Remaking Transfer Pricing for the Digital Age:
Part One

ABA Fall Tax Meeting
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Panelists

• **Liz Chien**, Ripple Labs Inc.
• **Young Ran (Christine) Kim**, University of Utah SJ Quinney College of Law (moderator)
• **Olivia Long**, Matheson
• **Mike McDonald**, Ernst & Young LLP
• **Marissa Rensen**, IRS Office of Associate Chief Counsel (International)
Agenda

• Updates on the OECD Work
• Proposals in Pillar 1
• A Unified Approach (forthcoming in Oct. 2019)
• European Updates
• Implications for Transfer Pricing
Updates on the OECD Work
# BEPS 1.0: Why isn’t it sufficient?

## Overview of the project

### Coherence

- **Harmful or inappropriate use of international tax legislation to obtain unintended tax benefits**

  - Action 2: Hybrid mismatch arrangements
  - Action 3: Controlled foreign corporation (CFC) rules
  - Action 4: Interest deductions
  - Action 5: Harmful tax practices

### Substance

- **Mismatches where profits are being taxed vs. where people responsible for generating these profits are located**

  - Action 6: Preventing tax treaty abuse
  - Action 7: Avoidance of permanent establishment (PE) status
  - Action 8: Transfer pricing (TP) aspects of intangibles
  - Action 9: TP/aspects of risk and capital
  - Action 10: TP/aspects of high-risk transactions

### Transparency

- **Provide tax authorities information to carry out audits better and determine if fair share of taxes are being paid**

  - Action 12: Disclosure rules
  - Action 13: TP documentation and country-by-country reporting
  - Action 14: Dispute resolution

### Analytical

- Action 1: Digital economy
- Action 11: Methodologies and data analysis
- Action 15: Multilateral instrument
**BEPS 1.0: Why isn’t it sufficient?**

Overview of the project – outcomes

- Final BEPS reports were issued by the OECD on October 5, 2015.
  - Endorsed by G20 Finance Ministers on October 8, 2015.
  - Approved by G20 Leaders on November 15–16, 2015

- Recommendations for domestic law and treaty provisions in variety of forms:
  - There are also analytical reports (namely, Action 1, 11 and 15)
  - Some measures may have (almost) immediate effect in a number of countries.

<table>
<thead>
<tr>
<th>Immediate impact</th>
<th>Treaty-based action</th>
<th>Legislative action</th>
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<tbody>
<tr>
<td>Action 8 – Transfer pricing for intangibles</td>
<td>Action 2 – Hybrid mismatch arrangements</td>
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<td>Action 9 – Transfer pricing for risks and capital</td>
<td>Action 6 – Treaty abuse</td>
<td>Action 3 – Controlled foreign corporation rules</td>
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<td>Action 10 – Transfer pricing for other high-risk transactions</td>
<td>Action 7 – Avoidance of PE status</td>
<td>Action 4 – Interest deductions and other financial payments</td>
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<td>Action 13 – Transfer pricing documentation and CbC reporting</td>
<td>Action 14 – Dispute resolution</td>
<td>Action 5 – Harmful tax practices</td>
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*Can be implemented through the Multilateral Convention on BEPS (MLI) and / or bilaterally*
Inclusive framework on BEPS

Membership

129 BEPS members, including....

- Andorra
- Angola
- Argentina
- Australia
- Austria
- Barbados
- Belgium
- Belize
- Benin
- Bermuda
- Botswana
- Brazil
- British Virgin Islands
- Brunei Darussalam
- Bulgaria
- Burkina Faso
- Cameroon
- Canada
- Cayman Islands
- Chile
- China
- Colombia
- Congo
- Costa Rica
- Cote d’Ivoire
- Croatia
- Curaçao
- Czech Republic
- D.R. Congo
- Denmark
- Djibouti
- Egypt
- Estonia
- Finland
- France
- Gabon
- Georgia
- Germany
- Greece
- Guernsey
- Haiti
- Hong Kong
- Hungary
- Iceland
- India
- Indonesia
- Ireland
- Isle of Man
- Israel
- Italy
- Jamaica
- Japan
- Jersey
- Kazakhstan
- Kenya
- Latvia
- Liberia
- Liechtenstein
- Lithuania
- Luxembourg
- Macao
- Malaysia
- Malta
- Mauritius
- Mexico
- Monaco
- Montserrat
- Netherlands
- New Zealand
- Nigeria
- Norway
- Pakistan
- Panama
- Papua New Guinea
- Paraguay
- Peru
- Poland
- Portugal
- Romania
- Russia
- San Marino
- Saudi Arabia
- Senegal
- Seychelles
- Sierra Leone
- Singapore
- Slovakia
- Slovenia
- South Africa
- South Korea
- Spain
- Sri Lanka
- Sweden
- Switzerland
- Thailand
- Turkey
- Turks and Caicos Islands
- Ukraine
- United Kingdom
- United States
- Uruguay
- Vietnam

* Countries in the 2019-20 Steering Group of the Inclusive Framework in red
Developments since BEPS *Action 1* Report

- March 2018 *Interim Report* on Tax Challenges Arising from Digitalisation
- January 2019 *Policy Note* on Addressing the Tax Challenges of the Digitalisation of the Economy
- February–March 2019 *Public Consultation Document* on Addressing the Tax Challenges of the Digitalisation of the Economy
- May 2019 *Programme of Work* to Develop a Consensus Solution to the Tax Challenges Arising from the Digitalisation of the Economy

**Policy Note – January 2019**

“*Addressing the Tax Challenges of the Digitalisation of the Economy – Policy Note*”

- **Agreement to examine proposals involving two pillars** which could form the basis for consensus
  - **Proposals going beyond the arm’s length principle**
  - Should not result in taxation when there is no economic profit nor should they result in double taxation
  - Stresses the importance of tax certainty and effective dispute prevention and dispute resolution tools
Reaction to the reaction

• Substantive issues were deferred
• Impatience and dissatisfaction with status quo led to unilateral actions
• Inputs to “digitalized” business model highly mobile
• US reaction
  • Concern about measures that target US multinationals
  • Concern about more systematic use of unilateral measures could undermine an international tax system that works best on the basis of consensus
  • Support broader measures beyond digital companies
• OECD now going back to drawing board to have another go at consensus-based solution, and as part of that to look at things more broadly
May 2019 OECD Programme of Work

• The OECD Programme of Work (Workplan) introduced specifics with respect to the two pillar proposals.
• Primary stated goal is to address tax challenges of digital economy
  • However proposals extend beyond digital economy
• Significant changes proposed
  • Nexus rules and taxation rights
  • Movement away from separate entity to group-wide approach
  • Profit attribution that goes beyond the arm’s-length principle
  • Assumptions about value creation
  • Global anti-base erosion proposal (global minimum tax)
The two pillars approach

1. **Allocation to Markets**

   - **Nexus**
     - Rules that determine jurisdiction to tax a non-resident enterprise
   - **Profit allocation**
     - Rules that determine the relevant share of the profits that will be subject to taxation

   - On nexus, market jurisdictions would have the right to tax even in the absence of traditional nexus
   - All profit allocation proposals involve solutions that go beyond the arm’s-length principle.

2. **Global Minimum Tax**

   - Global anti-base erosion proposal (right to ‘tax back’ where other jurisdictions have not exercised their primary taxing rights).
   - The proposal has two components: an income inclusion rule and a tax on base-eroding payments.
   - A related co-ordination rule would mitigate the risk of double taxation.
Proposals in Pillar One
## Allocation of taxing rights
### Interpretative trends and legislative transformation

### Pillar 1

<table>
<thead>
<tr>
<th>Pre BEPS</th>
<th>BEPS</th>
<th>Post BEPS</th>
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</thead>
<tbody>
<tr>
<td>Separate entity approach</td>
<td>Recognition of separate entities conditional based on conduct and substance</td>
<td>Moving towards group-wide approaches to taxation?</td>
</tr>
<tr>
<td>Nexus rules within separate entity</td>
<td>Activity-based PE concepts strengthened</td>
<td>Virtual PE concepts</td>
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<tr>
<td>Profit allocation</td>
<td>Arm’s length principle and the use of one-sided methods</td>
<td>(Residual) profit splits or market returns or global formulary apportionment</td>
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### Pillar 2

<table>
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<tr>
<th>Allocation of taxing rights with double/minimum taxation rules</th>
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<tbody>
<tr>
<td>Domestic sovereignty to determine tax base and rate</td>
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<tr>
<td>Domestic sovereignty to determine tax base now limited by OECD/G20 minimum standards and ATAD. Still sovereignty on tax rate</td>
</tr>
<tr>
<td>Additional global standard on minimum tax rate?</td>
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- **Global norm based on fixed place PE concepts**
- **Arm’s length principle and the use of one-sided methods**
- **Activity-based PE concepts strengthened**
- **Arm’s length principle and multi-sided perspective based on conduct instead of contracts. Rebuttable presumptions**
- **Virtual PE concepts**
- **(Residual) profit splits or market returns or global formulary apportionment**
# Pillar 1
Revised nexus and profit allocation rules

## 3 proposals

<table>
<thead>
<tr>
<th>Proposal</th>
<th>Description</th>
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<tbody>
<tr>
<td>1</td>
<td>The ‘Modified RPSM’ proposal</td>
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<tr>
<td>2</td>
<td>The ‘distribution-based’ proposal</td>
</tr>
<tr>
<td>3</td>
<td>The ‘fractional apportionment’ proposal</td>
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## Common aspects

- Allocating more taxing rights to the jurisdiction of the customer and/or user (the market jurisdiction)
- Finding of nexus in the absence of physical presence
- The possibility of simplifying conventions

## 3 building blocks

<table>
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<tr>
<td>1</td>
<td>New profit allocation rules</td>
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<tr>
<td>2</td>
<td>New nexus rules</td>
</tr>
<tr>
<td>3</td>
<td>New market jurisdiction taxing right</td>
</tr>
</tbody>
</table>
# Pillar 1
## Taxing rights and profit allocation

### Step 1:
- Determine the new taxing right by virtue of presence in a country
- Distinct from existing permanent establishment (PE) rules and Article 7
- Presence determined by customers, users or other measures of ‘market access’

### Step 2 - Methods:
- Identify new methods of profit allocation to this new taxing right
- Methods extend beyond arm’s-length principle (ALP)
- Methods that extend beyond the Authorized OECD Approach (AOA), which is aligned with ALP

### Step 3 - Application:
- Allocation of the taxing right
- Possible application of formulary methods
- Focus on dispute resolution and elimination of double tax

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**OECD’s stated purpose:**
- **to define a new taxing right**
- **to redefine profit allocation beyond ALP**
- **simplicity, certainty**
New profit allocation rules under Pillar 1
OECD workplan

Starting point is group/segment or legal entity (LE) or aggregated LE profit

Determine routine profits using existing transfer pricing methods or statutory ratios

Develop rules to allocate residual profit to markets vs. other intangibles
  - Sales
  - Capitalized costs
  - Future income projections
  - Fixed percentages

Allocation of residual profit to markets using allocation keys e.g., revenues, employees, assets, users

Requires robust dispute resolution mechanisms to avoid double taxation
New profit allocation rules under Pillar 1
OECD workplan

Distribution approaches

► Development of safe harbors that specify minimum profits for distribution/sales functions
► Minimum market profits could rise/fall(?) with group profits
► Minimum profits would be lower for remote access vs. markets with functions/people presence
► Some consideration for level of costs incurred for local marketing
Pillar 1: practical (still unresolved) issues

1. Basic Approach to determine ‘New Taxing Right’
   - “Top Down” versus “Bottom Up” Approaches
   - “Principled” versus safe harbor versus formulary
   - Incremental tax in jurisdiction versus minimum tax in jurisdiction

2. Income computation basis
   Should tax base for computing income be linked to:
   - Global (MNC) income?
   - Financial reporting or tax reporting?
   - Presumed local distribution return?
   - Separate calculations for regions/business units?
   - Commercial profits for financial reporting?

3. Relationship to arm’s length principle
   - Haircut approach?
   - What mechanism ensures zero sum aggregate adjustments?
   - Standardized formula versus arm’s length tools?

4. Withholding taxes impact
   - Should withholding taxes on royalties still apply if marketing profits are now allocated to a market jurisdiction outside where the commercial profits are booked?

5. Nexus standard
   - Which countries get a piece of the pie? Who wins, who loses?
   - How to identify the taxpayer in jurisdictions where MNE has no physical presence? Ultimate parent?
   - Should there be sector exemptions?
     - B2B
     - Financial services

6. Dispute resolution
   - Uniform application of ‘new taxing right’ across all jurisdictions?
   - How to provide for multi-sided rather than bilateral dispute resolution?
A Unified Approach
(forthcoming in Oct. 2019)
European Updates
The work of the EU

• Ideal solution – extension of PE concept to include significant digital presence

• Profit allocation – ALP having regard to functions, assets, risks (including DEMPE) and economically significant activities

• This proposal was not progressed
The work of the EU (ctd)

3% DST

An interim tax of 3% on revenues made from three main types of services, where the main value is created through user participation.

- Online placement of advertising
- Sale of collected user data
- Digital platforms that facilitate interactions between users

... and provided by businesses with:

- Total annual worldwide revenue above: 750 M€
- Total annual revenue from digital activities in the EU above: 50 M€
March 2018: two EU proposals launched (digital PE and DST)

March 2019: EU fails to reach agreement on DST

July 2019: Ursula von der Leyen retains taxation of ‘big tech’ on EU agenda

June 2019: No consensus position on OECD work

- Only DST proposal is progressed
- Led by France with support from Spain, Italy, Greece, Poland, Portugal, Belgium, UK, Slovakia,
- Opposition: Ireland, Finland, Denmark, Sweden
European Country positions

**France:** leading the charge; keen to tax the GAFA; introduced DST; retroactive effect; US arrangement

**Sweden:** doubts assumptions about where value is created in highly digitised business models

**Slovakia:** introduced digital PE concept in 2018

**Germany:** Ostensibly supportive of pillar 1 work

**UK:** 2% DST announced; most sustainable solution will be at OECD; understood to be driving the ‘user participation’ nexus

**Ireland:** acknowledgement that change is coming; any allocation to market jurisdictions should be modest and targeted; aligned with existing transfer pricing rules

**Slovakia:** introduced digital PE concept in 2018

**Austria:** 5% digital advertising tax proposed

**Czech Republic:** 7% DST proposed

**Spain:** 3% DST proposed

**Italy:** 3% DST proposed

**Poland:** evaluating DST
European taxpayer positions

- **Santander**: supportive of change; does not expect to be impacted by change; supportive of significant economic presence proposal

- **International Hotels Group**: broadly supportive of change; need more precise delineation of intangibles targeted; difficulties with RPSM

- **AstraZeneca**: scope of project too broad and should target only highly digitalised business models not pharmaceuticals where value is driven by R&D

- **Volvo**: do not consider ring-fencing to be appropriate or even possible, focus on practicalities of agreeing profit splits and delaining with TP disputes
European taxpayer positions (ctd)

- **Booking.com**: opposes attempts to ring-fence digital economy; advocates in favour of marketing intangibles proposal
- **BlaBlaCar**: supportive of change; supportive of significant economic presence proposal; profit allocation must be based on functional analysis
- **Spotify**: oppose any attempt to ring-fence digital economy; somewhat supportive of marketing intangibles proposal; valuing non-routine functions will be problematic
- **Zalando**: opposes attempts to ring-fence digital economy; tax should be levied on profits not revenues; tax should not be levied twice
Implications for Transfer Pricing
## Implications for Transfer Pricing

### Transfer Pricing Rules in General
- Relevance of the arm’s-length principle (e.g., prescriptive methods, hard to value intangibles, Treasury’s “10 by 10” Pillar 1 proposal)?
- In current environment, does transfer pricing contribute to greater uncertainty for taxpayers?
- Is the natural evolution of international tax towards prescriptive methods and possibly, global formulary?
- Shelf life of transfer pricing as we know it?

### Implications for the US TP rules
- How will the Unified Approach be implemented in the U.S.?
  - Will a change in law be needed?
  - How will our treaties be affected?

### Global Implications
- Identifying the ‘surrender’ company / jurisdiction
- How will the multilateral solution interact with existing bilateral treaties and processes?
- Impact on APAs being agreed now
Questions?

Thank you.