CBT/TN/05/20

TECHNICAL NOTE

Inclusive Framework issues Statement on the Two-Pillar Approach to Address the Tax Challenges Arising from the Digitalisation of the Economy

1. Introduction

1.1 This is the fifth in ATAF's series of Technical Notes on the tax challenges arising in Africa from the digitalisation of the economy. The fourth Technical Note CBT/TN/04/2019 titled ***"The changes needed to the global tax rules if Africa is to address the tax challenges arising from the digitalisation of the economy"*** provided an overview of the conclusions of the in-depth discussions of the ATAF Cross Border Taxation Technical Committee (CBT) in October 2019 on the current Inclusive Framework proposals. The CBT identified the key policy issues for Africa and the key recommendations that ATAF will make to the Inclusive Framework on the changes that are needed to the current global tax rules.

1.2 On 23rd and 24th January the CBT met in Pretoria, South Africa, to discuss the upcoming Inclusive Framework meeting taking place in Paris on 29th and 30th January. The CBT discussed the OECD Secretariat's Unified Approach proposals on Pillar One and the work being done on Pillar Two.

1.3 The outcomes of the CBT discussions were shared with all of the African delegates participating in the Inclusive Framework meeting to assist them in making their interventions at that meeting.

2. Unified Approach on Pillar One

Introduction

2.1 At its January 2020 meeting the Inclusive Framework agreed that the Unified Approach will be the basis for a new nexus rules and new profit allocation rules. The Unified Approach endorsed by the Inclusive Framework is largely based on the ***Unified Approach proposed by the OECD Secretariat in October 2019***.

2.2 It is expected that any consensus-based agreement must include a commitment by members of the Inclusive Framework to implement this agreement and at the same time to withdraw relevant unilateral actions.

2.3 A key discussion at the meeting was the U.S. safe harbour proposal which would mean that multinational enterprises (MNEs) could elect whether to be subject to the new nexus and profit allocation rules. Many countries expressing concerns about the feasibility of such an approach, but the Inclusive Framework agreed that the final decision will be taken after other elements of the consensus-based solution have been agreed upon. The Inclusive Framework members will carry out further work

ATAF shares the concerns of many Inclusive Framework members that a safe harbour regime, whereby MNEs could elect out of being subject to thenew rules, would seem to make the rules tantamount to a voluntary tax which would not be workable in practice.

on the feasibility of the proposal.

2.4 The unified approach is designed to adapt the current taxing rights by taking into account new businesses models and thereby expand the taxing rights of market jurisdictions (which, for some business models, is the jurisdiction where the user is located). The approach proposes three types of taxable profit that may be allocated to a market jurisdiction:

- **Amount A**

A share of residual profit allocated to market jurisdictions using a formulaic approach applied at an MNE group (or business line) level. This new taxing right can apply irrespective of the existence of physical presence, especially for automated digital services. It reflects profits associated with the active and sustained participation of a business in the economy of a market jurisdiction, through activities in, or remotely directed at that jurisdiction, and therefore constitutes the primary response of the unified approach to the tax challenges of the digitalisation of the economy.

- **Amount B**

A fixed remuneration based on the arm's length principle for defined baseline distribution and marketing functions that take place in the market jurisdiction.

- **Amount C**

The return under Amount C covers any additional profit where in-country functions exceed the baseline activity compensated under Amount B. A further aspect of Amount C is the emphasis it gives to the need for improved dispute resolution processes. The scope of Amount C is still being discussed and considered as a critical element in reaching an overall agreement on Pillar One.

The New Taxing Right (Amount A)

2.5 Amount A allocates a portion of the residual profits of a business to market jurisdictions. The amount allocated is over and above the arm's length return that might be allocable to in-market activities such as baseline marketing and distribution but is not an additional remuneration in respect of those same in-market activities.

2.6 The Unified Approach states that the new taxing right will be broadly relevant to two types of business.

2.7 Automated and standardised digital services provided to a large and global customer or user base. These are businesses that, in general, are able to provide digital services remotely to customers in markets using little or no local infrastructure. In these situations, they generally benefit from exploiting powerful customer or user network effects and generate substantial value from interaction with users and customers.

2.8 Other businesses that generate revenues from selling goods or services, whether directly or indirectly, to consumers (i.e. consumer facing businesses). This is a broad set of businesses that includes traditional businesses that have been disrupted to a lesser degree by digitalisation, e.g. businesses that manufacture physical products,

sell those products through physical distribution channels and support sales with less sophisticated marketing methods such as television and banner advertising.

2.9 Further work will be required on the definition of an automated digital service and a consumer facing business.

2.10 Extractive industries and other producers and sellers of raw materials and commodities will not be within the consumer-facing definition, even if those materials and commodities are incorporated further down the supply chain into consumer products.

2.11 The proposal states that most of the activities of the financial services sector (which includes insurance activities) take place with commercial customers and will therefore be out of scope. It is also stated that there is a compelling case for the consumer-facing business lines such as retail banks and insurance within financial services businesses to be excluded from scope given the impact of prudential regulation and, for example, bank/insurance licensing requirements that are designed to protect local deposit/policy holders in the market jurisdiction. The Unified Approach considers that this typically ensures that residual profits are largely realised in local customer markets and therefore justifies that these activities should be excluded from scope.

2.12 It is also considered inappropriate to include airline and shipping businesses in the scope of the new taxing right.

Thresholds

2.13 The new taxing right will operate with a number of thresholds. First, it will be limited to MNE groups that meet a certain gross revenue threshold. The paper states that this threshold could, for instance, be the same as for Country-by-Country (CbC) reporting (i.e. MNE groups with gross revenue exceeding €750 million). Second, even for those MNE groups that meet the gross revenue threshold a further carve-out will be considered where the total aggregated in-scope revenue is less than a certain threshold. Third, consideration will be given to a carve-out for situations where the total profit to be allocated under the new taxing right would not meet a certain de minimis amount.

Members have reported differing views to ATAF on the issue of monetary thresholds. Some of our members are concerned that many of their taxpayers may be subsidiaries of MNE groups with turnover of less than €750 million and will therefore lose vital tax revenue if the threshold is set at that level. ATAF will be carrying out research with its members to assess the impact of such thresholds on member countries.

Nexus

2.14 For MNEs in scope a new nexus rule will be created based on indicators of a significant and sustained engagement with market jurisdictions. The rule will be contained in a standalone rule to limit any unintended spill-over effects on other existing tax or non-tax rules.

2.15 The generation of in-scope revenue in a market jurisdiction over a period of years would be the primary evidence of a significant and sustained engagement. The revenue threshold would be commensurate with the size of a market, with an absolute minimum amount to be determined.

2.16 For automated digitalised businesses in scope, the revenue threshold will be the only test required to create nexus. For other in-scope activities, e.g. the sale of tangible goods, the proposal will not create a new nexus if the MNE is merely selling consumer goods into a market jurisdiction without a sustained interaction with the market. Further work will be carried out to explore the use of possible additional or "plus" factors, such as the existence of a physical presence of the MNE in the market jurisdiction or targeted advertising directed at the market jurisdiction.

ATAF has concerns that an absolute minimum threshold might mean that smaller African economies are not within the scope for Amount A and therefore we are not supportive of this proposal.

We also have concerns regarding the proposal that there may be different and more restrictive nexus rules for other in-scope activities than for automated digital services – referred to in the paper as "plus factors". We do not see a policy rationale for such differentiation at present and consider that such plus factors will be too difficult to quantify and create a further layer of definition complexities that are not warranted.

The Quantum of Amount A

2.17 In contrast to the traditional transfer pricing "separate entity" approach, the calculation of Amount A will be based on a measure of profit derived from the consolidated group financial accounts. The calculation of Amount A is based on a formula designed to identify the portion of the residual profits that is to be allocated to eligible market jurisdictions, as Amount A applies only to the portion of profit exceeding a certain level of profitability. As part of this formula, the quantum of Amount A might also be weighted to account for different degrees of digitalisation between in-scope business activities (so-called "digital differentiation").

2.18 After determining the quantum of Amount A, it will be necessary to distribute Amount A among the eligible market jurisdictions based on an agreed allocation key. This allocation key will be based on sales of a type that generate nexus.

2.19 Amount A is part of the three-tier profit allocation system that makes up the Unified Approach. In practice, this means that an MNE group would first apply the arm's length principle based profit allocation rules (including Amounts

B and C) to determine an initial allocation of profit between different entities and hence between jurisdictions. The relevant Amount A of in-scope MNE groups would then be allocated to eligible market jurisdictions as an overlay or partial override to the arm's length principle based profit allocation rules.

ATAF has concerns regarding the so-called digital differentiation as such a differentiation may make the rules more complex and lead to disputes about whether a business is an automated digital service or a consumer facing business.

We also have concerns that such an approach does not accord with either the view expressed in various OECD reports that it is not possible to ring fence digitalisation and is a step back from the agreement that the policy rationale for this work is to ensure the appropriate allocation of taxing rights to market jurisdictions. That is clearly much broader in scope than automated digital services and we cannot see a justification for the proposed differentiation which seems to be reverting back to a differing tax treatment for digital businesses compared to other in scope businesses.

Many publications indicate that the most valuable global brands are a mix of digital service brands and consumer facing brands. As brand value appears to be a significant part of the policy rationale for Amount A there appears no economic justification for such a digital differentiation.

The fixed Return for Defined Baseline Distribution and Marketing Activities (Amount B)

2.20 Amount B aims to standardise the remuneration of distributors (whether constituted as a subsidiary or a traditional permanent establishment) that buy products from related parties for resale and, in doing so, perform defined "baseline marketing and distribution activities". It proposes a fixed return to distributors that fall within this definition – a fixed return that is based on the arm's length principle (i.e. Amount B would not be optional nor a safe-harbour).

2.21 The fixed return a market jurisdiction would receive through Amount B for baseline distribution and marketing activities would deliver a result that is based on the arm's length principle. To that aim, the work will explore how to account for different functionality levels, as well as differentiation in treatment between industries and regions.

2.22 The definition of baseline distribution activities will likely include distribution arrangements with routine levels of functionality, no ownership of intangibles and no or limited risks.

2.23 The expectation is that treaty changes will not be required to implement the Amount B regime, which should simplify its implementation. Rather, as the Amount B regime is expected to be in accordance with the arm's length principle, existing treaty provisions

should suffice to support its adoption.

ATAF and many of our members have expressed strong support for the proposals for a fixed minimum return for baseline distribution and marketing activities. We consider this will assist in addressing many of the current transfer pricing disputes taking place in Africa over the appropriate level of returns to such market and distribution activities where that return is determined using the current arm's length facts and circumstance approach.

ATAF is very strongly in favour of Amount B being a fixed minimum return rule as this will reduce transfer pricing disputes and increase tax certainty for both tax administrations and taxpayers in Africa.

However, it is vital there is a clear definition of what constitutes routine marketing and distribution activities if this rule is to be effective in achieving these objectives.

A new framework for dispute prevention and resolution for Amount A

2.24 The Inclusive Framework considers that it would be impractical (if not impossible) to allow all affected tax administrations to assess and audit an MNE's calculation and allocation of Amount A and to address potential disputes through existing bilateral dispute resolution mechanisms because they generally operate after the event. Any dispute between two jurisdictions over Amount A will likely affect the taxation of Amount A in multiple jurisdictions. Resolving such differences under the existing bilateral system would therefore require multiple mutual agreement procedures involving several jurisdictions where the MNE has meaningful activities or sales, an outcome which would be uncoordinated, inefficient and lengthy.

2.25 To avoid such an outcome, the Inclusive Framework proposes a new approach that would be supported by a clear, administrable and binding process for early dispute prevention. Innovative approaches will be explored under which tax administrations of the Inclusive Framework would provide early tax certainty for Amount A, for instance through the establishment of representative panels which would carry on a review function and provide tax certainty. The design of the process will also need to address the challenge of delivering binding agreements by all tax administrations.

2.26 In the event that a dispute might arise that is not already dealt with by the early dispute prevention process described above, appropriate mandatory binding dispute resolution mechanisms will be developed.

Tax certainty and dispute prevention and resolution for Amounts B and C

2.27 There is agreement that new effective and binding dispute prevention and resolution mechanisms are required for amount A. However, there are currently differing positions on the breadth of application of new enhanced dispute resolution mechanisms to other transfer

pricing and permanent establishment disputes that will continue to arise.

2.28 As some jurisdictions may have domestic obstacles to the adoption of mandatory binding arbitration, it may be necessary to consider mechanisms that do not present the same issues and that can be adopted by all members of the Inclusive Framework.

Whilst ATAF members agree that there is a need for effective dispute prevention and resolution mechanisms, many have reported they are strongly opposed to the adoption of mandatory binding arbitration.

Aside from that general concern about such mechanisms there does not appear to be a policy rationale under the Pillar One proposal for the scope of these mechanisms to apply to all transfer pricing and permanent establishment disputes. The new rules in terms of Amount A aim to allocate more taxing rights to market jurisdictions and Amount B also relates to allocating taxing rights in respect of distribution and marketing activities.

The scope of the Unified Approach is therefore to allocate appropriate taxing rights to market jurisdictions and in the process create greater tax certainty, this being achieved through the greater use of formulaic approaches and simplification conventions such as fixed returns in the allocation methods for determining the taxable profits in market jurisdictions.

There appears no policy rationale for extending the scope of any new dispute prevention and resolution mechanisms beyond tax allocation issues in relation to market jurisdictions.

Implementation

2.29 Implementing the new approach will require changes to domestic legislation and to tax treaties to remove existing treaty barriers. If different approaches could be envisaged to streamline the implementation of these changes, a new multilateral convention could be negotiated to establish a new multilateral framework for in-scope MNEs to ensure that all jurisdictions can implement the unified approach consistently and at substantially the same time.

2.30 Unlike the Multilateral Instrument used to implement some BEPS measures, a new multilateral convention would apply between jurisdictions that do not currently have a bilateral treaty, supersede the relevant provisions of existing treaties concluded to eliminate double taxation and contain all the international rules needed to implement the unified approach (scope, nexus, profit allocation, elimination of double taxation, and dispute resolution) that are central to achieving tax certainty

2.31 It is also expected that any consensus-based agreement must include a commitment by members of the Inclusive Framework to implement this agreement and at the same time to withdraw relevant unilateral actions, and not adopt such unilateral actions in the future. The Inclusive Framework has stated that the successful implementation of the Unified Approach hinges on the withdrawal of such actions because their continued application would challenge the legitimacy of

the Unified Approach and undermine the future stability of the agreed framework.

3. Pillar Two - The GloBE proposal

Income Inclusion Rule

3.1 The income inclusion rule would operate as a minimum tax by requiring a shareholder in a corporation to bring into account a proportionate share of the income of that corporation if that income was not subject to an effective rate of tax above a minimum rate. It aims to ensure that the income of the MNE group is subject to tax at a minimum rate thereby reducing the incentive to allocate income for tax reasons to low taxed entities.

3.2 On the question of blending (i.e. the ability to combine low-tax and high-tax income in determining the effective tax rate) a number of policy choices remain under consideration as well as design and compliance challenges of different approaches. There are a range of different elements to the GloBE proposal of which the type of blending is an important dimension but not the only one.

3.3 A key design issue for Pillar Two is the question of carve-outs. Different options are under consideration. The Inclusive Framework Programme of Work notes that carve-outs for regimes compliant with the standards of BEPS Action 5 on harmful tax practices and other substance based carve-outs would undermine the policy intent and effectiveness of the GloBE proposal. However, some jurisdictions have stressed the importance of including substance carve-outs because, in their view, such carve-outs are necessary to ensure that the focus of Pillar Two is on remaining BEPS issues.

Switch-over Rule

3.4 The Inclusive Framework considers the GloBE proposal should apply equally to foreign branches and foreign subsidiaries that are taxed at an effective rate of tax below the minimum rate. The switch-over rule is a mechanism designed to ensure that the income inclusion rule applies to foreign branches exempt under double tax treaties. It would only apply where countries have committed to use the exemption method in their tax treaties.

Undertaxed payments Rule

3.5 While the income inclusion rule taxes the parent on the low-tax income of a subsidiary, the undertaxed payments rule operates by denying a deduction or making an equivalent adjustment in respect of intra-group payments.

Subject to Tax Rule

3.6 The proposal also includes consideration of a subject to tax rule which could work by subjecting a payment to withholding or other taxes at source and denying treaty benefits on certain items of income where the payment is not subject to tax at a minimum rate.

3.7 The Inclusive Framework are exploring options and issues in connection with the design of a simple and targeted rule to address the most significant risks from a BEPS perspective. Further consideration will be given to the scope of the payments covered, the design of the minimum tax rate test, the extent of the adjustment required, the use of a de minimis threshold and the role of the subject to tax rule vis a vis the undertaxed payment rule. The work will also explore the application of a subject to tax rule to unrelated parties as regards Articles 11 and 12 of many tax treaties.

Rule co-ordination, simplification, thresholds and compatibility with international obligations

3.8 There is ongoing work on all aspects of co-ordination, simplification and the compatibility with international obligations such as non-discrimination.

In ATAF's view, for the GloBE rule to be effective in stemming artificial profit shifting through excessive base eroding payments by African taxpayers to related parties in no or low tax jurisdictions, the minimum effective tax rate must be set at a high enough rate to remove the incentive for such profit shifting. Statutory corporate income tax rates vary across African countries, but most African countries have rates between 25% and 35%. If the minimum effective rate is substantially below these rates, we consider it is unlikely to lead to a change in taxpayer behaviour in respect of such profit shifting.

The proposals for the GloBE rule include different options of blending[1].The majority of ATAF members are of the view that blending should be jurisdiction blending not global blending to limit tax planning opportunities.

On the issue of the ordering of the Income Inclusion Rule and Tax on Base Eroding Payments Rule our current view is that the Undertaxed Payment Rule should be applied first. This will assist in stemming the very substantial loss of tax revenues in Africa through base eroding payments but also assist in addressing the current imbalance in the allocation of taxing rights, which inappropriately favours residence jurisdictions to the disadvantage of low income countries, which are usually source jurisdictions.

However, if this creates too many difficulties in the design and implementation of the GloBE rules, ATAF considers the Subject to Tax Rule must be applied first and must be mandatory for all Inclusive Framework members in the proposed Multilateral Instrument. This rule ordering will help to address the current imbalance in allocating taxing rights between residence and source jurisdictions, as it will grant rights to the source jurisdiction to tax payments made from that jurisdiction, which have been taxed in the recipient jurisdiction at a rate below the minimum effective rate.

[1] Blending refers to the ability of taxpayers to mix high-tax and low-tax income to arrive at a blended rate of tax on income that is above the minimum rate.

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