresholds working together to ensure the appropriate rights to tax are granted to the 'source' state, and also that they are not both simultaneously triggered in relation to the same profits without an ordering mechanism in place to relieve double taxation.

III - Implementation and administration

Implementation issues

The programme poses new questions about the sufficiency of existing double tax relief mechanisms. This includes the effectiveness of existing treaty/ domestic law provisions and whether new/ enhanced provisions are needed – perhaps via a multilateral competent authority mutual agreement.

The working groups will also review current dispute prevention/ resolution procedures. This will include the idea of multilaterally coordinated risk assessments (e.g. similar to those piloted in the FTA international compliance assurance programme, or ICAP). Arbitration where necessary, in the manner set out in the the multilateral instrument on giving effect to BEPS treaty changes under Action 15 (the multilateral instrument, or MLI), is also a suggested remedy.

Technical issues for the work programme to consider include:

- effectiveness of existing treaty provisions, such as clear identification of the relevant taxpayer, appropriate adjustments under OECD Model Tax Convention Article 9(2) to address economic double taxation, eliminating juridical double taxation, and
- interaction between existing rights and the new taxing right, such as withholding taxes.

PwC comments: There will be an increased risk of double taxation from the mechanical operation of the global anti-base erosion program (GloBE: see Pillar 2 below) but also through the profit sharing element of profit allocation/ nexus. Existing dispute prevention and dispute resolution mechanisms will need to be improved and potentially broadened to work multilaterally. The biggest coordination challenge may come from both Pillars being introduced simultaneously, as each could impact the other's operation. If such an approach is taken, there may be merit in seeking to identify whether elements of each proposal are already resolved to some extent in the outcomes of the other, so that some form of offset is appropriate under existing or new measures.

Administration issues

The administrability of the solution is described as key to the ability of developing countries to adopt it. Some of this is in the relative simplicity of the approach selected while other elements relate to procedures and practices.

Administration concerns set out in the programme include required enforcement and collection arrangements for non-resident entities. There may be a need to identify new data points (e.g. total profit, total profit per business line, sales, users, etc.). The IF might agree simplified registration arrangements, possibly in conjunction with a broader level of protection against non-payment.

Technical issues for the work programme to consider include:

- exploring collection mechanisms (e.g., withholding tax), reporting obligations, and information dissemination, and
- need for new reporting obligations and new/ revised protocols for exchange of information

PwC comments: Formal agreements by jurisdictions to apply the consensus solution should be designed in a way that limits their ability to act unilaterally. If a fixed allocation metric is introduced, the system could also set the right incentives for all jurisdictions to respect the agreed metric.

Tax treaties

It seems unlikely that any of the proposals finally agreed (and especially those seeking to address profit allocation and nexus) could be effective without treaty changes. The programme suggests considering amending or supplementing the MLI or establishing a new multilateral convention.

PwC comments: While 78 countries have signed up to the MLI so far, some notable countries have not done so. On the basis of the objections put forward, it seems that a new convention is a more likely route to achieve the necessary adoption within a reasonable time frame. But it will be challenging to get a consensus on that approach.

Pillar 2 considerations

GloBE

The anti-base eroding payment proposals are now referred to as GloBE. It's envisaged that these would work alongside the Pillar 1 approach.

The two key design elements of GloBE remain the same and are stated as being 'inter-related' but the programme does not clarify if they are intended to work together or on a primary and secondary basis:

an "income inclusion" rule that seeks to apply a minimum tax at shareholder level, and

a "tax on base eroding payments" that seeks to deny deductions or treaty benefits where receipts are not deemed sufficiently taxed

There is a lot of work still to do. Many commentators at the USCIB Conference maintained that income inclusion should be the primary rule and that this would likely be designed in a 'rough and ready' way and not as an anti-abuse system. That would seek to look at the facts and not consider any 'substance' issues necessary to qualify those facts.

Levels of enthusiasm for Pillar 2 appear to be mixed among the 129 IF countries, but there is fairly broad political support. It's clear that the Pillar 1 approach will require nearly all those countries to agree, while a sufficiently large contingent of countries implementing elements of Pillar 2 could work in practice without a formal agreement to do so.

The areas for further work cited in the programme are familiar to those raised at the public consultation, and reflect broadly the design challenges below. US Treasury officials at the USCIB Conference pointed out that the task might be compared with the effort that went into the approximately 300 pages of regulations for the US GILTI rules, and how this can be simplified will be key to the success of this measure. An average rate or blended global rate regime might be simpler and encourage behavioural change more than a country-by-country minimum tax.

PwC comments: The programme makes clear that any new rules under this Pillar should not result in taxation where there is no economic profit, nor result in double taxation. The proposals see the GloBE as a means to stop any 'race to the bottom' on tax rates and help developing jurisdictions better mobilize domestic resources. Some jurisdictions might still be keen to see the rules specifically target aggressive and artificial arrangements only.

Income inclusion rule

Technical issues for the work programme to consider include:

- whether the minimum rate of tax should apply to 'top up' (to the threshold or the taxing jurisdiction's domestic rate) – the programme suggests that a top up to the threshold rate would be less distortionary
- whether the minimum rate of tax should be a fixed percentage, the parent's CIT rate, or a corridor and whether country level or blended rates of tax should be assessed
- whether the system could be simplified (e.g. using accounting data or global accounts), and
- how a switchover rule could work (i.e. application to branches, applying a tax credit rather than exempting profits).

PwC comments: The determination of the effective rate of tax suffered on an element of income may become considerably more complicated by Pillar 1 (e.g., where a royalty payment is made to an IP owner, but then, after routine functions are rewarded, a residual is reallocated in part to a number of market or user jurisdictions). This could potentially be addressed by limiting the scope of the measure where action is taken through other channels.

Tax on base eroding payments

In relation to the tax on base eroding payments, both the denial of deductions rule, and the denial of treaty benefits will also have significant challenges:

- design compatability with other rules/ treaties
- types of payment in scope and determination of whether they are 'undertaxed'
- gross or net corrections (whether the denial or deductions/ benefits would be in their entirety or in proportion to the level of undercharge), and
- application between unrelated parties.
- In addition, the coordination of these two elements will be examined, along with administrative and simplification mechanisms (e.g., sectoral carve-outs).

PwC comments: The subject-to-tax rule introduces changes to OECD Model Article 7 by denying treaty benefits and, from a practical perspective, the working groups need to be sure this is even feasible without changing national law.

Impact assessment

The OECD will undertake economic analysis, seeking to answer a number of questions, including those set out below.

- What are the pros and cons of the proposals with respect to the international tax system?
- How would the proposals affect the incentives for:
    - Taxpayers (e.g., profit shifting, investment and location of economic activity)?
    - Governments (e.g., tax competition)?
- What is the expected economic incidence / impact of the proposals?
- What are the expected effects of the proposals on the level and distribution of tax revenues across jurisdictions?
- What economic impact will the various proposals have for different types of MNEs, sectors and economies (e.g., developing countries; resource-rich countries; R&D intensive economies, etc.)?
- What data sources and methodologies could jurisdictions use to assess the proposals?
- What are the expected regulatory costs of the proposals?
- What would be the impact of the proposals on investment, innovation and growth?

PwC comments: In assessing the overall impact, it will be important but challenging to anticipate and build in behavioural change. However, it should be possible to envisage the increased number of disputes that may arise, some of which are likely to be multilateral in scope, and ultimately how mandatory binding arbitration might mitigate the effect.

The takeaway

The programme sets out an ambitious timeline:

- agreement of a unified approach to Pillars 1 and 2 by the end of 2019 (with a progress report in December)

- simultaneous parallel work by various Working Parties on embedded technical issues, and
- a final report by the end of 2020.

Any number of obstacles to finding consensus could arise in this process, especially in achieving a consensus approach that is both technically sound and easy to administer by countries irrespective of the resources available.

With the depth of issues confronting the IF, possibly to radically change the international taxing rights framework, it will be very challenging for the Working Parties to get through the voluminous technical questions delegated for consideration in a manner that meets political demands for completion.

We are concerned about the potential complexity of the proposals the IF is considering, particularly if they are broadly applicable, and without an increased appetite for arbitration mechanisms.

The Secretariat's commitment to carrying out economic analyses and impact assessments on various proposals and issues will need to be supported by external feedback. Stakeholders should be prepared to ensure that the impact on them is adequately considered. Buoyed by the level of business engagement in response to the Public Consultation, the OECD appears committed to consulting with stakeholders and gaining the benefit of their expertise throughout the entire process.

Let's talk

For a deeper discussion of how these issues might affect your business, please call your usual PwC contact. If you don't have one or would otherwise prefer to speak to one of our global specialists, please contact any of the people whose contact details are set out below::

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