

OECD consultation to reshape the international tax system for the digitalised age commences

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In brief

On 29 January 2019, the OECD released a policy note¹ and hosted a webcast to outline the future work by the Inclusive Framework on Base Erosion and Profit Shifting (BEPS) to address the tax challenges arising from the digitalisation of the economy. According to the policy note, the two pillars of work that will be examined by the Inclusive Framework throughout 2019 will address:

- The broader challenges to the tax system that are associated with digitalisation, focusing on the allocation of taxing rights among countries through one or more of three separate proposals - User Participation, Marketing Intangibles, and Significant Economic Presence;
- A minimum tax proposal that is designed to cope with the BEPS risks that are exacerbated by digitalisation, that would limit tax deductions for outbound payments and include income in investors' profit that have been shifted to low-tax jurisdictions.

On 13 February 2019, a detailed public consultation document² in respect of the above four proposals was issued by OECD and the public consultation was closed by 6 March 2019. A public consultation meeting was held in mid-March, following which the OECD will present a work-plan to Finance Ministers in June 2020. When approved, this work-plan will take the OECD project through to the final recommendations in 2020 addressing the tax challenges of the digitalisation of the economy.

The final recommendations may require treaty changes, and going beyond any current conception of the arm's length principle and limiting taxing rights to physical presence, according to the proposals outlined by the OECD consultation document, which will have a significant impact for all businesses. In this case, multinational enterprises and Chinese enterprises are suggested to keep an close eye on the relevant development and monitor the potential impact and retain the flexibility of strategic adjustment, no matter whether they provide "highly digitalised" business or not.

In detail

Background

In its BEPS Action 1 report on Addressing the Tax Challenges of the Digital Economy³ in 2015, the OECD recognised that the digitalisation of the economy poses broader tax challenges than simply exacerbating the base erosion and profit shifting (BEPS) challenges that the OECD was seeking to address at the time. The OECD committed to keep monitoring the impact of digitalisation on the international tax framework and report back to the G20 in 2020. Since 2017, several countries had introduced unilateral measures, and others - including the European Union - were considering doing so. Against this backdrop, the G20 renewed the mandate of the OECD's Task Force on the Digital Economy and asked them to prepare an interim report on their progress by April 2018.

The OECD Interim Report⁴ was released in March 2018. This detailed report examined a range of issues, particularly noting that the structure of businesses and the process of value creation has significantly evolved through the digitalisation of the economy.

Three salient characteristics were noted to be impacting the process of value creation, and they will become common features of an even wider number of businesses as digitalisation continues: cross jurisdictional scale without mass, heavy reliance on intangible assets, and the role of data and user participation. The Report concluded that there were three viewpoints held by Inclusive Framework members according to the Interim Report:

- One group believed that key features leads to misalignments on allocation of where value is created and profit is taxed. They did not wish to see change to the broad principles of international taxation.
- A second group of countries took the view that the ongoing digital transformation of the economy, and more generally trends associated with globalisation, presented challenges to the continued effectiveness of the existing international tax framework for business profits. Importantly, for this group of countries, these challenges were not exclusive or specific to highly digitalised business models. Therefore, the tax framework should be revised.
- The final group of countries believed that the BEPS package largely addressed the concerns of double non-taxation, and did not see the need for any significant reform of the international tax rules.

In January 2019, the OECD released a policy note on the tax challenges of the digitalisation of the economy, regarding opinions that all members of Inclusive Framework on BEPS will examine four proposals under two pillars. More detailed papers were released later on 13 February, which set forth the taxation principles and mechanisms of the proposals.

Pillar one: revised profit allocation and nexus rules

Under Pillar one, the OECD is considering three proposals, including User Participation, Marketing Intangibles and Significant Economic Presence. These three proposals will significantly change the profit allocation and nexus rules and expand the taxing right of user/market jurisdictions. The three proposals are attempt to recognise, from different perspectives, value created by a business's activity or participation in user/market jurisdictions that is not recognised in the current framework for allocating profits despite the re-allocation methods of taxing rights are different from each other.

A: User Participation

The user participation proposal focuses on the value created by certain highly digitalised businesses through developing an active and engaged user base, and soliciting data and content contributions from them. This is the case predominantly for social media platforms, search engines, and online marketplaces. The proposal suggests to allocate profit to where active participate users are based, regardless of whether a permanent establishment or a physical presence in the users' jurisdiction has been established. It also suggests to use the following proposed four stage profit allocation mechanism to allocate profit to users' jurisdiction where active and participatory users are located:

- Calculate the 'residual' profits (the remainder after all routine functions have been rewarded)
- Attribute a proportion of the residual to the user base (either a pre-agreed percentage or thorough analysis)
- Allocate between user jurisdictions based on an agreed allocation metric (e.g. revenues), and
- Give rights to jurisdictions to tax these profits.

B: Marketing Intangibles

The proposal addresses a situation where an MNE group can essentially "reach into" a jurisdiction, either remotely or through a limited local presence to develop a user or customer base and other marketing intangibles. It sees an intrinsic functional link between marketing intangibles and the market jurisdiction. It proposes to revise the existing profit distribution rules based on "marketing intangibles" and distribute the marketing intangible assets and related profits to the countries where the market is located. Profit distribution in the jurisdiction where the market is located can be realized in the following two ways:

- Using the traditional transaction-based transfer pricing method: identify the marketing intangible assets and their contribution to the profits according to the specific situation, and adopt the current transfer pricing method to determine the corresponding profits belonging to the jurisdiction where the market is located; or
- Use the modified residual profit split approach: firstly identify and deduct the regular profits from the overall profits, and then assign the residual profits to the marketing intangible assets according to a variety of potential indicators (such as cost or formulaic approaches), and then distribute the profits to each market location according to a certain distribution standard (such as income).

Under the new nexus rules, a business may be subject to local taxes even if it does not constitute a permanent establishment or physical presence in the jurisdiction where the market is located. This new proposal could apply to more businesses than just those that are highly digitalised.

C: Significant Economic Presence (SEP)

This proposal mainly considers the fact that the enterprise can be deeply involved in local economic activities without establishing an entity with the development of economic digitization and technology progress. The allocation of profit to a SEP could be based on a fractional apportionment method, which requires the performance of three successive steps:

- Definition of the tax base to be divided (e.g. MNE global profit margin multiplied by local sales)
- Determination of the allocation keys to divide that tax base (e.g. sales, assets, employees or users), and

- Weighting of these allocation keys.

While sustained revenues would be an important factor in determining whether a business had a SEP in a jurisdiction, secondary factors are suggested to be included, such as location and data contribution of users, volume of digital content derived, billing and collection in local currency (local form of payment), local language website, responsibility for delivery and/or support services, sustained marketing activities, etc. In general, SEP is looking to identify where businesses have an important economic relationship with a market but attributing taxing rights in a simpler way that would be more easily administered.

Pillar one contains a more diverse range of opinions, the final proposal may take forward one opinion individually or merged elements of each into a hybrid solution. The first solution appears similar to the UK's proposals in its Discussion Documents for taxation of digital economy; the second was attributed to the US; the third solution was put forward by a group of countries including India, which is implementing its own domestic rules based around one concept of SEP. The first two solutions have more detail and both imply a requirement for business to allocate greater profit to where they interact with market, regardless of whether there is a permanent establishment in the market jurisdiction and potentially therefore could be reconciled into one proposal more easily than the third one.

Pillar two: Global anti-base erosion proposal

The proposal under Pillar two provides comprehensive solution to the risk of moving profits to low tax jurisdictions through two approaches of income inclusion rule and tax on base eroding payments.

1) Income inclusion rule: It would allow taxation of income of a business's controlled entities or branches that are subject to low effective tax rates. This would apply through direct or indirect attribution where there is a significant shareholding (e.g. 25%) which is intended to supplement existing CFC rules. Technical issues under consideration include control test and entities in scope, mechanism for assessing whether tax paid is below the minimum, safe harbours, income attribution mechanisms, thresholds, etc.

2) Tax on base-eroding payments: In order to avoid risk of base-eroding in payers' jurisdiction, it would deny deductions or treaty relief where payment is subject to a low effective rate on receipt or income is not taxed adequately.

The scope of proposal under Pillar two, which clearly goes beyond "highly digital" businesses, is likely to be welcomed by some countries that take anti-tax avoidance rules seriously. At the same time, countries will need to change tax treaties to ensure the rules do not result in double taxation. In addition, as it involves combining the two approaches coherently, OECD recognizes that the rules will need to be coordinated.

The OECD public consultation document was clear that new rules should not result in taxation when there is no economic profit, nor double taxation. Also mindful of compliance and administrative burdens, the OECD states that the proposals will be designed to be as simple as possible.

Next steps

The deadline of comment period of OECD written consultation is 6 March 2019. A public consultation will then take place in the middle of March 2019, which will influence the scoping and work plan that will be presented to the full Inclusive Framework and the G20 Finance Ministers in May and June 2020 respectively. The OECD technical work will then continue throughout 2019, led by its Task Force on the Digital Economy, and will reach a new international taxation rules by 2020 to address the tax challenges of the digitalisation of the economy.

The takeaway

The OECD work on taxation of digital economy will be accelerated as the date to release final recommendations is approaching. International tax rules are facing significant changes and multinationals are probably facing new nexus, profit distribution rules and "upgraded" BEPS measures. The changes go beyond highly digital businesses and could affect other traditional cross-border businesses. Therefore, whether or not they engage in digital business, multinational enterprises should pay close attention to the development of taxation on digitalised economy and actively participate in OECD public consultation.

Technical issues of various proposals and their impacts to transfer pricing

Pillar one contains three solutions, which have not yet been decided on the final one to apply. The final solution needs to strike a balance between the accuracy of the theoretical level and the simplicity of the operational level, so as to ensure the rationality as well as the feasibility of the implementation. It also need to avoid excessive tax collection and compliance burden for tax authorities and multinational enterprises. In addition without tax consideration, the financial statements prepared by multinational enterprises in accordance with existing accounting standards may not meet the requirements in the implementation of the above proposals.

It is not easy for multinational groups to adopt appropriate apportionment methods to distribute relevant profits, which should be unanimously recognized by different market/national tax authorities in the implementation process. Therefore, setting-up a complementary mechanism to effectively avoid and solve bilateral disputes is also a very important consideration.

In addition to the important changes in the current rules for the division of taxation rights in various countries, the proposal stated by public consultation document is going to adjust the current transfer pricing principle – the arm's length principle. According to the traditional method of transfer pricing, if a transnational enterprise only remotely participates in the economic activities and creates value in the location of the market, it will obviously not be deemed as having function, risk, assets or

value contribution in local marketplace. The advises of allocating profits proposed by the public consultation document under pillar one will change the traditional transfer pricing analytical methods based on functional risk and value contribution. Multinational enterprises should recognize it and get ready as early as possible.

The "Global anti-base erosion proposal" under pillar two intends to combat the artificial transfer of profits by multinational groups to low-tax countries through related party transactions. An important technical issue needs to be addressed with respect to this measure: if the recipient has sufficient "substantial activities" in the country where the income is subject to a lower tax rate according to the local tax law, this may not be an artificial tax avoidance arrangement, can the payer be allowed to deduct the payment as an exception? If not, the measure would seem to deviate from the BEPS's consistent aim of profits should only be allocated where there is substantial activity (value creation), and may even interfere with the tax autonomy of countries. This issue deserves further discussion.

If the proposal of pillar one only intends to re-distribute the profits generated by the digital economy business among countries, then for most multinational groups it may be just a "zero sum game". The tax burden of these multinational groups may increase even though they do not have tax avoidance intentions or behaviours, especially for tax-based erosion payments under pillar two. Will such proposal prevent investment and business activities around the world, or in some regions of the world? In addition, the OECD public consultation document only focuses on the issue of corporate income/profit tax, and does not express any views on indirect taxes. In fact, some countries have already adopted indirect tax measures to address the tax challenges of the digital economy, which also have a certain impact on the tax burden of multinational enterprises. Businesses and academia also expect the OECD to pay more attention to the study the indirect tax issues.

Impact on multinational groups (including Chinese companies)

The final recommendation for taxation on digitalised economy has yet to be released, thus its impact on multinational groups, including Chinese companies, still remains to be seen.

Possible impact of Pillar one: For foreign multinationals, the online sales platforms (including goods and services) holding certain market share in China may be affected. While, the business of foreign social media platforms and search engines service in China is currently limited. Among these proposals, the marketing intangibles proposal is not only applicable to the digitalised business, but also to traditional industries such as retail of consumer goods, therefore it may impacts on the appropriate profit level and transfer pricing arrangement of Chinese subsidiaries of foreign groups. For the user participation proposal, it may have higher requirements on the application capability of big data by companies. In that respect, relevant multinational groups should strengthen the application of big data in the aspect of user "participation", and assess and evaluate the tax cost in the jurisdiction of where the market is located, so as to adjust the development strategy in their market place.

Possible impact of Pillar two: the proposal under this pillar may increase the overall tax burden of groups having cross-border payments among related parties. It is suggested that multinational groups should pay attention to the OECD follow up work plan and consider the impact on related-party transactions.

Unilateral measures faced by China going-abroad enterprises: Several countries have introduced their localised measures before the global agreement is reached. Although some countries state that it is a temporary measure, the going-abroad enterprises should still pay close attention to these measures at this stage. These Chinese groups should be fully aware of the new tax policies that they may face and adjust the internal tax operation procedures to get ready for the tax compliance requirement in each country. Mutual agreement procedures may be considered where double taxation incurred due to the unilateral measures.

The implementation of taxation on digitalised economy in China

Chinese multinational groups engaged in digitalised businesses will continue to improve their competitiveness in the global market in the long term. Therefore, we suggest the Chinese tax authorities to give more consideration to the principle of tax neutrality when formulating laws and regulations as well as participating in international discussions on taxation rules for the digital economy. Protecting the international competitiveness of Chinese multinational corporations and avoiding domestic tax base from erosion are expected to be considered in parallel.

Meanwhile, we also suggest that enterprises keep an eye on the position of the Chinese tax authorities on the taxation of the digital economy, and conduct an analysis of the value chain and value drivers of the enterprise group to assess the potential impact as well as retain the flexibility of their strategic adjustment.

Endnote

1. For the OECD document entitled "Addressing the Tax Challenges of the Digitalisation of the Economy – Policy Note", please refer to <http://www.oecd.org/tax/beps/policy-note-beps-inclusive-framework-addressing-tax-challenges-digitalisation.pdf>
2. For the OECD document entitled "Addressing the Tax Challenges of the Digitalisation of the Economy", please refer to <http://www.oecd.org/tax/beps/public-consultation-document-addressing-the-tax-challenges-of-the-digitalisation-of-the-economy.pdf>
3. For the OECD document entitled "Addressing the Tax Challenges of the Digital Economy, Action 1 - 2015 Final Report", please refer to <http://www.oecd.org/tax/addressing-the-tax-challenges-of-the-digital-economy-action-1-2015-final-report-9789264241046-en.htm>
4. For the OECD document entitled "Tax Challenges Arising from Digitalisation – Interim Report 2018", please refer to <http://www.oecd.org/tax/beps/tax-challenges-arising-from-digitalisation-interim-report-9789264293083-en.htm>



Let's talk

For a deeper discussion of how this issue might affect your business, please contact:

PwC's China Tax and Business Service Team

Peter Ng
+86 (21) 2323 1828
peter.ng@cn.pwc.com

Spencer Chong
+86 (21) 2323 2580
spencer.chong@cn.pwc.com

Edwin Wong
+86 (10) 6533 2100
edwin.wong@cn.pwc.com

Alan Yam
+86 (21) 2323 2518
alan.yam@cn.pwc.com

Charles Lee
+86 (755) 8261 8899
charles.lee@cn.pwc.com

Jeremy Ngai
+852 2289 5616
jeremy.cm.ngai@hk.pwc.com

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PwC's China Transfer Pricing Service Team

China

Spencer Chong
+86 (21) 2323 2580
spencer.chong@cn.pwc.com

Jeff Yuan
+86 (21) 2323 3495
jeff.yuan@cn.pwc.com

Mei Gong
+86 (21) 2323 3667
mei.gong@cn.pwc.com

Paul Tang
+86 (21) 2323 3756
paul.tang@cn.pwc.com

Thinker Chen
+86 (21) 2323 1329
thinker.x.chen@cn.pwc.com

Winnie Di
+86 (10) 6533 2805
winnie.di@cn.pwc.com

Qisheng Yu
+86 (10) 6533 3117
qisheng.yu@cn.pwc.com

Tao Han
+86 (10) 6533 3230
tao.han@cn.pwc.com

Kevin Tsoi
+86 (20) 3819 2380
kevin.lk.tsoi@cn.pwc.com

Charles SC Chan
+86 (755) 8261 8576
charles.sc.chan@cn.pwc.com

William Xu
+86 (28) 6291 2018
william.xu@cn.pwc.com

Rhett Liu
+86 (755) 8261 8366
rhett.k.liu@cn.pwc.com

Henry HP Zhu
+86 (512) 6273 1917
henry.hp.zhu@cn.pwc.com

Hong Kong

Cecilia SK Lee
+852 2289 5690
cecilia.sk.lee@hk.pwc.com

Peter Brewin
+852 2289 3650
p.brewin@hk.pwc.com

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For more information, please contact:

Matthew Mui
+86 (10) 6533 3028
matthew.mui@cn.pwc.com

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