Deloitte. 德勤

Tax
Issue P302/2019 – 8 November 2019

Tax Analysis

OECD's public consultation document: Secretariat Proposal for a "Unified Approach" under Pillar One

Authors:

Beijing
Julie Zhang
Partner
Tel: +86 10 8520 7511
Email: juliezhang@deloitte.com.cn

Candy Sun
Senior Manager
Tel: +86 10 8520 7704
Email: cansun@deloitte.com.cn

Gloria Li
Manager
Tel: +86 10 8512 5784
Email: fanli@deloitte.com.cn

On 9 October 2019, the OECD released a public consultation document: Secretariat Proposal for a "Unified Approach" under Pillar One. In this article, we briefly introduce the background of the document, the key features of the "Unified Approach", the next steps for getting consensus, and potential implications for enterprises.

1. Background

Before publishing the proposed "Unified Approach", the OECD had released a series of documents on addressing the tax challenges of the digitalization of the economy. These documents are part of the ongoing work of the OECD/G20 Inclusive Framework for the global implementation of the Base Erosion and Profit Shifting (BEPS) project. We list below the main documents issued on this topic by the OECD in 2019:

- On 29 January 2019, the G20/OECD Inclusive Framework on BEPS released a policy note "Addressing the Tax Challenges of the Digitalisation of the Economy- Policy Note". The Policy Note explained that the OECD will explore two areas (the "pillars") in parallel to work towards reaching a new consensus-based long-term solution:
  - Pillar One: Allocation of taxing rights between countries, looking at both nexus and profit allocation rules and, in particular, the reward for market/user countries.
  - Pillar Two: Explore on a "without prejudice" basis taxing rights that would strengthen the ability of jurisdictions to tax profits where another jurisdiction with taxing rights applies a low effective rate of tax to those profits.

- On 13 February 2019, the OECD released a consultation document "Addressing the Tax Challenges of the Digitalization of the Economy". This document sets out four proposals: three proposals are relevant to issues under Pillar One, and the fourth one, the "global anti-base erosion proposal", is relevant to issues under Pillar Two.

- On 31 May 2019, the OECD released a "Program of Work to Develop a Consensus Solution to the Tax Challenges Arising from the Digitalization of the Economy".

As the allocation of a new taxing right to market jurisdictions through new nexus and profit application rules may have significant implications for corporate tax revenue, countries have had diverging views on this topic, and there is not yet a political consensus. To help build a political consensus among the more than 130 countries participating in the G20/OECD Inclusive Framework, the OECD Secretariat has drawn on the commonalities of the existing three proposals under Pillar One and made a new proposal, the "Unified Approach", as set out in the public consultation document released by the OECD on 9 October 2019. In parallel, the OECD continues its work in respect of the global anti-base erosion proposal under Pillar Two and a consultation document is expected to be released in November 2019.

2. The "Unified Approach"

We outline below the proposed "Unified Approach" in terms of its scope, the new nexus rule, and the new profit allocation rule as described in the consultation document.

2.1 Scope

The "Unified Approach" should be focused on "large consumer-facing businesses", with a broad definition, e.g. businesses that generate revenue from supplying consumer products or providing digital services that have a consumer-facing element. However, the document only provides limited explanations of what may be considered "large consumer-facing businesses", and suggests that further discussions would be necessary to define the businesses in scope. Based on the current guidance, we understand the following:

- Large consumer-facing businesses would include highly digitalized businesses which interact remotely with users, as well as other businesses that market their products to consumers and may use digital technology to develop a consumer base, which means some traditional industries could also be in scope;
- Large consumer-facing businesses would include not only B2C businesses, but also some B2B businesses;
- Extractive industries, commodities and financial services may be specifically carved-out;
- Group revenue of EUR750 million has been suggested as the threshold for limiting the application of the "Unified Approach" to large businesses only (similar to what is used for country-by-country reporting requirements).

2.2 New rule to create a nexus between businesses and market jurisdictions (the new nexus rule)

Under the existing international tax framework, a jurisdiction may tax the business profits of a non-resident enterprise only if the

For more information, please contact:

Business Tax Service
National Leader
Hong Kong
Ryan Chang
Partner
Tel: +852 2852 6768
Email: ryanchang@DELOITTE.com

International and M&A Tax Service
National Leader
Shanghai
Vicky Wang
Partner
Tel: +86 21 61411035
Email: vicwang@deloitte.com.cn

Eastern China
Shanghai
Ye Hong
Partner
Tel: +86 21 6141 1171
Email: hoye@deloitte.com.cn

Transfer Pricing Service
National Leader
Beijing
Lian Tang He
Partner
Tel: +86 10 8520 7666
Email: lhe@deloitte.com.cn

Northern China
Beijing
Sophie Wei
Partner
Tel: +86 10 8520 7622
Email: swei@deloitte.com.cn

enterprise has a permanent establishment in the jurisdiction. This generally means the enterprise having some degree of physical presence.

In our increasingly digitalized global economy, many businesses operate beyond the traditional models and conduct more and more consumer-facing and/or user-facing activities from a remote location without a physical presence in the market jurisdictions. As a result, in spite of having "a sustained and significant" involvement there, businesses do not create a permanent establishment under the current rules and do not incur tax liabilities in the market jurisdiction.

The "Unified Approach" proposes a new nexus rule aimed at solving this problem. Following the new nexus rule, where a business has "a sustained and significant" involvement in the economy of a market jurisdiction, such as through consumer interaction, that market jurisdiction will have taxing rights on the business. How do we determine whether a business has "a sustained and significant" involvement in a market jurisdiction? The simplest way would be to define a revenue threshold as the primary indictor of "a sustained and significant" involvement, with this threshold being able to be adapted to the size of the market.

2.3 New profit allocation rule

Once it is determined that a market jurisdiction has a right to tax the business profits of a non-resident enterprise, the next question is how much profit should be allocated to that jurisdiction. Under the "Unified Approach", three possible types of taxable profits have been proposed: Amount A, Amount B and Amount C. These amounts would be allocated to market jurisdictions using a "three-tier mechanism". Amount A are profits allocated to market jurisdictions according to the new nexus rule, while Amount B and Amount C are profits allocated to market jurisdictions according to the traditional nexus rule (e.g., a subsidiary or permanent establishment). The interaction of the three amounts will need to be studied further to avoid duplication of profits being allocated to market jurisdictions.

Amount A – the market jurisdiction's portion of deemed residual profit according to the new taxing right

A market jurisdiction entitled to tax under the new nexus rule needs to have a new profit allocation rule to determine the amount of the business profits that it may tax. The new nexus rule and the new profit allocation rule comprise the "new taxing right" of a market jurisdiction.

The Secretariat has proposed to use a formulaic approach to calculate the amount of the profits that a market jurisdiction may tax. This approach would go beyond the arm's length principle and beyond the limitations on taxing rights as determined by reference to a physical presence.

Amount A would be calculated by following the four steps below:

Step 1: Determine the total profits of the group

- The relevant measure of profits could be derived from the consolidated financial statements under the accounting standards of the headquarters jurisdiction, prepared in accordance with Generally Accepted Accounting Principles (GAAP) or International Financial Reporting Standards (IFRS). Some standardised adjustments need to be considered further. Additionally, as the profit margin of a group may vary substantially across business lines, regions or markets, further consideration need to be given to the measurement of profits across business lines and geographic regions.

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

- The deemed routine profit seeks to approximate the remuneration for routine activities.
- To reduce disputes in this area, a simplified approach has been suggested for the calculation of the deemed routine profit: deemed routine profit = total profit multiplied by an agreed fixed percentage. This percentage may vary by industry.
- The deemed residual profit of the group = total profit of the group less deemed routine profit

Step 3: Calculate the portion of the deemed residual profit that is attributable to market jurisdictions

- Non-routine profits may be attributable to many activities, including those targeted by the new taxing right as well as ones not targeted by the new taxing right, e.g., trade intangibles, capital, and risk. For example, a social media business may generate non-routine profits from its consumers' data and valuable brand, but also from its innovative algorithms and software. The new taxing right targets the former, not the latter.

- For simplicity, an internationally agreed fixed percentage could be used to determine the amount of the deemed residual profit to be attributed to the market jurisdiction under the new taxing right: the deemed residual profit to be attributed to the market jurisdiction = the residual profit of the group (from step 2) multiplied by an agreed fixed percentage (at this point, no percentage has been suggested).
- Different percentages could be adopted for different industries or business lines.

Step 4: Allocate the relevant portion of the deemed residual profit between different market jurisdictions

- Allocating the relevant portion of the deemed residual profit calculated in step 3 between the eligible market jurisdictions. The allocation could be based on a previously agreed allocation key, using variables such as sales.

Amount B - Fixed return for certain baseline activities (e.g., routine marketing and distribution functions)

Profits arising from certain baseline activities in market jurisdictions, in particular routine marketing and distribution functions, would remain taxable according to existing rules (e.g., transfer pricing under the arm's length principle and profit attribution under permanent establishments).

To reduce disputes and increase certainty in this area, the use of a fixed return for the "baseline" activity has been suggested. This fixed return could be determined by a single fixed percentage or a fixed percentage that varied by industry or region. However, a clear definition of the activities that qualify for the fixed return would also be required.

Amount C - Additional return

Taxpayers and tax administrations would retain the ability to argue that the activities taking place in the market jurisdiction go beyond the baseline level of functionality and therefore warrant a profit in excess of the fixed return contemplated under Amount B. Thus, an additional profit – Amount C – may be due where this is supported by the application of the arm's length principle.

In addition to suggesting the use of simplified methods to calculate profits taxable in each step of the three-tier approach, it has also been suggested that consideration should be given to improve the existing dispute prevention and resolution mechanisms to avoid double taxation and to reduce compliance costs.

3. Next steps

Interested parties are invited to submit their comments on the proposed "Unified Approach" no later than 12 November 2019. The OECD will hold public consultation meetings regarding Pillar One issues on 21 and 22 November 2019 in Paris. Another public consultation document for Pillar Two is expected to be released in early November 2019. The related public consultation meeting will take place in December 2019.

The OECD looks forward to a consensus-based solution on the new nexus and profit allocation rules, as well as the global anti-base erosion proposal, by 2020. In particular, much expectation has been placed on the Inclusive Framework meeting in June 2020. However, even after a political consensus has been reached, a significant amount of technical work will still need to be carried out to address the details, because the "Unified Approach" only provides a framework. This means that there is still a long way to go from agreeing to the "Unified Approach" to implementing it in jurisdictions around the world.

The OECD Secretariat drafted the "Unified Approach" proposal using a simple and easy-to-implement approach. For example, the proposed rules use straightforward revenue thresholds and fixed percentages to determine whether rules apply and the resulting profit allocations. This is a key take-away for future policy development. Developing a policy that is easy-to-implement may enhance its acceptability internationally, and international consensus based solutions bring certainty to enterprises.

4. Potential Impact to Enterprises

The OECD is currently conducting an economic analysis of the impact brought by the tax challenges arising from digitalization of the global economy. According to preliminary findings, new nexus and profit allocation rules may lead to a modest increase in global tax revenues, although changes to the distribution of taxing rights among jurisdictions may be significant. Low and middle-income economies are expected to gain revenue, while larger market jurisdictions may receive the most benefit. At the same time, investment hubs are likely to experience significant losses to their taxable profits.

China is a very large market jurisdiction. For in-scope large enterprises targeting the growing Chinese consumer market, the "Unified Approach" may increase their taxable profits in China. Nevertheless, as China has already sought to tax the value created by in-country marketing intangibles, the exact impact on these large enterprises will need to be analysed after the details of the "Unified Approach" have come out.

Furthermore, as more and more large Chinese enterprises have made outbound investments[1] or targeted consumers in markets outside China, the "Unified Approach" may also increase the tax costs of these enterprises in the market jurisdictions. However, since many Chinese enterprises invest in or target consumers in developing countries, the impact on these enterprises will first depend on whether these market jurisdictions adopt the "Unified Approach".

The reallocation of profits from investment hub jurisdictions (generally with low tax rates) to market jurisdictions may increase the applicable tax rate and thus increase the total tax burden of multinational groups. On the other hand, if profits are reallocated from home jurisdictions (with high tax rates) to market jurisdictions, the impact on the overall tax burden may be limited, assuming that the tax paid in the market jurisdiction can be claimed as a foreign tax credit or the foreign income is exempt from tax in the home jurisdiction.

Finally, if the "Unified Approach" is adopted, there will be significant impact on existing double taxation agreements, OECD transfer pricing guidelines, profit attribution rules for permanent establishments, as well as domestic tax law. These would all need to be reviewed and revised. As a result, enterprises that may be impacted by the proposed rules need to track progress on the OECD's work plan over the coming years to be ready for the resulting reform.

[1] According to the World Investment Report 2019 issued by the United Nations Conference on Trade and Development, China is ranked in second place in terms of outward investments. For details, please refer to https://unctad.org/en/PublicationsLibrary/wir2019_en.pdf

Tax Analysis is published for the clients and professionals of the Hong Kong and Chinese Mainland offices of Deloitte China. The contents are of a general nature only. Readers are advised to consult their tax advisors before acting on any information contained in this newsletter. For more information or advice on the above subject or analysis of other tax issues, please contact:

Beijing
Andrew Zhu
Partner
Tel: +86 10 8520 7508
Fax: +86 10 8518 7326
Email: andzhu@deloitte.com.cn

Harbin
Jihou Xu
Partner
Tel: +86 451 8586 0060
Fax: +86 451 8586 0056
Email: jihxu@deloitte.com.cn

Shenyang
Jihou Xu
Partner
Tel: +86 24 6785 4068
Fax: +86 24 6785 4067
Email: jihxu@deloitte.com.cn

Chengdu
Frank Tang / Tony Zhang
Partner
Tel: +86 28 6789 8188 / 8008
Fax: +86 28 6500 5161
Email: ftang@deloitte.com.cn
tonzhang@deloitte.com.cn

Hong Kong
Sarah Chin
Partner
Tel: +852 2852 6440
Fax: +852 2520 6205
Email: sachin@deloitte.com.hk

Shenzhen
Victor Li
Partner
Tel: +86 755 3353 8113
Fax: +86 755 8246 3222
Email: vicli@deloitte.com.cn

Chongqing
Frank Tang / Tony Zhang
Partner
Tel: +86 23 8823 1208 / 1216
Fax: +86 23 8859 9188
Email: ftang@deloitte.com.cn
tonzhang@deloitte.com.cn

Jinan
Beth Jiang
Partner
Tel: +86 531 8518 1058
Fax: +86 531 8518 1068
Email: betjiang@deloitte.com.cn

Suzhou
Kelly Guan
Partner
Tel: +86 512 6289 1297
Fax: +86 512 6762 3338
Email: kguan@deloitte.com.cn

Dalian
Jihou Xu
Partner
Tel: +86 411 8371 2888
Fax: +86 411 8360 3297
Email: jihxu@deloitte.com.cn

Macau
Raymond Tang
Partner
Tel: +853 2871 2998
Fax: +853 2871 3033
Email: raytang@deloitte.com.hk

Tianjin
Bill Bai
Partner
Tel: +86 22 2320 6699
Fax: +86 22 8312 6099
Email: bilbai@deloitte.com.cn

Guangzhou
Victor Li
Partner
Tel: +86 20 8396 9228
Fax: +86 20 3888 0121
Email: vicli@deloitte.com.cn

Nanjing
Frank Xu / Rosemary Hu
Partner
Tel: +86 25 5791 5208 / 6129
Fax: +86 25 8691 8776
Email: frakxu@deloitte.com.cn
roshu@deloitte.com.cn

Wuhan
Gary Zhong
Partner
Tel: +86 27 8526 6618
Fax: +86 27 6885 0745
Email: gzhong@deloitte.com.cn

Hangzhou
Qiang Lu/ Fei He
Partner
Tel: +86 571 2811 1901
Fax: +86 571 2811 1904
Email: qilu@deloitte.com.cn
fhe@deloitte.com.cn

Shanghai
Maria Liang
Partner
Tel: +86 21 6141 1059
Fax: +86 21 6335 0003
Email: mliang@deloitte.com.cn

Xiamen
Jim Chung
Partner
Tel: +86 592 2107 298
Fax: +86 592 2107 259
Email: jichung@deloitte.com.cn

About the Deloitte China National Tax Technical Centre

The Deloitte China National Tax Technical Centre ("NTC") was established in 2006 to continuously improve the quality of Deloitte China's tax services, to better serve the clients, and to help Deloitte China's tax team excel. The Deloitte China NTC prepares and publishes "Tax Analysis", "Tax News", etc. These publications include introduction and commentaries on newly issued tax legislations, regulations and circulars from technical perspectives. The Deloitte China NTC also conducts research studies and analysis and provides professional opinions on ambiguous and complex issues. For more information, please contact:

National Tax Technical Centre
Email: ntc@deloitte.com.cn

National Leader/Northern China
Julie Zhang
Partner
Tel: +86 10 8520 7511
Fax: +86 10 8518 1326
Email: juliezhang@deloitte.com.cn

Western China
Tony Zhang
Partner
Tel: +86 28 6789 8008
Fax: +86 28 6317 3500
Email: tonzhang@deloitte.com.cn

Eastern China
Kevin Zhu
Partner
Tel: +86 21 6141 1262
Fax: +86 21 6335 0003
Email: kzhu@deloitte.com.cn

Southern China (Mainland)
German Cheung
Director
Tel: +86 20 2831 1369
Fax: +86 20 3888 0121
Email: gercheung@deloitte.com.cn

Southern China(Hong Kong)
Doris Chik
Director
Tel: +852 2852 6608
Fax: +852 2851 8005
Email: dchik@deloitte.com.hk

If you prefer to receive future issues by soft copy or update us with your new correspondence details, please notify Wandy Luk by either email at wanluk@deloitte.com.hk or by fax to +852 2541 1911.