ATAF's opinion on the Inclusive Framework Pillar One (including the Unified Approach) and Pillar Two proposals to address the tax challenges arising from the digitalisation of the economy

Outlined below is ATAF's detailed response on the technical aspects of the changes proposed under Pillar One released by the OECD Inclusive Framework this week and ATAF's view of discussions under Pillar Two.

Proposed Unified Approach under Pillar One

We support the Unified Approach objective of revising the allocation of taxing rights between residence and source jurisdictions by allocating more of an MNE's taxable profits to the market jurisdictions.

The proposal notes that it has been suggested that some sectors (for example, extractive industries and commodities) would be carved out of the scope of the new rules. ATAF has been one of the proponents of a possible carve-out for the extractive industries and commodities and will continue to argue for such a carve-out as in our view marketing intangibles are often not a key value driver for commodities.

New nexus rule

ATAF supports the proposal to revise the current nexus rules that are not dependent on physical presence and gives a jurisdiction the right to tax a foreign entity on the profits it generates in that jurisdiction whether or not it has a physical presence in that jurisdiction. Digitalisation increasingly enables MNEs to carry out business in African countries with no or very limited physical presence in those countries, and it is only appropriate that countries have the right to tax the profits the MNE makes in the country from those business activities.

We have noted that the rule proposes taxing rights would not be dependent on physical presence but largely based on sales. The rule might have a threshold test. ATAF has stressed

to the Inclusive Framework the need for any such threshold to be country-specific and adjusted to the relative size of the country's economy to ensure that jurisdictions with smaller economies are not excluded from the new nexus rules. We are therefore pleased to see that the proposal reflects that approach being taken in the design of the threshold.

ATAF supports the proposals in the unified approach to introduce rules that go beyond the arm's length principle with more simplified approaches to profit allocation to market jurisdictions. African tax administrations often report that the complexities in the application of the arm's length principle make it extremely challenging to stop artificial profit shifting by abusive transfer pricing practices. Simpler rules should enable African tax administrations to protect the tax base from artificial profit shifting and provide greater tax certainty for both governments and taxpayers.

New profit allocation rules

ATAF is broadly supportive of the proposed new profit allocation rules in the unified approach as these are based on the principle of allocating greater tax rights to market jurisdictions and the use of simplification conventions.

In particular, we strongly support the proposal under Amount B to allocate a fixed remuneration for tax purposes to routine marketing and distribution activities taking place in a market jurisdiction and reflecting an assumed baseline activity. This will address many of the current transfer pricing disputes taking place in Africa over the appropriate level of returns to such market and distribution activities where that return is determined using the arm's length principle.

ATAF is in favour of Amount B being a fixed minimum return rule as this will reduce transfer pricing disputes and increase tax certainty for both tax administrations and taxpayers in Africa. ATAF has stressed to the Inclusive Framework the need to develop a clear definition of what constitutes routine marketing and distribution activities. This will be needed if this rule is to be effective in achieving these objectives.

We are therefore pleased to see the proposal acknowledges the need for a clear definition of the activities that qualify for Amount B.

As stated above, in our view Amount B should be a fixed minimum remuneration and must not be a safe harbour that includes an arm's length let-out[1] 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. We will be expressing to the Inclusive Framework our strong opposition to any rule that introduced a mandatory safe harbour with an arm's length let out.

We also support the proposal under Amount A to allocate to market jurisdictions a portion of an MNE's non-routine profits to reflect the value created in the market that is not recognised in the existing profit allocation rules. We agree that Amount A should be determined using simplifying conventions and that the starting point for calculating the non-routine profits should be the profits of the MNE group, possibly derived from its consolidated Financial Statements.

The proposal states that the non-routine profit element of the overall MNE profit would be calculated by designating a deemed routine return on the activities of the group or business line and the remaining profit would be deemed to be the non-routine profit. We consider this a reasonable approach but, in our view, if this rule is to result in a fairer allocation of profits and taxing rights to market jurisdictions the calculation of the deemed routine return must be set at a level that fairly reflects the value of such routine functions. If the calculation attributes an excessive return to such routine activities, the integrity of the new profit allocation rules will be seriously undermined.

Having calculated the non-routine profit, the unified approach proposes using a simplifying convention to determine the portion of the deemed non-routine profits that is attributable to the market jurisdiction and the portion that is attributable to other factors such as trade intangibles, capital and risk, etc. We support the use of such an approach as this will simplify the rules and provide greater tax certainty. However, we are concerned that any such formulaic approach must provide for a fair proportion of the non-routine return to be allocated to marketing intangibles as in our view the current transfer pricing rules often result

[1] 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.

in a substantial undervaluation of the contribution of the market jurisdiction to the MNE's profits.

The final step of the proposed approach allocates the marketing intangibles portion of the deemed non-routine profit among the market jurisdictions. The unified approach proposes that the allocation is based on agreed allocation keys, using variables such as sales and, in the case of some highly digitalised businesses, user participation. We will be stressing to the Inclusive Framework that careful consideration needs to be given to how the allocation keys are weighted as determining the relative value of factors such as sales and user participation appears very complex.

The proposal that taxpayers and tax administrations might argue that the marketing and distribution activities taking place in the market jurisdiction warrant a profit in excess of Amount B and that an additional profit (Amount C) should be allocated to the market jurisdiction is in our view an appropriate proposal. The unified approach would not meet its objective of allocating more taxing rights to market jurisdictions if the new rules resulted in less profits being allocated than under the arm's length principle.

We recognise the need for effective dispute resolution mechanisms to eliminate protracted disputes and double taxation. However, we do not support the suugestion that global adoption of mandatory binding arbitration should be available if there are disputes regarding the amounts allocated under the unified approach proposal. Many of our members are strongly opposed to mandatory binding arbitration as they consider it impinges on their sovereignty.

Pillar Two – Global anti-base erosion (GloBE) rule

The proposed second pillar of work notes that there are still BEPS challenges to be addressed. ATAF welcomes this work as it is our view that the BEPS outcomes do not stem IFFs out of Africa because they do not adequately address the risks to African tax bases from artificial profit shifting.

In our view, a key focus of the work needs to be on developing rules that address base eroding payments such as excessive interest payments, management fees, royalties and service fees paid by African taxpayers to related entities located in no or low tax jurisdictions. Such payments are decimating the tax base of many African countries.