

OECD/G20 Inclusive Framework moves forward on new tax rules

February 4, 2020

In brief

Following the conclusion of a two-day meeting on January 29-30, the OECD/G20 Inclusive Framework on BEPS (the 'Inclusive Framework') issued a [package of documents](#) that update the state-of-play regarding work on tax challenges arising from the digitalization of the economy, and set forth a revised work program. The Inclusive Framework endorsed the OECD Secretariat's concept of a 'Unified Approach' to Pillar One on profit allocation/nexus rules and committed to achieving agreement within 2020. Whether Pillar One will apply only as a safe harbor will be held for ultimate decision until the key design features have been agreed, as countries' views strongly differ on this point -- although it is agreed that unilateral measures will need to be withdrawn. A long-awaited public presentation of the OECD's economic analysis of the two Pillars will be made in February.

In detail

Background

The Inclusive Framework – comprised of nearly 140 jurisdictions – has been seeking a solution to the tax challenges arising from digitalization of the economy. After preparatory work, the Inclusive Framework settled on an initial approach based on two pillars:

- Pillar One proposes a three-part profit allocation mechanism that partially departs from the arm's length principle (while also creating a new taxing right that is not based on physical presence), and
- Pillar Two would feature both an income inclusion rule (i.e., generally a foreign minimum tax) and denial of deductions for base-eroding payments, as well as other supporting rules.

These pillars form the core of the proposed new system, although many technical details remain unresolved regarding operation of the rules in practice. More details on the project (including our previous detailed bulletins) can be seen [here](#).

Analysis

The Inclusive Framework document package includes: (1) a political statement; (2) an outline of the Pillar One Unified Approach architecture; (3) a revised work program; (4) a chart illustrating Amount A effects on multinational entities (MNEs); and (5) a progress note on Pillar Two.

The political statement highlights that, for the first time, the Inclusive Framework is supporting the Unified Approach as the basis for further negotiations on revising taxing rights. This endorsement refocuses member countries on a mixed approach to profit allocation and nexus from the various proposals set out earlier – user participation, marketing intangibles, and significant economic presence. A key goal of Pillar One will be to increase tax certainty through effective dispute prevention and resolution features. Members must resolve several critical concepts, including: whether to structure Amount A to account for differences amongst digital companies; the structure of dispute prevention/resolution tools; regional differences; and continued application of digital services taxes and other unilateral measures.

In the Pillar One Unified Approach outline, the Inclusive Framework states that the scope of Amount A would be focused on two types of businesses: automated digital services (generally involving online advertising and searches, cloud computing, social media and intermediation platforms, and streaming services), and consumer-facing businesses (where revenues are generated from the ultimate sale of goods and services to individual consumers). The definition of consumer facing has been modified from previous iterations to exclude the provision of intermediate products and components that are incorporated into a finished product sold to consumers (often B2B) but will apply to franchise rights and third-party resellers. A non-inclusive list of affected businesses includes: personal computing products, clothes, branded foods, automobiles, and franchise licensing arrangements (such as hotels and restaurants). There will be specific carve-outs for most extractive industries and commodities, financial service activities that are not retail in nature, and airline/shipping activities.

The applicable threshold for in-scope businesses will consider an overall group gross revenue threshold, with additional limits based on aggregate in-scope revenues, and a de minimis threshold. Amount A nexus would not be based on physical presence but rather on significant and sustained engagement in a market jurisdiction; a revenue threshold could be the sole determiner for automated digital services, while other consumer-facing businesses will need a variety of factors. The nexus revisions will require a design to limit filing and tax-related obligations in market jurisdictions and may involve a one-stop shop concept for registration and reporting.

As Amount A will feature a formula-based allocation mechanism – looking at a portion of deemed residual profits – there are many technical issues to resolve, including the use of business line/regional segmentation, the notion of digital differentiation, and specific revenue-sourcing rules for different business models. The outline identifies profit before tax as the most favorable profit level indicator and stressed the need for loss carryforward rules to apply.

Work to determine how to avoid double counting among Amounts A, B, and C, as well as mechanisms for double taxation relief, will continue.

Regarding Amount B, the outline notes that the fixed return for baseline marketing and distribution activities is ‘based on’ the arm’s length principle, but will need to account for regional, industry, and functionality differences. A definition of baseline activities will need to be developed but likely will include no/low risk, lack of intangibles, and routine levels of functionality. Further technical work is envisioned on profit level indicator, fixed percentage at an agreed profit, benchmarking studies, and regional/industry differentiation. The stated goal is for Amount B to operate within the existing treaty network.

The outline recognizes a clear need for increased tax certainty under the Unified Approach, particularly before tax assessments are made and to make them binding in nature. In addition to enhancing traditional dispute prevention and resolution tools, a review panel is also being considered to help make determinations regarding Amount A aspects (such as scope). Subject to consensus, mandatory binding dispute resolution tools will be developed.

The exact implementation method for the Unified Approach is still being explored, although domestic legislation and tax treaty changes clearly would be necessary, along with transition rules. A multilateral convention potentially could solve a number of difficult technical implementation issues but would require the highest levels of political support. The outline emphasizes that commitment to implementing Pillar One will require countries to withdraw relevant unilateral measures.

Based on the US request, the Inclusive Framework will consider an alternative Pillar One approach involving a safe harbor whereby electing MNEs would be subject to Pillar One on a global basis. That work will occur concurrently and will focus on technical issues such as potential Amount A scope modifications, administrative rules, and avoidance of double taxation.

The revised Work Program for Pillar One sets out eleven work streams covering a broad range of issues that need to be addressed in refining the proposal.

The Progress Note on Pillar Two indicates that technical work is underway, although the note provides few details. Work continues on policy and design issues, such as the use of financial accounts (and dealing with temporary differences), blending options, carve-outs, and coordination between the income inclusion and undertaxed payments rules. The minimum rate has not yet been discussed.

On the horizon

The next full Inclusive Framework meeting will take place at the beginning of July; there is an ambition that the IF will be able to sign off on a complete political agreement covering Pillars One and Two at this time, allowing the OECD to deliver a report to the G20 Leaders at their November meeting. Further work to determine the technical mechanics of the political framework will occur and implementation will require several years for countries to put in place requisite legislation and multilateral instruments. An implementation package is therefore unlikely to be ready before the end of 2021 (or later).

The OECD will hold a webcast on February 13 to discuss economic analysis and impact assessment of the digitalization of the economy project.

The takeaway

- The Inclusive Framework is doubling down on its ambitious timeline to come up with a consensus solution by the end of 2020; this puts significant strain on all pressure points as inability to bridge gaps among countries through additional negotiation time makes it harder to achieve consensus.
- Explicit mention of removing unilateral measures as a condition for consensus is a welcome acknowledgement, but there is lack of clarity on which measures will be affected.
- Tax certainty is key to achieving the project's goals, but there is not yet a clear view on how to achieve binding resolution.

Let's talk

For a deeper discussion of how this issue might affect your business, please contact:

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