Taxing the digital economy

OECD Proposed Pillar One Unified Approach

7 November 2019

Speakers

Melissa Geiger

Partner, Head of International Tax and Tax Policy

Matthew Herrington

Partner (Solicitor), International Tax

Kirsty Rockall

Partner, Transfer Pricing

Agenda

The journey so far and forces driving change

Overview of the proposed Pillar One approach

Open issues

Q&A

The journey so far and forces driving change

Three key trends in global tax reform policy

Adoption of BEPS 1.0	— Coordinated action on international standards - County-by-country reporting, multilateral instrument, transfer pricing guidelines — Domestic law adoption of BEPS recommendations - U.S. tax reform/EU Anti-Tax Avoidance Directive (ATAD)/other domestic reforms
Proliferation of unilateral measures	— U.K. and Australia diverted profits tax — U.S. tax reform (BEAT/FDII) — Digital services taxes (DSTs) and other unilateral measures to address taxation of the digital economy
OECD effort to re-establish consensus **BEPS 2.0**	— Reconsider balance between source- and residence-country taxation — Address concerns spurred by consideration of challenges of taxation of digital economy without ring-fencing — Strengthen and extend BEPS recommendations

Concerns driving 'BEPS 2.0'

Scale without mass

Increasing ability to reach markets without traditional physical nexus

Value of markets

Some countries believe that the current rules insufficiently remunerate market jurisdictions

Intangible mobility

BEPS 1.0 did not fully address country concerns about taxpayer discretion to concentrate profits at location of intangibles

Attribution of profit to marketing and distribution

A number of countries have taken aggressive approaches to taxation of limited risk distributors

Simplicity versus accuracy

Current rules are complex and difficult to administer, and jurisdictions with limited resources believe they are at a disadvantage

Ring-fencing?

Will new rules discriminate against highly digitised businesses relative to other business models?

OECD timeline

January 2019	Policy Note introduces ‘Pillar One’ and ‘Pillar Two’
May 2019	Programme of Work describes Pillar One and Pillar Two, options to be considered
June 2019	Progress report to G20 finance ministers
October 2019	Public Consultation Document on Pillar One
November 2019	Public Consultation on Pillar One; Public Consultation Document on Pillar Two
December 2019	Public Consultation on Pillar Two
January 2020	Outlines of architecture agreed, including ‘reduced number of options under Pillar One’
End of 2020	Final report

Overview of the proposed Pillar One approach

Unified Approach - Background and scope

— May 28 Programme of Work presented three alternatives for new profit allocation rules:
  - Modified residual profit split method
  - Fractional apportionment method
  - Distribution-based approach

— Scope – focused on consumer-facing businesses
  - Excludes extractive industries
  - Other potential carve-outs, including financial services, to be studied
  - Potential size limitations, e.g. €750 million threshold

— Unified Approach based on commonalities among these methods
  - Formulaic residual profit split with expanded nexus
  - Fixed baseline distribution return
  - Continued role for existing transfer pricing rules
  - Recognises importance of measures to prevent and resolve disputes and double taxation

Unified Approach - Market jurisdiction taxable profit

Taxable profit to market jurisdictions based on three amounts:

Amount A – Amount allocated to market jurisdictions under new taxing right

- Determine total profit of group or business line
- Subtract formulaic 'deemed routine profit' to determine 'deemed residual profit'
- Apply fixed percentage to deemed residual profit to determine Amount A
- Allocate Amount A to market jurisdictions using sales-based formula
- Expanded nexus approach not dependent on physical presence
- Look through third-party distributors in determining sales
- 'Going beyond arm's-length principle'

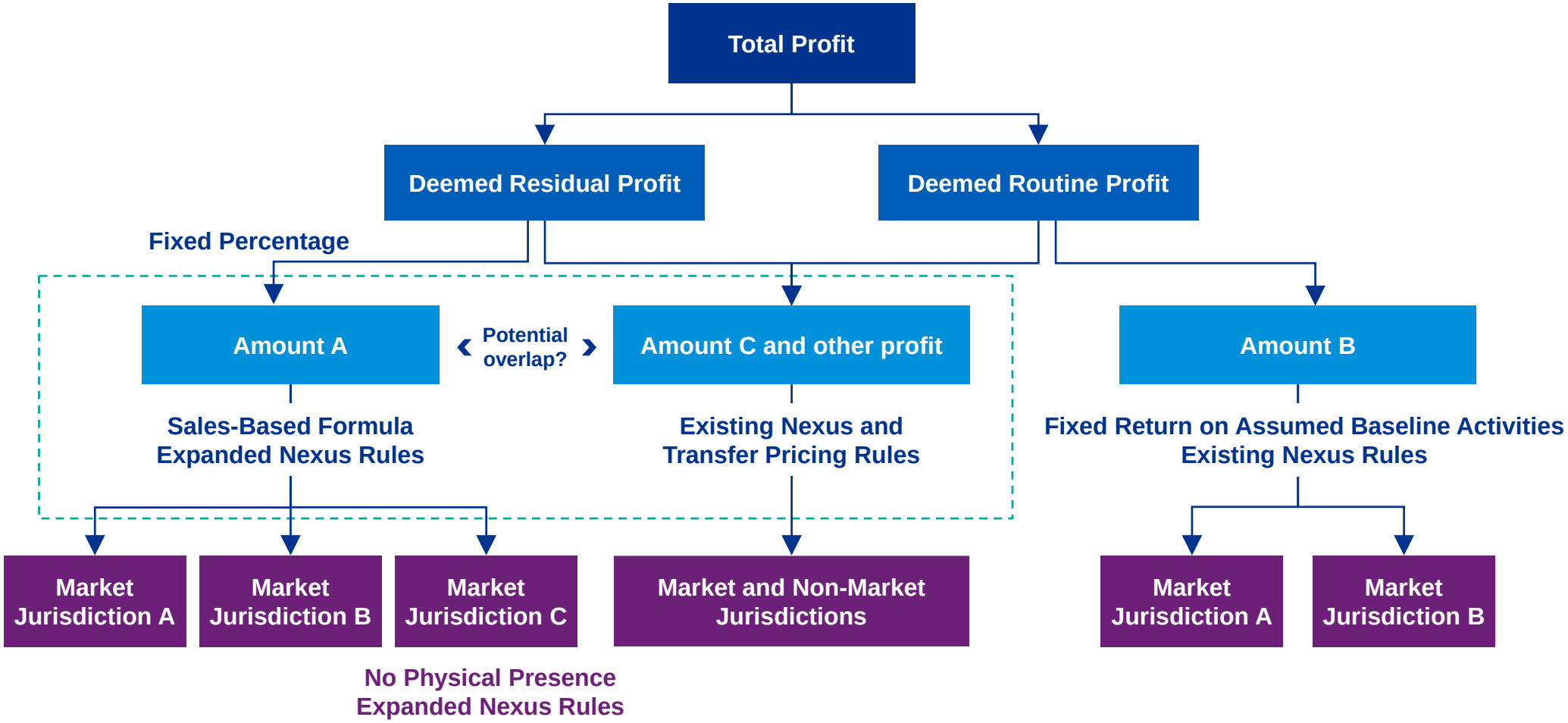
Amount B – Fixed remuneration for baseline marketing and distribution activity

- Intended to represent arm's-length compensation under existing principles

Amount C – Compensation for additional market jurisdiction functions beyond baseline

- Determined under existing transfer pricing rules
- Subject to enhanced dispute prevention and resolution mechanisms

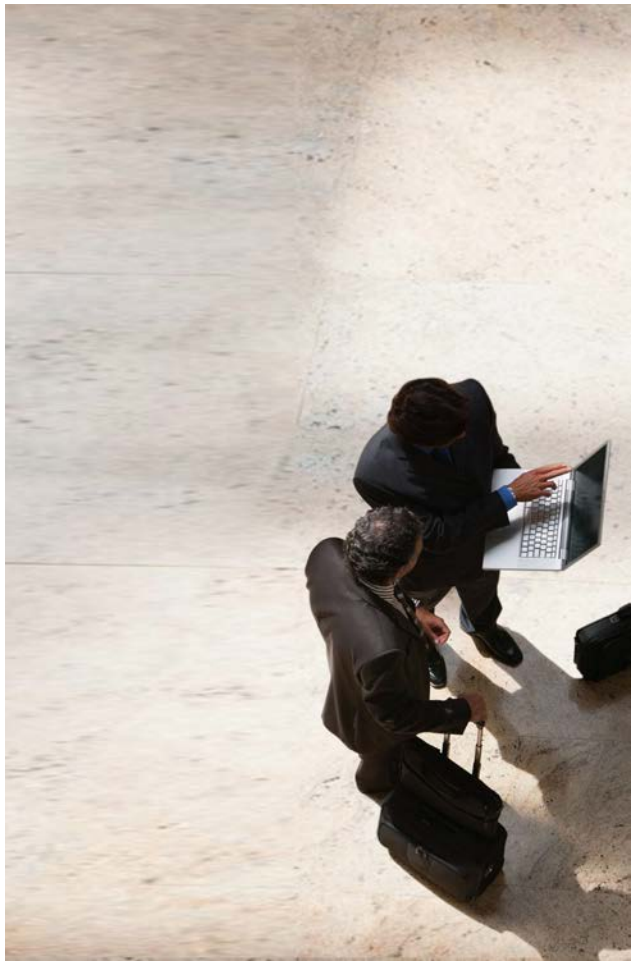
Unified Approach - Illustrated



Unified Approach - Scope issues

The OECD indicates that scope will be focused on 'large consumer-facing businesses.'

- What is 'consumer-facing'?
  - Supply through intermediaries, supply of component products, use of franchise arrangements – where in the value chain is the B2B vs. B2C distinction drawn?
  - Exclusions for specific industries? How to avoid complexity and subjectivity?
    - Extractive industries excluded, financial services to be studied
- What is 'large'?
  - €750 million CbyC threshold?
- Use of segmentation
  - In versus out of scope determined by line of business?
- Balancing competing objectives
  - Keeping focus on intended business models (ring-fencing?)
  - Potential for disputes around definitional issues
  - Neutrality among business models



Unified Approach – Elimination of double taxation

The OECD recognises that the Unified Approach raises various issues with respect to elimination of double taxation.

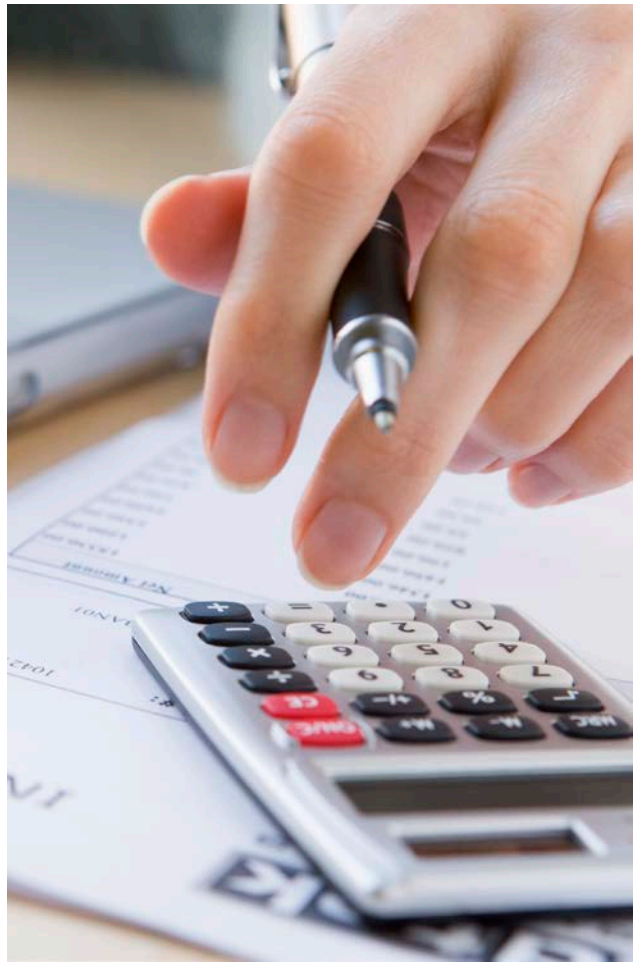
— Identifying surrender jurisdiction for Amount A
  - Potential complexity especially for business models with more than a small number of risk-bearing entities

— Avoiding double-counting or duplication among Amounts A, B, and C
  - Amount C may draw on same residual profit pool as Amount A
  - Treatment of losses
  - Reconciling deemed routine profit and actual routine profit per existing rules

— Dispute prevention and resolution mechanisms
  - Will Amount B approach really reduce disputes?
  - Prevalence of multijurisdictional issues under Unified Approach
  - Expanded need for mandatory binding arbitration?
  - Need for clearly articulated principles as basis for dispute resolution

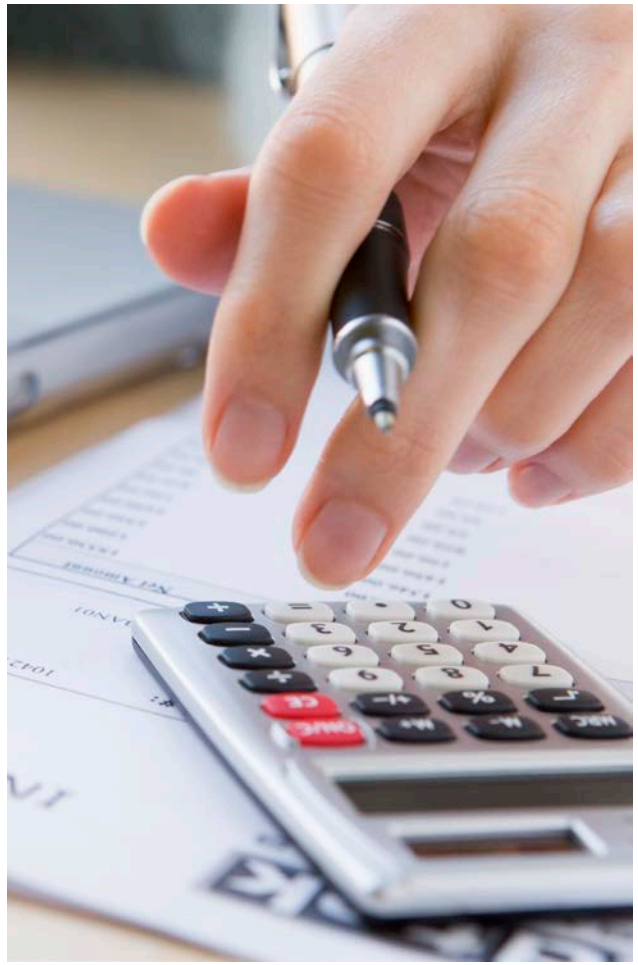
Unified Approach - Other issues

- Determining deemed residual profit and Amount A
  - Differential rules for deemed routine profit and Amount A by industry or other factors?
- Defining and applying new nexus rule for Amount A
  - ‘Look-through’ of intermediaries
  - Addressing concerns of developing countries while ensuring administrability
- Issues around Amounts B and C
  - Need for clear definition of baseline marketing and distribution
  - Variation of Amount B return by industry?
  - How much leeway for variation from baseline amount before Amount C kicks in?
  - Can Amount C be negative? Role of taxpayers and counterparty jurisdictions (competent authority) in asserting Amount C



Unified Approach - Other issues (cont.)

- Use of segmentation
  - Worldwide profit from financial statements versus segmentation by line of business or region?
  - If segmentation: financial statement segments or custom tax definition?
- Impact of reduced focus on actual intercompany transactions
  - Withholding tax (including collection of tax on Amount A) and characterisation
  - Resolution of double tax associated with Amount B (determination of counter-party jurisdiction)
  - Reconciliation with customs
- Relationship to permanent establishment concerns



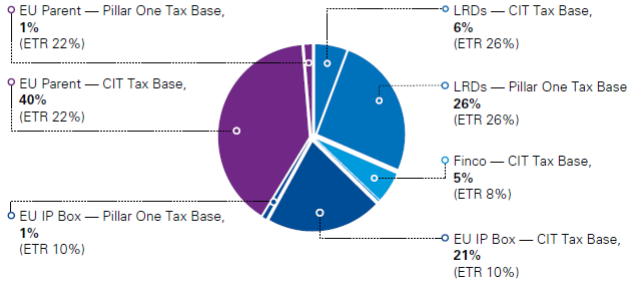
Next steps

Scenario planning: responding to the BEPS proposals

Our model can support you in identifying the impact that the OECD's BEPS 2.0 options under consideration may have on your business (cash tax payable and effective tax rate). The tool is customisable and offers flexible visualisation capabilities.

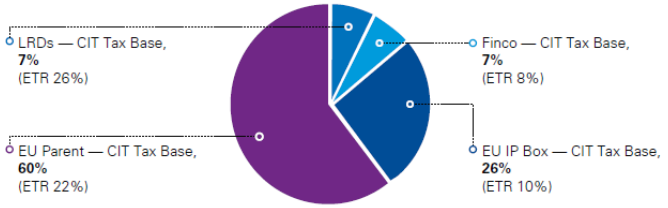
Pillar One — MRPS

Tax base for specific year by jurisdiction



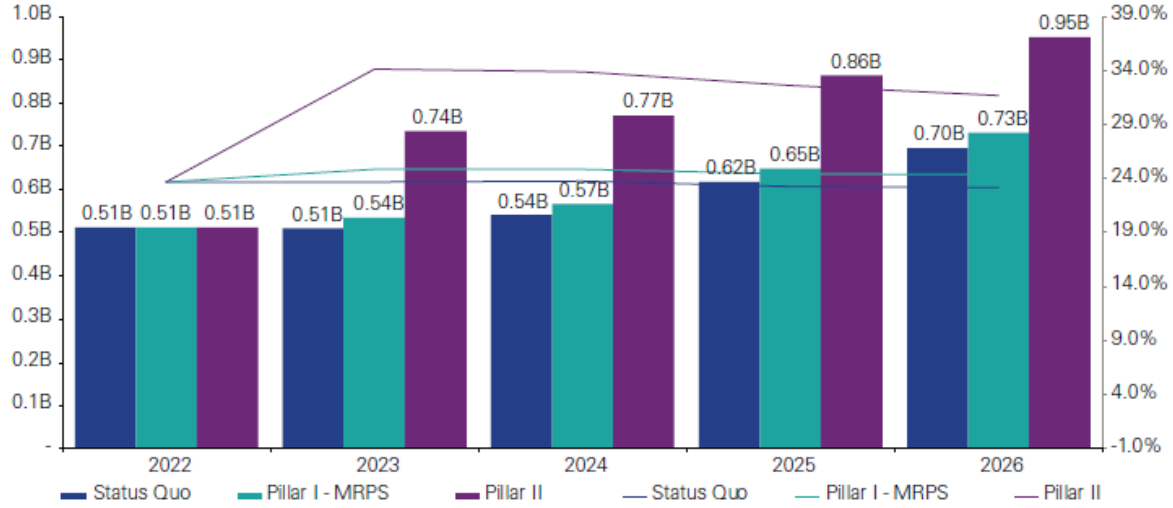
Scenario selected: status quo

Tax base for specific year by jurisdiction



Scenario comparison of Cash Tax and ETR for 2022 — 2027

Cash Tax and ETR — All Years



Source: KPMG BEPS 2.0 Model

What comes next

12 November 2019

Written comments due to OECD

December 2019

Public Consultation on Pillar Two

21-22 November 2019

OECD Public Consultation

January 2020

Revised proposals expected from OECD

November 2019

Public Consultation document on Pillar Two

End 2020

Final report

KPMG

Q&A

kpmg.com/uk