



ATAF TECHNICAL NOTE

Inclusive Framework proposals to address the tax challenges from the digitalisation of the economy

1. Introduction

- 1.1 This is the third in ATAF's series of Technical Notes on the tax challenges arising in Africa from the digitalisation of the economy. The second Technical Note CBT/TN/02/2019 titled "*Inclusive Framework proposals to address the tax challenges arising in Africa from the digitalisation of the economy*"¹ provided an overview of the proposals set out in the Public Consultation Document titled "*Addressing the Tax Challenges of the Digitalisation of the Economy*" that might form part of a long-term global consensus-based solution to the broader tax challenges arising from the digitalisation of the economy and the remaining BEPS issues.
- 1.2 Following the public consultation on the proposals, ATAF and several African countries participated in the Inclusive Framework meeting in late May 2019 to discuss the proposals set out in the Public Consultation Document and how the gaps between the different proposals might be bridged. At that meeting the Inclusive Framework agreed a *Programme of Work to Develop a Consensus Based Solution to the Tax Challenges Arising from the Digitalisation of the Economy*.
- 1.3 In early July 2019 the ATAF Cross Border Taxation Technical Committee (CBT Technical Committee) and other ATAF members met with the OECD to discuss in depth the Programme of Work (PoW) and how a consensus based proposal that meets the needs of African countries might be reached. This Technical Note provides a summary of those discussions and ATAF's current views on the issues set out in the PoW to address these challenges through i) new nexus rules, ii) new profit allocation rules and iii) a new global anti-base erosion rule.

2. New nexus rules

- 2.1 As set out in the previous Technical Notes the current nexus rules² only permit a jurisdiction to tax a foreign entity on the profits it generates in the country if the foreign entity's activities create a taxable presence in that country. Such a taxable presence usually requires the foreign entity to have a physical presence in the country.

The digitalisation of the economy is increasingly leading to multinational enterprises (MNEs) being able to "reach" into a jurisdiction and carry out business without any physical presence in that jurisdiction and thus create no taxable presence in that country.

- 2.2 The CBT Technical Committee (CBT) therefore considers that new nexus rules are needed which ensure that such business activities including the value created by user participation are taxable in the market jurisdiction. Such rules will need to be included in a country's domestic tax legislation and require changes to tax treaties.

The CBT considers that the changes to tax treaties should be through a new standalone provision and not through revisions to the existing permanent establishment provisions in Article 5 and 7 of Model Tax Conventions due to the technical complexities of such revisions and the need for consequential revisions to other Articles of Tax Treaties.

- 2.3 The CBT discussed the Programme of Work's proposal that there would need to be an evaluation and development of indicators of an MNE's remote but sustained and significant involvement in the economy of a market jurisdiction and this would require a sustained local revenue threshold and a range of additional indicators including users. The CBT considers that it is vital that the revenue threshold does not disadvantage small African economies by being set at a level that will not create taxing rights in their jurisdiction denying them an opportunity to tax the profits derived from their market through remote business models. Further, the CBT considers that the threshold should not be an absolute number but rather a relative factor for each market jurisdiction. There will also be a need for comprehensive and careful consideration of a range of additional factors (the plus factors under PoW) that might be combined with the local revenue threshold.

¹ <https://www.oecd.org/tax/beps/public-consultation-document-addressing-the-tax-challenges-of-the-digitalisation-of-the-economy.pdf>

² These rules are explained in ATAF Technical Note CBT/TN/01/19

3. New profit allocation rules

- 3.1 The CBT discussed the three proposals set out in the PoW and strongly support the common objective of all of the proposals to allocate more profits to market jurisdictions. This was conceptually and economically appropriate as the rules needed to ensure the profits allocated to market jurisdictions reflect the value created in those jurisdictions through marketing intangibles. For example brands that are reflected in the positive attitude in the mind of customers and have therefore been created in the market jurisdiction. Other marketing intangibles such as building customer relationships are also derived from activities targeted at customers and users in the market jurisdiction, and this supports the treatment of such intangibles as being created in the market jurisdiction.
- 3.2 The new profit allocation rules also need to reflect the value created for MNEs in market jurisdictions obtained through the sustained engagement and active participation of users which is a critical component of value creation for certain highly digitalised businesses.
- 3.3 The CBT considers that the current transfer pricing rules which are based on the arm's length principle are too complex to administer when trying to determine the profits that are created by intangibles which are a significant value creator for many MNEs, particularly for some highly digitalised businesses. The CBT is strongly in favour of the adoption of simplification measures where appropriate. Such measures will assist tax administrations address artificial profit shifting, increase tax certainty and reduce costly and time consuming transfer pricing disputes. However it is important that a principled and sustainable approach is used to determine such simplification measures, and such measures should be as close as possible to a proxy of the arm's length principle.
- 3.4 The CBT strongly supports the proposal in the PoW to develop rules that allocate to market jurisdictions a portion of an MNE's non-routine profits to reflect the value created in the market that is not recognized in the existing profit allocation rules
- 3.5 Using the existing transfer pricing rules and the arm's length principle to determine such non-routine

profit is not appropriate due the complexities of pricing intangibles. Simplification rules should therefore be developed to determine the non-routine profit. Such simplification rules should be used to i) determine the routine profit that is subtracted from the MNE's total profit to determine the non-routine profit and ii) to determine the amount of the non-routine profit that is to be allocated between the market jurisdictions. The adoption of simplification rules will both increase tax certainty and reduce transfer pricing disputes. However the simplification rules should be principled in approach and the determination of the routine profit should be as close as possible to a proxy of the arm's length profits.

- 3.6 The CBT strongly supports the proposal in the distribution based approach that the new profit allocation rule provides a baseline amount of profits attributable to marketing, distribution and user-related activities. Such a rule would be a vital element of the new profit allocation rules and should be in addition to the non-routine profit allocated to the market jurisdiction as set out in section 3.5 above. That baseline amount should be a fixed minimum profit and must not be a safe harbour that include an arm's length let-out³ as such safe harbours are difficult for tax administrations with limited capacity to administer and may lead to artificial profit shifting to low tax jurisdictions. The CBT stressed their strong opposition to any rule that introduced a mandatory safe harbour with an arm's length let out.
- 3.7 The CBT also supports the proposal in the distribution based approach that where there are more functions in the market jurisdiction than are compensated in the baseline activity the baseline profit could increase based on the additional functions. Such an additional allocation of profit should be based on the current transfer pricing principles to ensure as principled an approach as possible for the new rules.
- 3.8 The policy rationale for allocating part of the non-routine profits to market jurisdictions does not generally apply in the case of exported commodities as marketing intangibles are often not

³ A safe harbour is a rule that applies to a defined category of taxpayer or related party transactions and often applies a simplified transfer pricing approach which if used by the taxpayer will exempt that transaction from all or part of the general transfer pricing rules. Where a safe harbour has an arm's length let out the taxpayer has the right to apply a different price where the taxpayer is able to demonstrate that price is consistent with the arm's length principle.

a key value driver for commodities. The CBT therefore considers it is vital that commodities are excluded from the new profit allocation rules.

- 3.9 The CBT recognises the need to develop robust and effective tax dispute resolution mechanisms but does not support this being by mandatory arbitration.

4. Global anti-base erosion (GloBE) proposal

- 4.1 The PoW notes that the proposal seeks to address the remaining BEPS challenges through the development of two inter-related rules:

i. **an income inclusion rule** that would tax the income of a foreign branch or a controlled entity if that income was subject to tax at an effective rate that is below a minimum rate; and

ii. **a tax on base eroding payments** that would deny a deduction or impose a source-based taxation (including withholding tax) together with any necessary changes to double tax treaties for certain payments unless the payment was subject to tax at or above the minimum rate.

- 4.2 These rules would be implemented by way of changes to domestic law and tax treaties and would incorporate a co-ordination or ordering rule to avoid the risk of economic double taxation.

- 4.3 The combined rules are intended to affect behaviour of taxpayers and Government tax policy on matters such as the granting of tax incentives. This is expected to limit the impact of the rule order on tax collection in jurisdictions.

- 4.4 The PoW will explore an inclusion rule that would impose a minimum tax rate noting that this approach would be consistent with a policy of establishing a floor on tax rates by ensuring that an MNE would be subject to tax on its global income at the minimum rate regardless of where it was headquartered.

- 4.5 The second key element of the proposal is a tax on base eroding payments and the work programme states that this would complement the income inclusion rule by allowing a source jurisdiction to protect itself against the risk of base eroding payments. This element of the proposal will explore:

- an undertaxed payments rule that would deny a deduction or impose source-based taxation (including withholding tax) for a payment to a related party if that payment was not subject to tax at a minimum rate; and
- a subject to tax rule in tax treaties that would only grant certain treaty benefits if the item of income was subject to tax at a minimum rate.

- 4.6 The CBT noted that the proposal will explore the nature, extent and operation of the adjustment to be made under the rule. The CBT is of the view that this work will need to consider carefully whether the adjustment would be limited to the minimum effective tax rate and the impact of such a limitation on taxpayer behaviour on profit shifting out of jurisdictions with effective tax rates that might be significantly higher than the minimum effective rate.

The CBT has concerns regarding the ordering of the global anti-base erosion rules where the income inclusion rule might be implemented first yet most of the base eroding payments would arise from source jurisdictions. A more appropriate approach would be to implement the Subject to Tax rule first as it would not be restricted to related party payments and will be straightforward to implement through the already effective withholding tax mechanism. This rule will help to address the current imbalance in allocating taxing rights between residence and source jurisdictions.

- 4.7 ATAF Technical Note CBT/TN/01/19 highlighted to ATAF members that under the global anti-abuse pillar of work, a minimum effective tax rate test may lead to another jurisdiction taxing the income of taxpayers who benefit from a tax incentive regime in a country and that ATAF members should review their tax incentive regimes and policies to evaluate the impact that a minimum effective tax rate test might have on their effectiveness. The CBT noted that the work programme will explore the possible use and effect of exclusions (carve outs) for tax incentive regimes from the rules. As the issue of tax incentive is a cross government agency issue in many African countries the CBT members will bring this matter to the attention of relevant