



TECHNICAL NOTE

Inclusive Framework issues Statement on the Two-Pillar Approach to Address the Tax Challenges Arising from the Digitalisation of the Economy

1. Introduction

1.1 This is the fifth in ATAF's series of Technical Notes on the tax challenges arising in Africa from the digitalisation of the economy. The fourth Technical Note CBT/TN/04/2019 titled ***“The changes needed to the global tax rules if Africa is to address the tax challenges arising from the digitalisation of the economy”*** provided an overview of the conclusions of the in-depth discussions of the ATAF Cross Border Taxation Technical Committee (CBT) in October 2019 on the current Inclusive Framework proposals. The CBT identified the key policy issues for Africa and the key recommendations that ATAF will make to the Inclusive Framework on the changes that are needed to the current global tax rules.

1.2 On 23rd and 24th January the CBT met in Pretoria, South Africa, to discuss the upcoming Inclusive Framework meeting taking place in Paris on 29th and 30th January. The CBT discussed the OECD Secretariat's Unified Approach proposals on Pillar One and the work being done on Pillar Two.

1.3 The outcomes of the CBT discussions were shared with all of the African delegates participating in the Inclusive Framework meeting to assist them in making their interventions at that meeting.

2. Unified Approach on Pillar One

Introduction

2.1 At its January 2020 meeting the Inclusive Framework agreed that the Unified Approach will be the basis for a new nexus rules and new profit allocation rules. The Unified Approach endorsed by the Inclusive Framework is largely based on the ***Unified Approach proposed by the OECD Secretariat in October 2019***.

2.2 It is expected that any consensus-based agreement must include a commitment by members of the Inclusive Framework to implement this agreement and at the same time to withdraw relevant unilateral actions.

2.3 A key discussion at the meeting was the U.S. safe harbour proposal which would mean that multinational enterprises (MNEs) could elect whether to be subject to the new nexus and profit allocation rules. Many countries expressing concerns about the feasibility of such an approach, but the Inclusive Framework agreed that the final decision will be taken after other elements of the consensus-based solution have been agreed upon. The Inclusive Framework members will carry out further work

ATAF shares the concerns of many Inclusive Framework members that a safe harbour regime, whereby MNEs could elect out of being subject to the new rules, would seem to make the rules tantamount to a voluntary tax which would not be workable in practice.

on the feasibility of the proposal.

2.4 The unified approach is designed to adapt the current taxing rights by taking into account new businesses models and thereby expand the taxing rights of market jurisdictions (which, for some business models, is the jurisdiction where the user is located). The approach proposes three types of taxable profit that may be allocated to a market jurisdiction:

- **Amount A**

A share of residual profit allocated to market jurisdictions using a formulaic approach applied at an MNE group (or business line) level. This new taxing right can apply irrespective of the existence of physical presence, especially for automated digital services. It reflects profits associated with the active and sustained participation of a business in the economy of a market jurisdiction, through activities in, or remotely directed at that jurisdiction, and therefore constitutes the primary response of the unified approach to the tax challenges of the digitalisation of the economy.

- **Amount B**

A fixed remuneration based on the arm's length principle for defined baseline distribution and marketing functions that take place in the market jurisdiction.

- **Amount C**

The return under Amount C covers any additional profit where in-country functions exceed the baseline activity compensated under Amount B. A further aspect of Amount C is the emphasis it

gives to the need for improved dispute resolution processes. The scope of Amount C is still being discussed and considered as a critical element in reaching an overall agreement on Pillar One.

The New Taxing Right (Amount A)

2.5 Amount A allocates a portion of the residual profits of a business to market jurisdictions. The amount allocated is over and above the arm's length return that might be allocable to in-market activities such as baseline marketing and distribution but is not an additional remuneration in respect of those same in-market activities.

2.6 The Unified Approach states that the new taxing right will be broadly relevant to two types of business.

2.7 Automated and standardised digital services provided to a large and global customer or user base. These are businesses that, in general, are able to provide digital services remotely to customers in markets using little or no local infrastructure. In these situations, they generally benefit from exploiting powerful customer or user network effects and generate substantial value from interaction with users and customers.

2.8 Other businesses that generate revenues from selling goods or services, whether directly or indirectly, to consumers (i.e. consumer facing businesses). This is a broad set of businesses that includes traditional businesses that have been disrupted to a lesser degree by digitalisation, e.g. businesses that manufacture physical products,

sell those products through physical distribution channels and support sales with less sophisticated marketing methods such as television and banner advertising.

2.9 Further work will be required on the definition of an automated digital service and a consumer facing business.

2.10 Extractive industries and other producers and sellers of raw materials and commodities will not be within the consumer-facing definition, even if those materials and commodities are incorporated further down the supply chain into consumer products.

2.11 The proposal states that most of the activities of the financial services sector (which includes insurance activities) take place with commercial customers and will therefore be out of scope. It is also stated that there is a compelling case for the consumer-facing business lines such as retail banks and insurance within financial services businesses to be excluded from scope given the impact of prudential regulation and, for example, bank/insurance licensing requirements that are designed to protect local deposit/policy holders in the market jurisdiction. The Unified Approach considers that this typically ensures that residual profits are largely realised in local customer markets and therefore justifies that these activities should be excluded from scope.

2.12 It is also considered inappropriate to include airline and shipping businesses in the scope of the new taxing right.

Thresholds

2.13 The new taxing right will operate with a number of thresholds. First, it will be limited to MNE groups that meet a certain gross revenue threshold. The paper states that this threshold could, for instance, be the same as for Country-by-Country (CbC) reporting (i.e. MNE groups with gross revenue exceeding €750 million). Second, even for those MNE groups that meet the gross revenue threshold a further carve-out will be considered where the total aggregated in-scope revenue is less than a certain threshold. Third, consideration will be given to a carve-out for situations where the total profit to be allocated under the new taxing right would not meet a certain de minimis amount.

Members have reported differing views to ATAF on the issue of monetary thresholds. Some of our members are concerned that many of their taxpayers may be subsidiaries of MNE groups with turnover of less than €750 million and will therefore lose vital tax revenue if the threshold is set at that level. ATAF will be carrying out research with its members to assess the impact of such thresholds on member countries.