China Tax Alert

Issue 10, February 2020

OECD work on new international tax rules moves to details stage

Regulations discussed in this issue:

- Statement by the OECD/G20 Inclusive Framework on BEPS (IF) on the Two-Pillar Approach to Address the Tax Challenges Arising from the Digitalisation of the Economy, approved by the IF on 29-30 January 2020
- Secretariat Proposal for a Unified Approach under Pillar 1 – Public Consultation Document ('Oct 2019 consultation document'), released on the OECD website on 9 October 2019.
- Programme of Work to Develop a Consensus Solution to the Tax Challenges Arising from the Digitalisation of the Economy ('programme of work'), released on the OECD website on 31 May 2019.

Background

On 31 January 2020 the OECD released on their website a statement by the Inclusive Framework on BEPS (IF). In this statement, agreed after IF meetings in Paris on 29-30 January, IF members affirmed their commitment to reach an agreement on a consensus-based solution to the tax challenges of digitalisation by the end of 2020.

Of particular note is the IF agreement on the path forward for updating the international tax standards on nexus and profit attribution rules. This is Pillar 1 of the IF's two pillar approach; Pillar 2 is a global minimum tax. In October 2019 the OECD Secretariat had put forward specific proposals on this in their 'unified approach' to Pillar 1. The IF members have now agreed to an adapted version of this unified approach as an 'architecture' for new rules, and as a basis for negotiations at the next stage of the process. The goal is for global agreement on the 'key features' of the new rules by July 2020, and on detailed rules by end 2020, though there is no guarantee that this can be achieved. The planned rules would have a major impact on multinational enterprise (MNE) global structures, supply chains and business models, including for China outbound and inbound activity, and developments in coming months should be closely followed.

The unified approach

As explained in several 2019 KPMG China Tax Alerts (Issues 7, 17 and 29), since June 2019 various OECD Working Parties (WPs) have been working through the technical design challenges Pillar 1 and 2. In parallel, the IF Steering Group (SG) countries worked to find a political compromise. For Pillar 1 the focus was on narrowing the gap between separate proposals put forward by the US, UK and India. Not having arrived at a compromise, and in a bid to move the process forward, in October 2019 the Secretariat put forward their proposed 'unified approach' for public consultation. The key features of this are (i) a new tax nexus rule that would give countries taxing rights over foreign enterprises without any physical presence in their markets, and (ii) a new formulaic approach to profit attribution, with the calculation being conducted at the MNE group level. Details can be read in the linked KPMG China Tax Alerts.

In December 2019 matters were further complicated when the US Treasury proposed, in a letter to the OECD, that the Pillar 1 rules could take the form of an elective 'safe harbor' for MNEs. This led to friction with several European countries, in particular with France, which has put in place a new digital services tax (DST) from 2019. A US Trade Representative report, also issued in December 2019, identified the French DST as a discriminatory trade practice and proposed the application of tariffs on French exports to the US. Announcements by various other European countries on their planned adoption of DSTs, and statements of EU Commission support for such countries in the event of US tariff impositions, raised the possibility of a serious tax-trade conflict.

However, talks between the US and French governments, and discussions at the IF meetings in Paris, led ultimately to an interim compromise. The IF members were able to agree upon a set of four documents, being (i) the IF statement reaffirming their commitment to work towards a consensus solution by the end of 2020, (ii) an architecture for the Pillar 1 rules as a basis for negotiation, (iii) an updated programme of work for Pillar 1, and (iv) a progress note on Pillar 2. These documents will be presented to G20 Finance Ministers for their endorsement at their 22-23 February meeting in Saudi Arabia.

In getting to a compromise, a number of modifications and clarifications were made to the October 2019 unified approach proposal:

- The US safe harbor proposal will be explored further, though final decision on it will be deferred until the other elements of Pillar 1 have been fleshed out. Many countries have opposed the safe harbor and Secretariat representatives have stated that it is very unlikely to be a basis for consensus. As such, this is a 'battle deferred' for another day.
- The consumer-facing industry scope of the October unified approach proposal (which included services provided by highly digitalized businesses) has been adjusted. The scope is now said to cover (i) automated digital services and (ii) consumer-facing businesses as two separate categories. This has been accompanied by the inclusion of B2B digital services (e.g. cloud services) within automated digital services. Two different nexus rules have also been proposed. For automated digital services solely a revenue threshold would apply. For consumer-facing businesses nexus 'plus factors' would be used, such as existing physical presence in the market, or targeted advertising.
- Carve-outs are proposed for non-consumer-facing financial services, extractives, shipping and airlines, and some professional services.
- A number of areas of divergence between IF members are highlighted for resolution. These include (i) the degree to which dispute prevention and resolution mechanisms will be binding and their scope, (ii) the potential for Amount A profit allocations to markets to be adjusted to reflect the degree of digitalization of a business (desired by some European countries), and (iii) the potential for Amount A to be adjusted for 'regional factors' (this may relate to market premium adjustments, traditionally favored by China and India).

The detailed programme of work includes eleven work streams, with key features of the rules to be agreed by July, and the technical details to be set by end of 2020. For Pillar 2 it has simply been noted that progress has been made on the technical aspects, with more work to be done.

KPMG observations

The agreement of the IF members on a path forward at their 29-30 January meeting had not been a foregone conclusion. Many commentators had considered a breakdown in negotiations quite possible. Programme of work approval now means that efforts will progress to the next stage.

It is entirely possible that negotiations could hit further roadblocks in the coming months, in view of the ambitious timeframe, and the still large divergences between IF members. While attainment of a global consensus agreement is not assured, the risks of a tax-trade conflict emerging may focus national efforts at reaching a compromise.

In the coming months the detailed rules for Pillar 1 and 2 will be developed, and the OECD Secretariat have promised that further public consultations will be held. Enterprises operating cross-border with China will increasingly be able to evaluate the specific impact on their businesses. They should consequently be in a better position to seek targeted rule refinements. They may also be able to commence advance planning on adapting their accounting and tax risk management systems, as well as adjusting their business structures, for the new rules.

Ongoing, close monitoring is merited in the run up to the next crunch IF meetings in July in Berlin.

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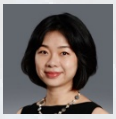

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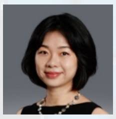

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