Managing the uncertainty of digital taxation

January 2020

Never before has the tax department played such an integral role in the success of the business. Chief tax officers (CTOs) are expected to align tax with business goals, drive strategic value, increase transparency, and improve the efficiency of tax operations. KPMG LLP’s (KPMG) CTO Insights is designed to highlight top-of-mind issues for tax executives and ways CTOs are addressing these opportunities and challenges. We are confident that you will find the information in each issue of CTO Insights practical and actionable in demonstrating the value you and your department bring to your organization.

The digitization of the global economy has reshaped entire markets and industries, and it’s poised to do the same for international tax policy and administration.

With its initiative on the tax challenges of the digitalizing economy, the Organisation for Economic Co-operation and Development (OECD) has asserted that traditional international income tax rules do not fit well with the increasingly prevalent and powerful multinational businesses models enabled by digital technology, which increasingly generate value from intangible assets. The OECD has pledged to address the issues at stake with multilateral international tax reform guidance.

As CTOs of multinational organizations follow the action, it’s becoming clear that the proposed changes will have wide implications. The OECD effort to reform international digital taxation is occupying ever more of the CTO agenda. CTOs are spending significant time educating the audit committee and senior leadership about new developments, expected impacts, and potential strategic and operational responses.

For one, the scope of proposed reforms is broad: early on, the OECD determined that the entire economy is digitized and it’s impossible to ring fence a separate “digital economy,” so any measures it enacts will be broadly applicable, with wide implications for businesses of all kinds—digital or not.

Second, the stakes are high: Pillar 1 (focused on reallocation of profit and revised nexus rules) and Pillar 2 (focused on preventing base erosion and profit shifting) may both potentially change fundamental aspects of the international tax system.

And finally, the timeline is ambitious: The OECD has promised a consensus-based solution by the end of 2020, and political pressure on the OECD is mounting. The proliferation of unilateral actions that could potentially destabilize the international tax system—including the implementation of country-specific digital services taxes and anti-abuse rules—is creating greater urgency.

Pillar 1 would rewrite nexus rules
The OECD’s latest public consultation draft, which is currently under discussion, outlines a unified Pillar 1 approach in which taxable nexus is no longer based on physical presence. Rather, taxing rights would be granted to the jurisdiction where profits are generated—interpreted to mean where customers and users are located—and a portion of corporate profits would be reallocated to those markets. Measures proposed under Pillar 1 would also adjust the formulas for determining how much profit is taxable in market jurisdictions, but the technical details are missing.
Navigating Pillar 1 changes is a top area of focus for CTOs of multinational enterprises, especially as their organizations experience increased audit activity in this area. But in most cases, strategic action must wait. The immediate task at hand is understanding which companies could be affected.

The Pillar 1 proposal would apply broadly to consumer-facing, cross-border activities of multinational enterprises, but there isn’t a lot of detail offered beyond that. Lacking definition and guidance, determining what is in scope will be instrumental for CTOs to determine the right course of action for their organizations.

Questions abound: How exactly are consumer-facing businesses defined? Will Pillar 1 rules apply to B2B companies with consumer-facing activities, such as those that sell goods and services to consumers through third-party distributors? What about related-party cross-border transactions? How will franchise owners—which already have a heavy regime of withholding taxes from local statutes that apply to franchising fees and royalties—be treated?

Even companies that don’t believe they will be directly affected by Pillar 1 proposals are closely tracking the developments. Some are concerned that confusion over complex business models (e.g., restaurants, hotels, insurance, pharmaceuticals, financial services) may cause them to be inappropriately categorized as consumer facing and therefore subject to more taxes in more markets. Others worry that Pillar 1 reforms potentially set the groundwork for an abandonment of traditional arm’s-length transfer pricing used in international taxation, which could have far-reaching effects on tax, compliance, and business operations.

As CTOs seek greater clarity, a common approach is direct OECD engagement. Active engagement with the OECD through one-on-one meetings, comment letters, and industry lobbying efforts helps CTOs generate attention for the specific impact of proposed reforms on their businesses and even shape final policies as consensus is being reached. Many CTOs are also in regular dialogue with U.S. and foreign treasury officials, but most would rather work with the OECD on a viable long-term solution than face the burden of dealing with individual governments enacting individual measures.

Pillar 2 would set a global minimum tax
The latest Pillar 2 proposal is also raising a lot of questions for CTOs’ global organizations. Under the Pillar 2 proposal, profit shifting to lower-tax jurisdictions would be penalized. Groups operating across borders would be required to pay a minimum level of tax determined by the amount of income they record in low-tax jurisdictions.

Although the standard has yet to be finalized, the Pillar 2 proposal includes a CFC rule that is similar to the GILTI regime in the United States. Indeed, many U.S. CTOs—as well as the U.S. Treasury department—are advocating for GILTI to be accepted under Pillar 2 as a qualifying tax regime. The Pillar 2 proposal also includes new taxes on cross-border payments, if those payments are not subject to a minimum level of tax.

It remains to be seen how GILTI will be treated or what effects that would have on other national tax regimes, such as if other countries have to adopt GILTI or if other foreign tax regimes would also be whitelisted.

More clarity is needed for CTOs to guide their organizations in a direction that ensures compliance while reducing the overall tax burden.
Achieving global consensus is in doubt

Although it is critical for CTOs to plan ahead for potential impacts of proposed global tax reforms, there’s a real chance that the OECD will fail to reach consensus on Pillars 1 and 2.

For one, some CTOs question whether the direction the OECD is taking is truly unified. The latest draft doesn’t reflect the agreement of all 134 participating countries and is open to feedback from business stakeholders. And some leading nations have already expressed doubts, including the United States, which has shared concerns that the proposed wholesale changes are prejudicial to high-profile U.S. tech companies.

In addition, some CTOs believe that trying to please every stakeholder to achieve consensus caused current proposals to go too far afield and that this overreach is creating more issues to address, thereby making it more difficult to reach global agreement.

Last, as the OECD moves full steam ahead to meet daunting timeframes, some CTOs worry it is rushing decisions. The latest proposals leave out vital technical details in favor of a vague, one-size-fits-all approach, they say. But measures that are open to too much interpretation will not be administrable without a tremendous amount of work in many jurisdictions.

Single governments are taking short-term measures

Given the time necessary to reach consensus at the OECD, the tax authorities of individual governments aren’t waiting for its work to be done. Many are implementing their own short-term reforms specific to their market, even as the OECD pursues a long-term solution.

Unilateral digital tax laws enacted in individual jurisdictions can affect any corporation that operates in—or even simply sells into—that jurisdiction. As such, they are increasing tax costs and financial reporting and compliance burdens for companies in nearly every industry, beyond just technology.

The workload of the tax departments is increasing as it tries to manage country-specific compliance. However, the fast pace of new developments combined with doubt about how global action will unfold makes it difficult for CTOs to have the confidence to take concrete steps or carry out long-term planning opportunities. CTOs are unsure whether the OECD’s final solution—if one is reached—will conflict with unilateral measures and ultimately force their repeal, and whether the U.S. tax code will be amended to more closely align with global rules.

Questions to consider

— How are you keeping tabs on the international tax proposals under discussion, including both short- and long-term developments?
— How will you model the impact of different proposals on your company’s profile under different scenarios and the interactions between proposals, which may have unexpected consequences?
— How will you engage with the OECD and individual governments about the practical impact of proposed measures, from both a tax and administrative standpoint?
— If the OECD doesn’t reach consensus, what will your tax profile look like in a world of unilateral measures, and how will you manage the country-by-country compliance and reporting burden?
For further information

Explore the resources below for deeper insights on the topics in this edition of CTO Insights.

Topical resources

Global Tax Reform
Get insights about the implications of BEPS and tax transparency on multinational companies.

Tax Challenges of Digitization
Evaluate the potential impact of proposed reforms on the taxation of the digital economy.

For previous editions of CTO Insights, please visit read.kpmg.us/cto-insights

Follow KPMG’s U.S. Tax practice on Twitter @KPMGUS_Tax

Contact us

Jeff LeSage
Americas Vice Chairman, Tax
T: 212-872-2100
E: jclesage@kpmg.com

Some or all of the services described herein may not be permissible for KPMG audit clients and their affiliates or related entities.

kpmg.com/socialmedia

The information in CTO Insights is based on discussions between KPMG professionals and CTOs at their clients as well as with government contacts.

The information contained herein is of a general nature and based on authorities that are subject to change. Applicability of the information to specific situations should be determined through consultation with your tax adviser.

The following information is not intended to be “written advice concerning one or more Federal tax matters” subject to the requirements of section 10.37(a)(2) of Treasury Department Circular 230.

© 2020 KPMG LLP, a Delaware limited liability partnership and the U.S. member firm of the KPMG network of independent member firms affiliated with KPMG International Cooperative (“KPMG International”), a Swiss entity. All rights reserved. The KPMG name and logo are registered trademarks or trademarks of KPMG International. NDP054101-1A