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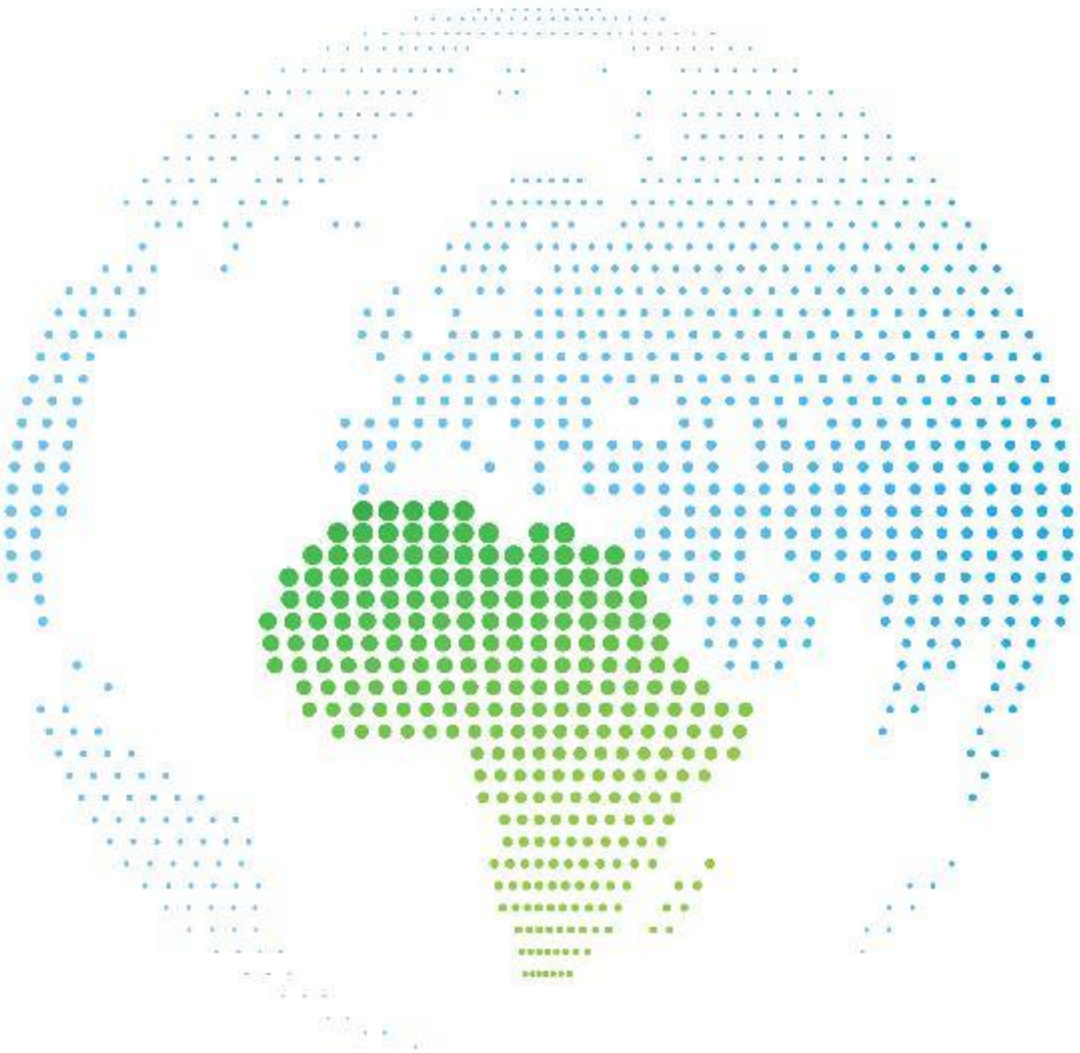

# Deloitte Africa Tax & Legal

## Transfer pricing update

17 February 2020

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## OECD’s Inclusive Framework renews commitment to efforts to address tax challenges from digitalisation of the economy

The OECD on 31 January released a “Statement by the OECD/G20 Inclusive Framework on BEPS on the Two-Pillar Approach to Address the Tax Challenges Arising from the Digitalization of the Economy.”

The statement affirmed the commitment of the 138-member Inclusive Framework to reach an agreement on a consensus-based solution by the end of 2020, while deferring a decision on US Treasury Secretary Mnuchin’s December 2019 proposal for a “safe harbour” approach to Pillar One until other elements of the solution have been agreed.[1]

The statement is accompanied by two annexes. The first annex, an “Outline of the Architecture of a Unified Approach on Pillar One,” has been agreed as the basis for negotiations and the second is a progress note on Pillar Two. The statement explains that any agreement on a reallocation of taxing rights under Pillar One would require improved tax certainty, including effective and binding dispute prevention and resolution mechanisms.

The statement highlights a number of other issues where significant divergences will have to be resolved. These include (i) the binding nature of dispute prevention and resolution mechanisms as well as the scope of the dispute resolution mechanisms; (ii) the suggestion by some members to weight the quantum of Amount A to account for different degrees of digitalisation between in- scope business activities (so-called “digital differentiation”); and (iii) the suggestion by some countries to account for regional factors in computing and allocating Amount A (through regional segmentation). The statement further notes that some jurisdictions and businesses had expressed concerns about the continued application of digital service taxes (DSTs).

### Pillar One – Nexus and Profit Allocation

The OECD Inclusive Framework has endorsed in Annex 1 an outline of the architecture of a unified approach as the basis for negotiations of a consensus-based solution under Pillar One. 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:

- A share of a multinational business’ non-routine return attributable to market intangibles (vs. that attributable to other factors, such as trade intangibles), determined using a formulaic approach, irrespective of the business’ residence or locations (Amount A).
- A fixed return based on the arm’s length principle for baseline marketing and distribution functions taking place in a market jurisdiction (Amount B).
- An additional return (Amount C) determined in accordance with existing transfer pricing rules when a market jurisdiction can successfully establish – subject to robust and binding dispute resolution

[1]Pillar One focuses on revising the allocation of taxing rights among countries, potentially including new approaches to nexus (permanent establishment) issues and the arm’s length principle, and Pillar Two seeks to ensure that companies are subject to a minimum level of taxation globally.

mechanisms – that there are more functions in the market jurisdictions than have been accounted for and included in Amount B.

## Amount A - new taxing right

**Scope**

Two broad types of business have been identified as within the scope of the new taxing right:

- **Automated digital services** provided on a standardised basis to a large user base across multiple jurisdictions (without regard to whether they are consumer-facing).
    - 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 (such as minor assembly or packaging) are in scope (but only if the special nexus requirements described below are met).
    - 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 are also in scope.
    - 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.
    - Examples of in-scope consumer-facing businesses include: personal computing products (such as software, home appliances, mobile phones); clothes, toiletries, cosmetics, luxury goods; branded foods and refreshments; franchise models, such as licensing arrangements involving the restaurant and hotel sector; and automobiles.
    - 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.
    - Regulated consumer-facing business lines in the financial services sector, such as retail banks and insurance, are broadly excluded from scope. However, consideration might be given to whether there are any unregulated elements of the financial services sector or related to the sector that require special consideration, such as digital peer-to-peer lending platforms.
    - Airline and shipping businesses will not be in scope.

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

**Thresholds**

Several thresholds are being considered, but none have been agreed to yet:

- Group gross revenue threshold – possibly in line with the EUR 750 million revenue threshold used for country-by-country reporting;
- De minimis test on the total aggregated group in-scope revenue from consumer-facing activities and/or automated digital services; and
- A carve-out where the total profit to be allocated under Amount A (the aggregate deemed residual profit) does not meet a de minimis amount.

**New nexus (taxable presence) rules**

The new rules would 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, 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 would arise in the market country if a country-specific sales threshold is exceeded. The threshold would 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 source revenues to markets, for example, to allocate revenue from online advertising services to the user's location and to determine how revenues are sourced when goods are sold via intermediaries.

This measure will require a new stand-alone tax treaty provision (in addition to the existing permanent establishment and business profits articles). Filing and other tax related obligations will be minimised when 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 country-by-country 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 the imposition of 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 (when profitability varies) and/or region will be explored in the context of balancing the need for simplicity and accuracy, and to take compliance burdens into account.

*Step 2: Determine the group's residual profit 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*

Non-routine profits may be attributable to many activities, including those not identified by the new taxing right, such as 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 the group profit, it is recognised that it is essential that there be appropriate mechanisms to eliminate double taxation and further work will be undertaken in this area.

**Interactions 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.

Future 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 the 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 unified approach seeks 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 when a business has not opted in to 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, while 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 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 made 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 that would otherwise be taxed at an effective rate below a 'minimum rate.' The progress note states 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 remains.

### Next steps

The statement includes a revised Program of Work for Pillar One, published as Annex A, 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, including the definition of the categories of business activities that fall within the scope of the new taxing right, and the determination of the appropriate thresholds for the percentage(s) of profits that will be reallocated under the new taxing right. Remaining work is to be completed by November 2020 with a view to agreeing and publishing a final report by the end of 2020.

## Key contacts

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