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The Brave New World of Global Tax

Dissecting Pillar 1 and 2

Negotiations at the OECD

Thursday, May 21, 2020

Bloomberg Tax & Accounting

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Agenda

Objective of the OECD Project

Pillar 1 – Unified Approach

Pillar 2 – GloBE Proposal

Unilateral Measures

Outlook

Q&A

Part 1

Objective of the OECD Project

The OECD's Objectives

- **Grew out of the 2015 Action 1 Report**
 - Concerns regarding nexus, data and characterization of transactions
 - Raises possibility of withholding tax, equalization levy, or changes to nexus threshold/profit allocation
 - BUT wedded to current international standards, based on principle that digital economy cannot be divorced from real economy
 - Hope that concern could be addressed by other BEPS actions and VAT destination principle
- **At the time, reflected of broader consensus of major OECD members**
 - e.g. the UK position in 2014 that tax planning techniques were generic and could be addressed by other strands of the BEPS Project. Possible need to reconsider PE standard and taxation of online advertising
 - *“In general terms, however, digital technology should be seen as an opportunity to foster growth and we would not want to see this impeded by ill-considered actions emerging from the BEPS project.”*

Evolution of the OECD Approach

- **March 2018 Interim Report**
 - Followed establishment of Inclusive Framework
 - Suggestion (though contested) that value drivers for digital businesses were fundamentally different
 - Acknowledgement that certain countries were exploring “interim” measures – desire to maintain consensus
- **January 2019 Policy Note**
 - Pillar 1 – shift to market jurisdiction (though three different models)
 - Pillar 2 – reinforce tax base of resident jurisdiction and reflect impact of US tax reform
- **May 2019 Roadmap – synthesises the Pillar 1 Models**
- **October 2019 Pillar 1 report**
 - *“In a digital age, the allocation of taxing rights can no longer be exclusively circumscribed by reference to physical presence.”*
 - *“there are increasing doubts that the arm’s length principle can be relied on to give an appropriate result in all cases”*

Challenges

- **Different conceptions of value creation**
- **Shifting domestic political debates**
- **Differing views on what (if any) profits should be reallocated**
 - Developing countries
 - Larger European economies
 - The US
- **Impact of US tax reform**
- **No time to assess impact of BEPS 1.0**
- **Ill-defined objective of Pillar 2**
- **Particular sectoral considerations**
- **Broader breakdown of international cooperation**

Part 2

Pillar 1 – Unified Approach

OECD Pillar 1 Proposals

- **Proposals under Pillar 1**

- Allocate **greater taxing rights to the market jurisdictions**. This is intended **to result in more income and taxation in the jurisdictions where consumers are located** whether the taxpayer has a physical presence in the market or not.
- **Bring broader scope than highly digitized or automated business models** as it also includes **consumer facing businesses**. Certain industries may be excluded such as the extractives and financial services.
- **Likely to apply to large businesses** with revenue over EUR €750m.
- Creates a **new nexus rule** which **allows profit allocation to a jurisdiction regardless of whether there is a physical presence**.

OECD Pillar 1 Proposals

- **Pillar 1 - three tier mechanism**

- Under Pillar 1, a **three tier mechanism of allocating profits is proposed:**

- **Amount A:** a share of the deemed residual profit is allocated to market jurisdictions based on a formulaic calculation based on agreed metrics including sales and other industry specific factors. **Amount A is proposed to operate independently of Amount B and Amount C** below. This goes beyond the arm's length principle.
- **Amount B:** a fixed remuneration aligned to the arm's length principle for "baseline" routine distribution, sales and marketing activities that take place in the market jurisdiction.
- **Amount C:** Additional profits are allocated to market jurisdictions based on existing transfer pricing rules where functions exceed the baseline activities compensated under Amount B.

Amount A

Key technical questions in relation to Amount A need to be resolved before consensus can be reached

- **Key Challenges for Amount A**

- **Scope**

- Determining the scope of Amount A is critical. The OECD has indicated Automated Digital Services and “consumer facing” businesses are within the scope of Amount A.
- There are challenges in defining what is meant by “consumer facing” e.g. in relation to the pharmaceutical industry in most of the countries in which pharmaceutical companies operate it is not permissible to advertise or promote medicines directly to customers. Pricing of medicines is regulated by governments and payors and is not based on consumer demand.

- **Nexus**

- Determining the revenue threshold for a company to be included within Amount A is an issue that needs to be considered further. Consideration should be given to harmonizing thresholds with other international tax requirements such as CBCR.

- **Determining the tax base**

- The OECD proposes that a MNC’s consolidated financial accounts are the starting point for determining profit before tax and that the accounts are then segmented. There are a number of challenges with this including how the accounts are segmented if an MNC does not ordinarily undertake segmentation.
- A key question is how losses are treated. The transitional period to the new regime will provide challenges for the Amount A calculation as it will be difficult to trace and adjust for historic losses. For some industries, looking at profits on an annual basis may not provide a true picture of the company’s financial position e.g. for pharmaceutical companies, Amount A would need to take into account losses and the costs of failed R&D projects and ensure that cumulatively there has been a routine reward for all functions to determine whether there is any above normal profits to be allocated.

Amount A

Implementation Challenges

- **Key Challenges for Amount A**
 - Implementation Challenges
 - Amount A could bring increased complexity and an increased administrative burden with multiple jurisdictions responsible for operating the mechanism to allocate profits.
 - The mechanism to apply Amount A should bring simplification and reduce the risk of disputes and double taxation. For example, the tax authority of the parent company could take responsibility for administering reallocation and distribution of payments and the OECD recognizes that the role of the tax administration for the ultimate parent entity needs to be considered further.
 - There should be no payment of Amount A to the markets without having a tax refund agreed by the tax authority of the country in which tax has already been paid on those profits so as to reduce the risk of double taxation.

Amount B

Key technical questions and implementation challenges in relation to Amount B need to be resolved before consensus can be reached

- **Key Challenges for Amount B**

- The introduction of a fixed remuneration under Amount B for baseline marketing and distribution functions is a positive step as it should offer simplification to MNCs and reduce the level of routine tax audits. It is important that there is a clear definition of baseline marketing and distribution functions and consideration is given to different industry/regional returns. It could be structured along the lines of the Australian Tax Office issued guidance on Transfer Pricing issues related to inbound distribution arrangements PCG 2018/DG which provides for a range of distribution margins on an industry basis.

- **Implementation Challenges**

- A number of issues remain in relation to the implementation of Amount B.
- If a MNC undertakes a wide range of activities, then the question remains as to how to treat the rest of the activities including segmenting the results between baseline and non baseline activities.
- The interaction of a fixed remuneration under Amount B and the interaction with APA and MAP settlements also needs to be considered.
- Amount B may be monitored by a further annual reporting requirements for MNCs, adding to an existing heavy compliance burden.

Amount C

An effective dispute prevention and resolution mechanism is needed to avoid double taxation under Pillar 1

- **Key Challenges for Amount C**

- Scope

- Amount C allows for additional profit where in country functions exceed the baseline activity compensated for under Amount B. There needs to be a clear definition as to what is meant by baseline and hence which activities would be deemed to exceed that. There is also the risk that the aggregate of Amount A, Amount B and Amount C over rewards the markets at the expense of innovator countries.

- Dispute prevention and resolution for Amount A

- An effective dispute prevention and resolution mechanism is needed.
- The OECD has proposed that there is a standard self-assessment return and documentation package which is validated by the lead tax administration with the establishment of a review panel and a determination panel to resolve questions. Again, this is an additional compliance burden that MNCs have to face.

- Dispute prevention and resolution for Amount B and Amount C

- The OECD suggests that the existing MAP infrastructure and processes be improved. Timing and process should be clearly defined with mandatory correlative adjustments preventing double taxation. In addition, there should be a reduction in the current delays that taxpayers face in obtaining corresponding relief through the MAP process.
- The OECD proposes voluntary mediation before triggering a binding dispute resolution mechanism. There needs to be a clear, strong and effective mandatory binding arbitration process mutually agreed and peer reviewed by tax administrations.

Part 3

Pillar 2 – GloBE Proposal

Setting the Scene of Pillar 2

- **BEPS Action 1 = Digitalisation exacerbates BEPS issues**
- **Work on action 1 is perceived to have highlighted “fundamental issues with the international tax framework”**
- **Resulting in an agenda to address how taxing rights should be allocated X-border**
 - Pillar 1- measures to reallocate profit related to certain types of income
 - Pillar 2 – Global anti-base erosion measures – A new minimum tax
- **Note that Pillar 2 has come some distance from a targeted digitalisation measure**

Pillar 2

- **Objective: To counter global base erosion**
- **Enabling the rights of jurisdictions to counteract low tax rates in other jurisdictions**
- **Create a level playing field**
- **Limit tax sovereignty to protect tax sovereignty**
- **Expected to change behaviour of tax jurisdictions and MNC taxpayers**
- **Pot of gold ~\$100BN 4% CIT revenues v. not yet modelled cost of trade war?**

- **How do we overcome base erosion:**
 - Include more income in scope of tax in a higher tax jurisdiction
 - Limit/ prevent / tax payments to low tax jurisdictions

- **Which leads us to two basic rules and two complementary rules**
- **But only targeted at the main sources of base erosion**

OECD Pillar 2 Proposals

- **Income inclusion rule**
 - A top-up tax if income has been taxed below a minimum rate
 - Many questions asked, not yet answered, but latest information from OECD is of good progress but we don't yet have updated detail.
 - How to calculate; Where to collect; What's the rate
 - How to determine the tax base? Use of accounting profits?
 - How to determine tax paid;
 - Are they determined for each entity, each jurisdiction" blended"; or for the whole group.
 - Tax attributes and multi-year averaging? Covid 19!
 - Jurisdictional blending appears to become the preference?

OECD Pillar 2 Proposals

- **Switchover rule**

- Assists the income inclusion rule by considering how treaty situations need to adapt.
- The switchover rule swaps an exemption method under a treaty for branches in jurisdictions with low tax rates to a credit mechanism, thereby resulting in more tax paid in the parent jurisdiction of the branch.
- How will it apply? Who is motivated to switch?
- Similar treatment for immovable property.

OECD Pillar 2 Proposals

- **Undertaxed payments rule**

- A rule seeking to deny a deduction for a payment to a related party that is taxed by the recipient location below a minimum rate.
- Or, seek to impose source based taxation (WHT) on the payment. (For which, also see the Subject to tax rule)
- Questions here centre around what is “undertaxed”; which types of payments does it apply to; how does it interact with other measures and therefore should this be deal with by carve outs? Note that unlike Pillar 1 carve outs are not focused on industries.

OECD Pillar 2 Proposals

- **The subject to tax rule**
 - Supports the undertaxed payments rule
 - A new rules to be included in treaties
 - Only grants treaty benefits (e.g. reduced WHT rate) if the item of income is subject to tax at a minimum rate
 - Could be applied to unrelated parties for Articles 11 and 12 of the OECD model convention (interest and royalties) and beyond?

Pillar 2 – Do You (yet) See the Jigsaw Picture?

- **Many “how” questions**

- The many questions remaining on Pillar 2 create much confusion.
- The rules as currently proposed are a shopping list, not a final tax system . They overlap / conflict.
- Programme of work “exploring options and issues with design
- The expected use of financial accounts to establish the base created significant feedback.
- The rules also conflict with CFC regimes, similar unilateral systems & other BEPS actions.
- The order in which they apply is critical
- Some are transaction level taxes (though currently referenced to ETR no STR)
- Most feedback preferred that the IIR takes precedence. But how?

Pillar 2 – Do You (yet) See the Jigsaw Picture?

- **To illustrate bottom up:**
 - Does switchover apply first to enable headline rate applicable to all entities to be established?
 - Do we then determine undertaxed payments rule at a transaction level based on statutory rate if using source based taxation? Deductibility could be determined later. How does this change if an effective rate is used?
 - Then does the subject to tax rule determine the rate and rules for WHT under the UPR?
 - At year end, groups will need to process Pillar 1 Amount A changes by jurisdiction?
 - Then do we consider UPR; STT rule; any and all CFC and similar impacts before finally determining tax paid by jurisdiction to determine whether IIR applies?
- **Or top down – if apply IIR and only use the other rules only if IIR does not give a good answer – but timing?**

Pillar 2 – Conclusion

- **Wide remit**
- **Using group strength to require a level playing field – OECD membership has fundamentally changed**
- **The alternative to a trade war?**
- **Fast”er” progress – consensus based**
- **But no detail yet of how many complex questions have been addressed**
- **April 2020 OECD says still a priority and on schedule for 2020**

Part 4

Unilateral Measures

Unilateral Measures – Interaction with the OECD Pillar 1

- **Unilateral Measures are the “silver bullet” in the hands of MS in the event an agreement is not achieved at the OECD level**
 - Many countries have either enacted their own unilateral measures (see French, Spanish and UK DSTs) ahead of an international consensus, or are considering their introduction with a larger scope. They all assume that users data are the main value creation drivers of today’s economy: debatable at best.....
 - It seems apparent that even if consensus is achieved, but it is not satisfactory enough at international level, most countries will move forward with the introduction of unilateral measures
 - Consequence 1: most of the unilateral measures currently under discussion are taxes on gross revenues and NOT on income – coverage by tax treaties under the definition of “tax” is likely to be denied – outcome will be double taxation
 - Consequence 2: give up on the redefinition of a new taxation world. Who is in who is out?
 - Consequence 3: MNEs will likely pass on the cost to customers, adding on to the VAT already collected from consumers through distant sales

The UK Digital Services Tax

- **Applies with effect from 1 April 2020; payments due 9 months after end of relevant accounting period.**
- **Applies to revenues deriving from provision of social media, search engines and online marketplaces, to the extent attributable to UK users**
 - Rules to determine when attributable to UK users
- **De minimis thresholds - £500m worldwide revenues/£25m revenues attributable to UK users**
- **Rate: 2% on revenues in excess of £25m**
- **Alternate charge for low-margin businesses: $0.8 \times \text{operating margin} \times \text{revenues}$**
- **To be reviewed in 2025**

Part 5

Outlook

Outlook

- **OECD still plans to meet the end of CY20 deadline to reach consensus**
- **Next step: July inclusive framework meeting, where the drivers for amounts A/B/C should be heavily discussed**
- **In the medium term: even if consensus is reached, it will take time before a new system is implemented, while countries are even more hungry for revenue due to COVID impacts**
 - Risk of multiplying unilateral measures in the interim period?
 - Previous APAS and rulings: grandfathered ? Or need to be renegotiated in light of the new system?
Will it the end of bilateral APAS/rulings?

Questions?

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