KPMG Meijburg & Co
Tax & Legal

BEPS 2.0 Update: A new tax system for the digital era

Report on the OECD consultation document "A Unified Approach under Pillar One", including feedback from the 'BEPS 2.0 Update' roundtable session organised by KPMG Meijburg & Co on 24 October 2019.

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Content

Why does the international tax system need an overhaul?

The existing framework of tax rules dates from a time when the world was a very different place to the one we know today. Today's world calls for an international system that takes sufficient account of an increasingly digitalised economy. A future-proof tax system not only takes account of the physical presence of a company, but also with a virtual or digital presence.

Two pillars

In recent years the debate on an overhaul of the tax system has focused on taxing the profits of internationally operating companies. The international Organisation for Economic Cooperation and Development (OECD) has as one of its goals for 2020 to find a global solution for the challenge of digitalisation. Together with the member countries in the Inclusive Framework on BEPS (IF), a Programme of Work has been drawn up comprising two pillars, the first focusing on taxation of the digital economy, the second on a global minimum profit tax.

Current state of affairs: consultation document on a global solution

On 9 October 2019 the OECD published a consultation document describing what a global solution under the first pillar could look like.

"The proposal for a system overhaul is very politically motivated. Europe has lost the digitalisation battle with the United States. It appears that the programme was designed as a response to pressure from various European countries to narrow the gap that has arisen."

– Participant at the 'BEPS 2.0 Update' roundtable session organised by KPMG Meijburg & Co

The proposal

The consultation document has been roundly criticised, because the current draft leaves many questions unanswered. It is, for example, unclear which companies and business sectors are covered by it. Nor does it contain precise rules for the allocation of the tax base. But what is the alternative? Without a global solution, countries will use unilateral rules to resolve the challenges of the digital economy. This would not be the best scenario for the business sector. The consultation document is based on the re-allocation of the tax base, whereby double taxation is, in principle, avoided. This in comparison to new unilateral measures, which could actually create double taxation.

Brief review

BEPS 1.0 is not a solution for an imbalance between 'market jurisdictions' and 'head-quarter countries'

The unilateral measures introduced by various countries, for example the digital services tax in France, create the impression that BEPS 1.0 has fallen short in this area. The dissatisfaction of, in particular, market jurisdictions (countries) and developing countries was the basis for the second stage of the BEPS project. To create political support for BEPS 2.0, a balance must be sought between the interests of headquarter countries and market jurisdictions. That is a complex matter, all the more so because there is no clearly demarcated line between both country groups. A perfect example is Germany, which, on the one hand, has all the characteristics of a market jurisdiction, while being the home base for a few large automotive companies on the other.

The status of tax plans in the spring of 2019

In the spring of 2019 the OECD drew up three proposals for the first pillar, all of which have the same goal.

- **Proposal 1**
  The first option seeks alignment with user participation. This would see profit allocated on the basis of active user participation on a digital platform, thus allowing companies without a physical presence in the users' country to be taxed. This model is aimed at internet companies, such as social media platforms and search engines.

- **Proposal 2**
  A second option proposed by the OECD is the marketing intangibles approach. This method aims to allocate profit to the market jurisdiction (the country where the consumer resides) based on the idea that the brand of the tech service provider and consumer data add value to the profit. This proposal has a considerably broader approach than that of the user participation model. The reason for this is because digitalisation affects more business models than just those of internet companies.

- **Proposal 3**
  The third option is based on broadening the concept of 'permanent establishment' to include a virtual presence. The concept of a 'significant economic presence' would thus be broadened to include a digital component. Where a user participation model and a marketing intangibles model are designed for

taxing the 'residual profit' of multinationals, this third proposal goes one step further. The entire profit is allocated on the basis of various factors, with the economic presence forming the tax base. Some factors that could be used to determine this presence are: a user base with accompanying data, maintaining a website in the language of the jurisdiction, permanent (online) marketing and promotional activities.

In practice, none of these three options appears to have garnered sufficient political support from the member countries in the OECD BEPS Inclusive Framework. To create a framework which would have sufficient support, the OECD has proposed drawing up a unified approach based on the similarities between the three options.

Framework for overhauling the system: Unified Approach

The package of rules comprises elements of all three previous proposals

The above three proposals are similar in different ways. Firstly, jurisdictions (countries) where the users are located will have more opportunities to tax. Secondly, physical presence is no longer the only starting point for taxation. A third similarity is that the proposals go further than the arm's length principle (rules and methods for determining the prices that subsidiaries within a group can charge one another for intra-group transactions. For example, for goods, services, licenses and loans). This principle will remain in force for part of the tax system, but a new package of rules will be introduced. Lastly, the proposals are aimed at simplifying the tax system and increasing tax certainty.

"The consultation document contains much that is unclear. The approach is impractical and the document still contains major omissions."

– Participant in the 'BEPS 2.0 Update' roundtable session organised by KPMG Meijburg & Co

For which companies does the Unified Approach entail change?

In principle, the Unified Approach applies to digital companies with cross-border activities. However, in practice its scope is far broader. The proposal covers all consumer-oriented companies: large multinationals that generate income from consumer contact. This contact can be via the supply of products/services, but also via the provision of digital services involving consumers. For the time being, there is no precise definition. This makes it unclear where the line between Business to Business (B2B) and Business to Consumer (B2C) will be drawn. Only during the next OECD stage will it become clear how, for example, rules will deal with franchising and supplies via intermediaries. Under the current plans it is also unclear whether only certain activities will be taxed or the entire group turnover.

"It is clear what the plans mean for a business that sells cars directly to consumers. But are you also covered by the plans if you sell cars to a middleman? Although indirectly you are selling to consumers, you are actually a B2B business. This is a grey area and the rules appear to contradict themselves."

– Participant in the 'BEPS 2.0 Update' roundtable session organised by KPMG Meijburg & Co

Which companies and activities are exempt under the Unified Approach?

The Unified Approach appears not to apply to companies that are actively involved with the extraction of minerals or the trade in raw materials and could possibly also not apply to the financial services sector. It will be a challenge to clearly demarcate this. Banks are increasingly data-driven, while internet companies are expanding their activities to include financial services; a clear demarcation is also difficult to make in this case. It is possible that a distinction will be made between traditional financial service activities - such as financial services and lending - and data-related activities.

Exemption on the basis of company size

There is also a carve-out in respect of company size. The new rules only apply to large companies. The term 'large' is subject to a threshold of EUR 750 million. Country-by-country reporting is also required. The existing rules for CbC reporting will be evaluated next year. A potential outcome of the discussions is that the actual threshold will be below the stated € 750 million.

How does the Unified Approach deal with companies with multiple activities?

A feature of the new system is that a specific tax base allocation is linked to each activity, while carve-outs apply to certain activities. However, allocating shared costs to specific activities is complex. The consultation document illustrates this using the example of a company with online retail activities - characterised by a low profit margin - and a cloud computing division with a high profit margin. If no distinction is made when taxing both activities, this will favour jurisdictions (countries) where the retail sales take place, compared to jurisdictions where the income is realised from cloud computing.

Other business models also do not make clear how segmentation will take place in practice. Segmentation, other than in respect of activities, is also a complex matter due to the uncertainty about the position taken by tax authorities. It is still unclear whether all market jurisdictions will adopt the segmentation applied by companies, which these companies base on, for example, prescribed accounting principles for annual reports (IFRS or GAAP).

What does the new nexus rule look like under the Unified Approach?

The proposal includes a new nexus definition, in addition to the existing concept of a fixed establishment. The physical presence of a company in a certain jurisdiction (country) is no longer the starting point. Instead, a taxable presence in countries were turnover is generated will also be a factor. The turnover threshold can be determined per country on the basis of market size. This means that under the new nexus rules 'taxable presence' would also apply to small countries. The rule also applies to companies that are active within a jurisdiction via non-affiliated distribution parties. However, the implementation of that rule could become complicated, since it cannot be taken for granted that these parties are open to sharing customer data.

Unified Approach in practice

What will the tax base allocation be and to which profits will it apply?

The Unified Approach uses a three-pronged approach to allocate profit among jurisdictions on the basis of turnover-related formulas. Missing from the OECD proposal are percentages and allocation formulas. As yet, there is also no specific definition of profit.

- **Amount A**

  Part of the Deemed Residual Profit, calculated as the 'non-routine profits' based on fictions, is allocated to the markets/countries where the multinational's customers are located. This part of the residual profit is calculated using a turnover formula and allocated to the market jurisdictions.

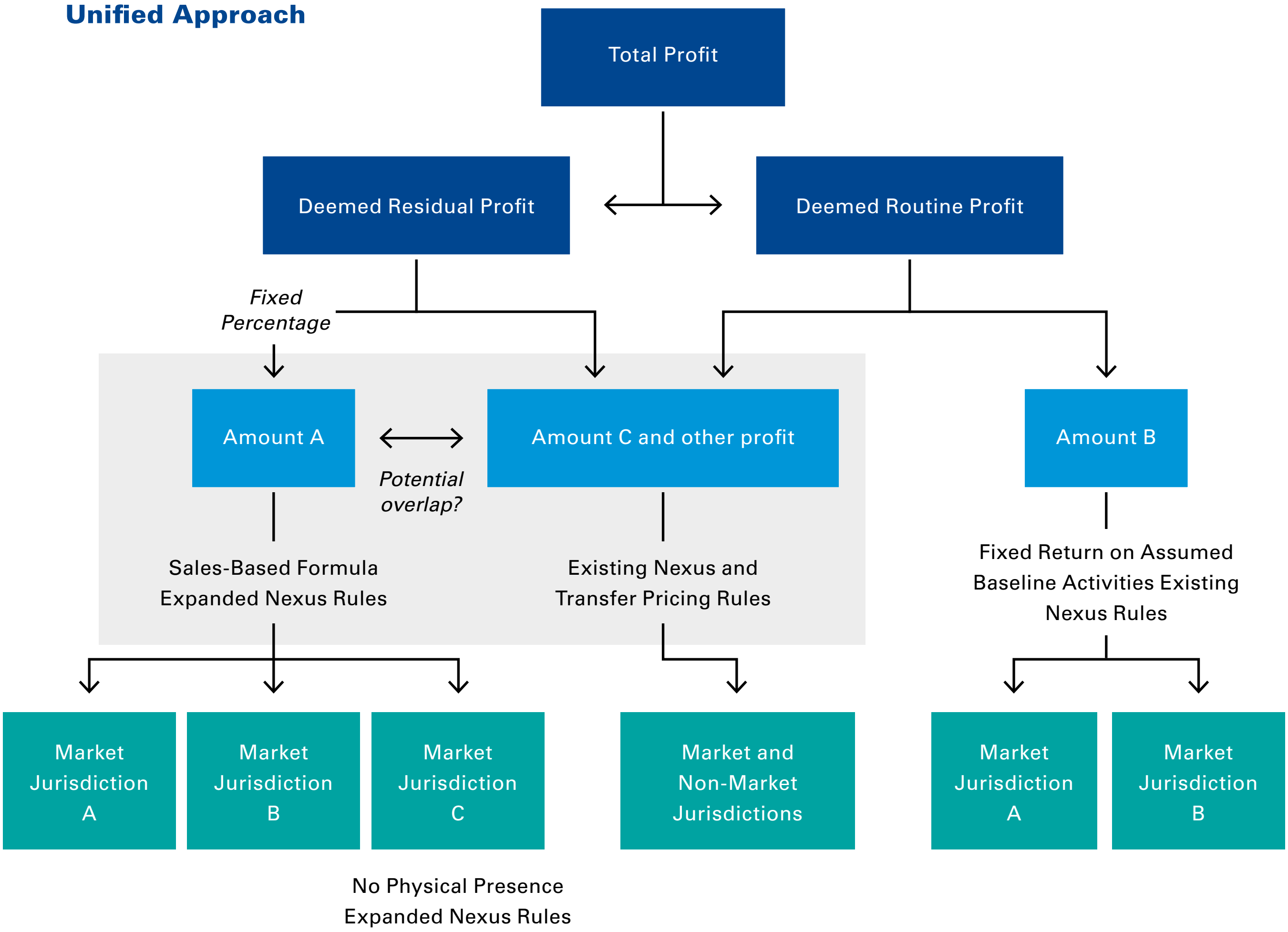
- **Amount B**

  Fixed return for routine functions: under current tax law, the permanent establishments - or subsidiaries - of a multinational, which are involved with marketing and distribution activities, are taxed on the basis of the arm's length principle. With a view to the large number of tax disputes, the introduction of a fixed percentage of the turnover for certain minimum activities is being considered. This will give taxpayers and tax authorities more certainty.

- **Amount C**

  And lastly it is proposed that activities that go beyond the usual marketing and distribution activities (Amount B) or that relate to other operating activities, are remunerated with Amount C, which in turn is allocated to the market jurisdictions. As this rule is based on the arm's length principle, it is essential to avoid the amount falling under the new approach being taxed in both the market jurisdiction and in another country. The OECD has therefore proposed mandatory binding arbitration to settle disputes arising as a result of the Unified Approach.

Unified Approach



"It is difficult to find any logic to the allocation formula. Instinctively, you start with Amount C."

– Participant in the 'BEPS 2.0 Update' roundtable session organised by KPMG Meijburg & Co

Observations on the consultation document

How are losses treated?

The OECD proposal for overhauling the system does not distinguish between profits and losses. The current draft leaves room to allocate losses to various jurisdictions. That also applies to the calculation of Amount A in a situation where the actual profit is less than the routine profit (Deemed Routine Profit), so that the residual profit is negative (Deemed Residual Profit). A mechanism still has to be developed to deal with such losses, with a claw-back or earn-out solution being the most obvious.

Distinction between trade and marketing intangibles

The OECD distinguishes between trade intangibles, such as a smart algorithm, and marketing intangibles, for example a valuable brand and user data. In the Netherlands, for example, the first segment falls within the scope of the Innovation Box - a special regime stimulating innovative activities - while excess profits from marketing intangibles are taxed at the normal rate. One effect of the measures is that part of the Innovation Box profit could possibly be taxed outside the Netherlands.

"A lot depends on the percentage for Amount B. If that is low, companies will move as much turnover as possible to this segment. With this approach, the OECD has opened the door to a debate on turnover segmentation. For example, how should you treat stock promotions? And promotions in general?"

– Participant in the 'BEPS 2.0 Update' roundtable session organised by KPMG Meijburg & Co

Strong focus on dispute resolution indicates a high degree of complexity

Preventing disputes and dispute resolution has been given a prominent place in the OECD consultation document. This indicates that the complexity of the new system is increasing - despite the wish for simplification. Of crucial importance is to find a balance between accuracy and simplicity when taxing Amounts A, B and C. A uniform tax rate may not do justice to the diverse nature of the underlying activities, while segmentation opens the door for arbitration. The disputes arising from this are different from the disputes about the interpretation of the arm's length principle.

Unified Approach: from model to practice

Is there international political support for overhauling the system?

Besides companies and other interested parties, governments also analyse the potential impact of the plans to overhaul the system; an extremely complex task at the macro level. Various governments are currently in discussion with multinationals. These governments are trying to gain a *fingerspitzengefühl* [intuitive understanding] of the actual impact on each company and each sector. If, based on this *fingerspitzengefühl*, countries suspect that the overhaul of the system will result in erosion of the tax base, it will be very difficult to reach a consensus on the actual implementation of the measures.

Gradual implementation can alleviate political concerns

A potential scenario is that any implementation will take place gradually. This will give the various jurisdictions (countries) the chance to see how the overhaul of the system plays out in practice. Based on this practical experience, modifications can be made and the implementation can continue on a step-by-step basis. It will be a major challenge to find sufficient support for this process in all the jurisdictions, with their sometimes opposing interests. Nevertheless, this may be a way of ensuring progress. Doing nothing will lead to further unilateral measures that, without coordination and/or harmonisation, will present even greater challenges.

What timetable does the OECD have in mind?

In November 2019 the OECD also published the consultation document for the second pillar, which proposes a global minimum profit tax. It is based on a letter sent jointly by France and Germany, in which they argue for the introduction of a minimum tax for multinationals. To a certain extent, both countries were continuing along the path that was started in 2004 when they advocated a minimum tax of 15% in the EU in the context of the Interest & Royalties Directive. Germany and France are committed to using the second pillar to tackle issues not adequately addressed in the consensus reached on the BEPS 1.0 package in 2015.

The link between the first and second pillars

Many countries are analysing the potential impact of the first and the second pillar simultaneously. They do so by weighing the advantages and disadvantages of the various packages against one another. As a consequence, both pillars are increasingly being seen in combination. Several member countries of the OECD Inclusive Framework already believe that it is not possible to introduce the first pillar without the second. From this perspective, the publication of the consultation documents on both pillars are a significant development. These documents have received the informal approval of the OECD Inclusive Framework steering committee, composed of 23 important countries representing both the major economies of the West and the emerging markets in Asia and South America.

Consensus within the OECD on three key areas

This illustrates that there is a broad consensus on three important matters. Firstly, there is support for the argument that market jurisdictions/countries must have the right to tax if a company does not have a physical presence in those countries. Secondly, it has been accepted that marketing intangibles and residual profits can form a basis for taxation in the market jurisdictions. And lastly, there is agreement on the need for a new nexus and a new form of profit allocation to implement all this. The OECD hopes to present a framework with the technical details of the Unified Approach in combination with the second pillar in 2020. The next step is to secure support for this framework from the G20 countries in July 2020, which would mean that the first and second pillars could be adopted in their final form during the G20 top in Riyadh (Saudi Arabia) on 21 November 2020.

What timetable does the EU have in mind?

The EU has various options to take the initiative. In the absence of a harmonised introduction of a digital services tax (DST), Italy, France and Spain took the initiative to introduce these rules via unilateral tax legislation, which will take effect at the beginning of 2020.

Impact assessment of the first and second pillars on European Member States

The EU is also expected to publish the assessment of the impact of the first and second pillars on the various Member States. If, in 2020, the G20 countries only adopt the overhaul of the system as a recommendation, rather than politically binding minimum requirements, such as parts of BEPS 1.0, this will open the door for Germany and France to take steps on this within the EU. Germany will take over the presidency of the EU Council in the second half of 2020. The presidency plays an essential role in guiding the legislative and political decision-making process. This role will give Germany the opportunity to, for example, once again place a proposal for an EU DST Directive on the EU agenda. And possibly also an EU legislative package for the harmonised introduction of the second pillar (minimum tax) in the EU.

Information

Would you like to know more about the OECD and BEPS developments and what these mean for your business?
Please feel free to contact your designated contact at KPMG Meijburg & Co or one of our specialists: Robert van der Jagt, Jaap Reyneveld, Vinod Kalloe, Sinan Gelici or Charlotte Straatman.

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