Pillar One and the arm's length principle

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1. Introduction

The tax challenges raised by the Digital Economy have triggered high dynamics in the International Tax environment. The recent Organization for Economic Cooperation and Development (OECD) publications of the Pillar One and Pillar Two Blueprints are a clear example of this global phenomenon. The aim of this transfer pricing alert is to raise awareness on the design elements of Pillar One from a transfer pricing perspective. This Pillar aims to allocate new taxing rights of non-routine income (Amount A) to market jurisdictions, even in absence of physical presence (e.g. scale without mass), and routine income (Amount B), via the introduction of a new set of tax rules potentially operating on top of the existing ones.

In this alert we will i) from a bird's eye view set the scene regarding the international digital economic, business and tax environment, with a specific focus on the new taxation rights and approach addressed by the OECD in the Pillar One Blueprint, ii) explain some of the interactions between Pillar One and transfer pricing and iii) outline how we as PwC can help you navigate through the landscape and the possible impact of the proposed overhaul of the current direct tax system by Pillar One. However, we will first set out below ten relevant questions you should ask yourself when navigating through the various elements of Pillar One, in order to assess its potential impact on your current and future business, supply chain and transfer pricing set-up.

2. Ten relevant Pillar One questions to ask yourself

1. Could your business be in scope for the application of Pillar One Amount A (i.e. consumer-facing business ("CFB") or automated digital services ("ADS"))?
2. Does your business obtain revenues from ADS activities in market jurisdictions where it currently has no taxable presence?
3. Do you have the required insights into i) your company's current transfer pricing policies, ii) the income allocation relating to non-routine intangibles and iii) the utilization of Research & Development / Intangible Property / Patent regimes within your group in order to determine the possible non-routine income shift under Amount A?
4. Are you able to identify your Group's "paying entities" in order to determine the financial tax effects of Pillar One's Amount A and Amount B?
5. Is your current arm's length principle ("ALP") based (non)-physical presence in market jurisdictions (e.g. limited risk distributors, commissionaires, agents, fully fledged distributors, etc.) still strategically and operationally efficient and effective from a business perspective whilst anticipating Pillar One?
6. How would Pillar One impact the remuneration agreed upon under your multi- / bi- / unilateral Advance Pricing Agreements ("APAs")?
7. What will be the Pillar One financial tax impact of the possible different economic life cycles between your markets given possible cross-subsidization between profitable and less profitable/loss-making markets?
8. How will the tax treatment of losses (at group level, paying entity level and "in-market" entity level) under Pillar One impact your group's financial statements? Have these been recognized and will they continue to be recognized?
9. Are you comfortable that you have the required insights on the impact of Pillar One on your group-wide effective tax rate (ETR) and overall cash tax cost to inform your stakeholders?
10. Can you fulfill the main compliance requirements based on your current reporting systems such as having consolidated financial accounts segmented by business lines or clear internal reporting of in-market revenue and income?

3. Setting the scene

Although the advent of the digitalisation of the economy was pioneered by digital giants, today accelerated technological developments have led to substantial changes in business models throughout almost all industries. Remote digital-based interaction without physical presence (scale without mass), utilization and analysis of big data are becoming a common, integral feature of running a business. However the current tax rules do not seem fully equipped to keep up with these developments. In order to relieve the current international tax system of the pressure on its current merits caused by the worldwide digitalisation, new tax principles are being brought forward. From a transfer pricing perspective at least the following concepts are interesting:

1. The concept of recognizing taxable value contributions / value creation outside the MNE's own supply chain, even in absence of actual local physical presence, i.e. value deriving from external resources such as customers / users. Such a concept could to an extent limit the impact of scale with mass and allocate more taxable income to markets. This concept is not captured by the current tax system based on nexus and the ALP, according to which sourcing rules determining income taxation only consider value creating factors within the MNEs own supply chain based on (people) functions performed, assets employed and risks incurred; and

2. The ALP needs to advance to deal with the continuous evolution of technology and digitalization where the value of big data and its analytics within the MNE's value chain need to be carefully recognized, quantified and priced based on a precise delineation of the intercompany transaction / intracompany dealing in order to establish an arm's length allocation and taxation of business profits between standalone entities which are part of an MNE. This latter concept will not be further discussed in this alert.

OECD's Pillar One Blueprint

One of the possible solutions on the table to address the impact and consequence of the digitalisation of the global economy are the OECD's Pillar One and Pillar Two Blueprints, released by the OECD on 12 October 2020, after years of research and political debates with various stakeholders, including publications of interim reports and consultations.

- Pillar One, providing an initial framework which combines technical elements from previous solutions (i.e. marketing intangibles, user participation and significant economic presence) and whose scope includes digital companies (ADS) and CFBs. Pillar One recognizes three core components:

    - Amount A: a new taxing right for market jurisdictions which are allocated a share of a MNE's residual (non-routine) profit being reallocated, even without any physical nexus or with low local substance;

    - Amount B: a fixed return for certain baseline marketing and distribution activities taking place physically in a market jurisdiction (with the outcomes consistent with the ALP);

    - Processes to improve tax certainty through effective dispute prevention and resolution mechanisms.

- Pillar Two which would introduce a global minimum tax that would address remaining issues linked to base erosion and profit shifting (BEPS 2.0) by MNEs (out of scope for this alert).

We note that the Pillar One Blueprint is currently under discussion and its design may still change. The OECD however, is committed to publishing a final report, including a draft for legislative implementation by mid-2021.The OECD hosted a public consultation meeting on January 14-15 this year, which focused on the key questions identified in the Pillar One Blueprint and raised in the written submissions received as part of the consultation process. Although wide ranging views on the various design elements of Pillar One have been expressed by various jurisdictions, part of the OECD / G20 Inclusive Framework and other stakeholders, a very clear message has been given to the OECD: the current design of Pillar One is too complex and simplification is required. The public consultation summary prepared by PwC Tax Policy Globally, outlining some of the main items discussed as part of the consultation, can be accessed here.

Irrespective of whether the OECD will be successful in reaching consensus on Pillar One, the general trend is clear: the in-market cash tax costs are likely going to increase and ETRs may be volatile especially for larger, centralized and profitable digitized MNEs. Many jurisdictions are convinced of the non-routine value of their markets & users and will be looking for additional tax revenue to recover from the COVID-19 pandemic expenditure. The assessment of additional tax may occur under different scenarios: via a multilateral implementation of Pillar One, via unilateral or multilateral measures such as Digital Services Taxes, by updating / amending the current tax system (i.e. virtual permanent establishment ("PE")) including the ALP, or even a combination of measures, to increase the current income allocated to in-market (digital) activities.[1]

4. Initial transfer pricing considerations on Pillar One

In the section below we will set out specific initial transfer pricing considerations with respect to the current proposed Pillar One Blueprint. We will provide considerations on Amount A and B.

Amount A

- Recognition of non-routine value created outside the MNE's supply chain by in-market customer/users is, in its design a new concept in comparison to the current OECD Transfer Pricing Guidelines, which deviates from source state taxation rules based on physical presence as well as the more recent doctrine of control over Development, Enhancement, Maintenance, Protection and Exploitation (DEMPE) of intangibles introduced in the BEPS project. Pillar One's design entails an allocation of a portion of taxable income to market jurisdictions on the basis of the contributions of customers / users to value creation;

- Amount A overlays some of the current transfer pricing concepts. For instance, the identification of the "paying entities" for the purpose of Amount A entails the performance of a functional analysis outlining the entities in the group that are economically entitled to residual profits under the ALP. In addition, transfer pricing adjustments resulting in the recharacterization of certain entities within the MNE or in substantial reallocation of business profits between related parties will have spillover effects on the allocation of the Amount A, increasing the risk of double taxation;

- The application of Amount A could lead to a result where a portion of non-routine profits is allocated to market jurisdictions. Depending on the final agreement on Amount A, under the ALP, a similar financial outcome may only be achieved by having in-market, fully-fledged distributors;

[1] For more details about the Pillar One Blueprint, it is possible to get access to the document clicking here. If you are curious about taxation of globalization and digitalization of the economy under a broader spectrum you can click here to get more information.

- In case “in-market” activities will stay limited (i.e., as in a centralized business model), the introduction of Amount A will likely entail a shift of the ETR for the group;
- The tax liability stemming from Amount A is determined on the basis of financial results achieved at Group level. Thus, with the current design of Amount A, it is possible to have tax liability in a country for Amount A even in case of ALP-based loss-making activities, as Amount A is determined by purely considering the global MNE’s profit;
- Capital gains may not be recognized for the determination and allocation of Amount A. Consequently, it may not be possible to offset exit taxes levied by market jurisdictions relating to business restructurings against the portion of Amount A allocated to the market.

Specific considerations for decentralized business models

- The application of Amount A to decentralized business models (i.e. business models where non-routine profits are already allocated to market jurisdictions) could lead to cases where taxable income is reallocated from profitable entrepreneurial markets to less profitable entrepreneurial markets;
- Assessing in-market substance to identify one of the possible carve-outs proposed by the OECD is of key importance.

Amount B

- A functional analysis based on the OECD Transfer Pricing Guidelines will be essential to determine whether an entity has the functional profile described by the Blueprint and hence, it is in scope of Amount B;
- The scope of Amount B will not necessarily coincide with the scope and threshold limitations of Amount A;
- A question remains on whether Amount B is intended to only be applied to physical distribution activities or whether it is intended to also include more digitalised business models as part of the scope, for example by including entities which only perform marketing activities in market;
- Switching from the current system to Amount B may require adjusting the remuneration of related party distributors. Given the scope and threshold of Amount B the financial and tax implications for an MNE could exceed that of Amount A for MNEs, especially in case of a substantial increase in remuneration level;
- In case Amount B results in a decrease of the ALP determined profits, an exit tax discussion with local authorities may be triggered;
- Amount B will operate on the basis of a rebuttable presumption, meaning that the taxpayer will have the burden to demonstrate that an entity performing the baseline activities defined by the Blueprint should not be in scope; and
- The ALP remuneration agreed upon as part of multi-/bi-/unilateral APAs related to the Amount B transactions will be grandfathered for the duration of the agreement.

5. How can we as PwC Netherlands help you?

Pillar One could be qualified as a “re-set” of the international tax system, bringing more tax revenue to market jurisdictions. We can help you to assess the possible impact of Pillar One reflecting more and broader taxation rights allocated to the markets. Together, we can navigate the resulting uncertainty and challenges to your business by:

1. Understanding, mapping and quantifying the tax implications of Pillar One given your current business model (e.g. centralized vs decentralized, CFB vs ADS, reference industry);

2. Tooling based quantification of possible financial tax impact due to the shift of profits to local markets including changes in ETR, cash-flow taxes and estimation of the financial risk of double taxation; and

3. Determining the compliance requirements, assessing any possible data / process gaps, setting strategy towards compliance and assisting with implementation.

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