Grant Thornton
An instinct for growth™

Tax

Navigating

Digital

Say goodbye to the arm's length principle

How the push for digital tax consensus could upend transfer pricing as we know it

The G20 has endorsed The Organisation for Economic Co-operation and Development's (OECD'S) roadmap for resolving the 'tax challenges arising from the digitalisation of the economy' (BEPS Action Plan One) and is committed to working toward a consensus-based long-term solution by the end of 2020.[1]

While global consensus is clearly preferable to today's fragmented approach to taxing digitally-derived revenue, the OECD's search for a solution could end up heightening the risk of double taxation for all businesses rather than just Big Tech giants.[2] And under the reallocation of profits and minimum tax proposals that have emerged following a recent round of consultations, the arm's length principle that has governed transfer pricing for decades could become obsolete, with all the upheaval that would result.[3]

So, what does the OECD have in mind and what are the implications? Will the proposals survive the political realities of sovereign state control over tax policy, and the entrenched national interests that go with it?

[1] www.oecd.org – International community agrees on a road map for resolving the tax challenges arising from digitalisation of the economy, 31 May 2019

[2] www.grantthornton.global – digital taxation risks double taxation for all businesses, June 2019

[3] www.oecd.org – Programme of work to develop a consensus solution to the tax challenges arising from the digitalisation of the economy

After a slow and tentative start, the OECD's push for a solution on how to allocate and tax the profits from digital business is gathering momentum.

Following consultations, initial proposals from earlier in the year have now been crystallised into a twin-pillar framework and series of detailed options within it (referred to in this article as the 'OECD programme of work').[4] With the backing of the G20, the OECD has also set an ambitious roadmap for reaching an internationally-agreed consensus by the end of 2020.

So, what is being proposed within the OECD's programme of work and what are the implications?

[4] www.oecd.org – Programme of work to develop a consensus solution to the tax challenges arising from the digitalisation of the economy

Pillar one: Revised nexus and profit allocation rules

This would extend the corporate taxable presence (nexus) from a physical 'bricks and mortar' operation to where value is generated virtually (eg online sales) or through the exchange of certain types of intangible assets (eg data-driven customer insights).

Revised nexus

A permanent establishment (PE) for tax purposes would not just include a physical presence but also locations where customers can buy goods and services offered online.

The OECD is seeking to develop indicators for what triggers a taxable presence including revenue thresholds. Any change would require shifts in international treaties on dealing with PEs and transfer pricing.

Observations and implications

The proposed changes to taxation nexus will have to be coordinated with changes to local domestic law as most countries' legislative framework requires some physical link with the jurisdiction.

Unless the implementation of this change is closely coordinated and uniform, there will be an increasing risk of double or triple taxation.

Profit allocation rules

The OECD and certain European jurisdictions have floated various ideas for dealing with profit allocation. The starting premise is that group profit should be reallocated to 'market jurisdictions' based on a wider definition of a business presence nexus, which will have a lower threshold than the current physical presence requirement. There are three alternatives being looked at:

Modified residual profit split (MRPS)

MRPS is closest to traditional transfer pricing principles, but like the other options it seeks to allocate a portion of a multinational enterprise's (MNE's) income to market jurisdictions.

Modified residual profit split involves four steps

1. Determine the total profit to be split.
2. Remove 'routine' profit, based on either current transfer pricing rules or using simpler approaches.
3. Determine the non-routine profit (derived from the group's intangible assets) that can be allocated to the market jurisdictions either by adapting current transfer pricing rules or simpler proxies.
4. Allocate the non-routine profit to the relevant market jurisdictions using apportionment criteria such as number of employees.

The shift away from current transfer pricing to simpler alternatives would be justified by the need to avoid complexity in implementation. Key areas to be ironed out include the determination of routine and non-routine income. Further considerations include how to determine profits subject to MRPS and how to group entities and business units together.

Observations and implications

This approach to allocating profits is still at odds with the arm's length principle, by using a formula rather than focusing on what independent parties would agree. True, various Base Erosion Profit Shifting (BEPS)-related developments such as changes to interest rate deduction rules have been chipping away at the arm's length principle. But this is the tombstone.

The proposals presuppose that some form of harmonised accounting or taxation rules could be achieved across multiple jurisdictions. This is a very difficult challenge.

The OECD programme of work doesn't consider foreign exchange, the impact of which could lead to significant distortions.

Other expenses, such as interest, are not addressed. Would such expenses be borne by the head office jurisdiction or be allocated to the market jurisdictions?

Fractional apportionment

Rather than looking at whether profit is routine or not, the allocation would be based on a formula that considers pre-set profit allocation keys. These allocation keys could consider number of employees, assets, sales, users or other relevant criteria such as advertising.

Observations and implications

Again, this method would effectively replace the arm's length principle, taking us into a world of formulary apportionment.

This approach has conceptual similarities to how taxable income is allocated to sub-national jurisdictions such as US states or Canadian provinces. To achieve a fully efficient allocation without double taxation or non-taxation, each country would have to agree on the apportionment factors. In practice, it may be difficult to achieve one key that works for all industries as the true value drivers could be different. Although this can be dealt with by developing different allocation keys for defined industries or sectors, reaching a consensus will be a challenge. The difference between allocating profits within one country, and between countries whose rules may be very different, should not be underestimated.

Distribution-based

Drawing on ideas put forward during the recent consultations, the allocation of income to the market jurisdiction would be based on the level of marketing activity, distribution and user-related activities (eg giving a return to the market jurisdiction of a fixed percentage of sale). This would most probably need to take account of other levers, such as the overall level of profitability.

Observations and implications

This method is by far the simplest in its application and resembles the approach taken to interest deductibility where a flat 30% Earnings before interest, tax, depreciation and amortisation (EBITDA) limitation is becoming an international norm under BEPS.

Losses

While many intellectual property-rich businesses have incurred significant development losses, the previous OECD proposals on digital taxation did not fully consider the impact.

The OECD's programme of work addresses this by outlining different methods that could be used to deal with losses. The first is that the losses would be allocated in the same way as profits. Under this approach, a company would presumably have to compute its past losses and then recompute them under the new approach. The alternative is an earn-out approach under which the MNE would have a notional loss account. This would be allocated to profits, and taxation would occur once the notional loss account has been reduced to nil. The third alternative is to use a combination of these approaches.

Observations and implications

The recognition of losses is a welcome development, addressing the difficulties and anomalies that loss-making businesses could face.

A change in allocation and use of tax losses could have significant tax accounting considerations.

Pillar Two: Global anti-base erosion proposal

Seeks to compensate for diversion of taxable income from high to low tax jurisdictions by imposing a minimum tax.

Global anti-base erosion (GLoBE)

The OECD programme of work outlines significant changes to the taxation of Controlled Foreign Corporation (CFC) income, which will effectively result in a minimum tax and reduce the level of tax competition between jurisdictions.

There are two components to the GLoBE proposal: a minimum tax and a base erosion payment measure.

Minimum tax

Income would be subject to a minimum level of taxation, whether it's earned in the parent jurisdiction, a CFC or a foreign branch. If the income in the branch or CFC was not taxed at the minimum level of tax, additional tax would be levied in the parent jurisdiction. For example, if the minimum tax was set at 10% and the CFC paid 3%, then a 7% top-up would need to be paid in the parent company jurisdiction.

The OECD acknowledges that it may not be possible to reach consensus on one rate and therefore a range or corridor of rates could be used. The computation of a minimum tax on a CFC-by-CFC basis may yield inappropriate results – for example, where on a combined basis the CFCs of the MNC are taxed at a combined rate of 10% or more. The OECD is therefore considering allowing the blending of low-tax and high-tax CFC income. The OECD is also considering whether carve-outs should be used to simplify the minimum taxation regime. These carve-outs could include consideration of substance carve-outs for entities that comply with BEPS Action Plan Five measures against 'harmful tax practices' or where the income earned is a reasonable return on tangible assets.

Observations and implications

A minimum tax on CFC income could run up against existing tax treaties as it results in income earned in one state being taxed in another. This could lead to double taxation. Modifications to treaties will be needed to address this.

The OECD programme of work acknowledges that having a computation of a CFC's income done based on the parent company's tax laws could result in a complex and time-consuming exercise (this is the approach taken under the US tax system for its earnings and profits). The OECD is considering simpler alternatives such as using financial accounting income.

Many countries have adopted a territorial tax regime where income earned abroad is not subject to taxation in the jurisdiction of the parent company. This regime is often applied to CFCs and branches. The GLoBE proposals effectively eliminate territorial taxation. Many countries will not accept such a measure as it undermines their tax sovereignty.

The GLoBE could also greatly increase compliance costs for MNEs.

"The OECD acknowledges that it may not be possible to reach consensus on one rate and therefore a range or corridor of rates could be used."

Where does this leave us?

Before we consider what we're likely to see, it's worth stepping back and judging whether the G20 states, along with the wider Inclusive Framework countries,[5] will live up to their commitment to reaching a consensus.

While there are a lot of twists, turns and boulders in the road ahead, such a consensus is not beyond the bounds of possibility. More than 120 countries including China, India and the US have signed up for the Inclusive Framework,[6] which commits them to applying the mandatory aspects of BEPS Action Plan.[7] In turn, nearly 90 countries have agreed to use the Multilateral Instrument to incorporate elements of BEPS into bilateral tax treaties.[8] The appetite for consensus within digital taxation specifically is highlighted by the readiness of the UK and France to endorse the OECD roadmap and programme of work despite having struck out on their own legislative path.

As always, the snag is that these proposals could well run counter to local laws and interests. For example, the move to minimum tax can only be enacted if all states agree to give up what is one of their most cherished sovereign rights, setting tax policy. And even if a country signs up – and this is still very much an 'if' – it could still interpret and apply the rules very differently from others. An important aspect of the work programme is the economic impact assessment, and many countries are unclear whether they will be winners or losers from these changes.

A lot of what materialises hinges on the US – if it fails to ratify, the consensus framework set out in the OECD's programme of work is dead in the water. While the US has signed up to the Inclusive Framework, it is not a party to the Multilateral Instrument. And as the US has perhaps most to lose from proposals that would require it to share a lot of the tax it collects from its digital businesses, the question marks over its support are clear.

The other key consideration is whether some countries will balk at a radical and far-reaching set of proposals that go against both territorial taxation and the arm's length principle. This would lead to considerable upheaval for both tax authorities and MNEs. Mid-size MNEs could be especially affected, with the cost and complexity of compliance set to rise sharply.

So, should you sit tight and wait for all this to pass over? The short answer is no. The OECD's programme of work represents the direction of travel. Even if some of the controversial and hard to implement elements are reined in or dropped altogether, many and possibly even most countries will adopt some form of the proposals, even if others don't. The most important ramification is the death knell for the arm's length principle as we know it – some of the threads will survive, but its universal application and the reasonable certainty that come with it will be gone. Some argue that the formulae that replace it could make tax management more straightforward. This has to be set against the continuing fragmentation of taxation for business, and the compliance headaches and risks of double taxation and dispute that go with this. And as we've stressed in previous articles in this series,[9] it's all MNEs that will be affected rather than just Big Tech and other so-called digital businesses, at a time when digitisation is permeating every sector, from farming to financial services.

5 www.oecd.org – Inclusive framework on BEPS composition

6 www.oecd.org – About the Inclusive Framework on BEPS

7 The minimum standards as set out in the 'inclusive framework for the implementation of the BEPS package' cover harmful tax practices, tax treaty abuse, country-by-country (CbC) reporting requirements for transfer pricing and improvements in cross-border tax dispute resolution.

8 www.oecd.org – Multilateral Convention to Implement Tax Treaty Related Measures to Prevent BEPS and its Signatories

9 www.grantthornton.global – Digital taxation risks double taxation for all businesses, June 2019 and Lack of international consensus creates vacuum of uncertainty, September 2018

Careful what you wish for

The OECD's programme of works marks an important milestone in international tax reform. While the focus is digital business, measures such as minimum tax and reallocation of profits from where value created to where it is consumed will have a profound impact on all MNEs.

And this isn't going away – the political furore surrounding what is perceived to be the lack of corporate tax paid by businesses with a virtual but no physical presence within a country means that governments are under pressure to do something. If there is international agreement, all the better thinks the G20, but failure to reach or apply it won't hold up some form of reform.

The OECD programme of work is equally important in putting flesh on the bones of what had been vague conceptual approaches. The OECD's focus on the tax challenges of the digital economy is also significant as this had been the biggest missing piece of the jigsaw in the practical implementation of BEPS. Whatever transpires, it's important to consider it as part of the bigger tax shake-up, with BEPS at its heart.

While recognising the desire for change coming from politicians and lawmakers, we are calling on the designers to consider suitable protections for mid-sized businesses, a group that is already reeling from the compliance burden placed on them by the previous BEPS actions. The potential impact of the OECD proposals could include filing tax returns and paying tax in more jurisdictions, along with the possibility of higher tax payments overall. Possible solutions include realistic de minimis limits and safe harbours in both the proposed Pillar One and Pillar Two for these smaller international groups. There may also be opportunities to develop some sort of pre-clearance modelled on or similar to a simplified advanced pricing agreement (APA).

Ultimately, the OECD's programme of work is significant because of its wider consequences, unintended or otherwise. This includes the threat to an arm's length principle, which whilst sometimes complex and imperfect, has done the job that is needed. Without it, a whole new playbook for transfer pricing will be needed.

If you would like to discuss any of the areas raised in this article, please contact your local Grant Thornton adviser.

"The OECD's focus on the tax challenges of the digital economy is also significant as this had been the biggest missing piece of the jigsaw in the practical implementation of BEPS."

grantthornton.global