The OECD’s proposals for the taxation of the digital economy
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Tax analysis: The G20 has endorsed the Organisation for Economic Co-operation and Development’s (OECD) programme of work for reaching agreement on an international approach to taxing activities of multinational enterprises in the digital economy. Tomoko Ikawa (Partner (non-lawyer)) and Gary Barnett (senior PSL), Simmons & Simmons, discuss the OECD’s far reaching and controversial proposals in this area.

What is the latest OECD publication on the digital economy?
The OECD published a Report on 31 May 2019 entitled ‘Programme of Work to Develop a Consensus Solution to the Tax Challenges arising from the Digitalisation of the Economy,’ which proposes to take forward work on fundamental changes to the international tax system for introduction in 2020. The work will include both taking forward proposals for significant changes to the rules around determining nexus and profit allocation for tax purposes as well as the use of anti-base erosion rules.

The proposals are far reaching, and remain controversial, but have the potential to significantly change the international tax landscape. Fundamental concepts such as ‘permanent establishment’ and the ‘arm’s length principle’ will be re-evaluated as part of the process and the balance of taxing rights will, potentially, shift significantly towards market jurisdictions.

The proposals have extremely ambitious timelines—perhaps unrealistically ambitious given the changes contemplated. But the alternative of a proliferation of individual, jurisdiction-specific measures, creating significant administrative burdens and challenges to the global economy, has created a new urgency around finding a global solution to what a significant number of jurisdictions now recognise as a substantial problem.

What is the background to the publication of this Report?
Despite determining in its final Report on BEPS Action 1 that it would not be feasible to ring-fence the digital economy for tax purposes, international pressure has continued to mount over the tax treatment of the digital economy as a number of jurisdictions have concluded that more is needed to ensure fair taxation of digital business. As a result, in March 2018, the OECD delivered an interim Report, entitled ‘Tax Challenges Arising from Digitalisation’ recognising that, at that point, there was no general consensus among participating jurisdictions as to whether, and if so what, further measures to tackle taxation of digital services were needed.

Since then, however, the EU Commission put forward proposals to address the tax treatment of companies operating in the digital economy and, in addition, several jurisdictions have commenced implementation of unilateral, domestic measures, such as the UK’s proposed Digital Services Tax.

This continued political pressure has spurred the G20 and the OECD into intensifying their work in this area and led to the publication of a Policy Note in January 2019, quickly followed by a public consultation which set out a number of proposals for reform, grouped under two ‘pillars’:

• revised profit allocation and nexus rules, and
• a global anti-base erosion proposal for a minimum level of taxation

On 31 May 2019, the OECD published its programme of work for developing a consensus to take forward these proposals.

What is the programme timetable?
The OECD Report strikes a tone of urgency. It notes that a ‘growing number of jurisdictions are not content with the taxation outcomes produced by the current international tax system’ and are seeking to impose
various jurisdiction-specific measures or interpretations of the current rules. One of the focal points of dissatisfaction relates to ‘how the existing profit allocation and nexus rules take into account the increasing ability of businesses, in certain situations, to participate in the economic life of a jurisdiction without an associated or meaningful physical presence.’ The Report notes that ‘dissatisfaction has created a political imperative to act in a significant number of jurisdictions.’ However, proliferation of uncoordinated and unilateral actions risks significantly increasing compliance burdens, double taxation and uncertainty and ultimately adversely impact global investment and growth.

Against this background, the OECD has been tasked with delivering a long-term and consensus based solution in 2020. As the Report notes, this timeframe is an extremely ambitious one, given the need to ‘revisit fundamental aspects of the international tax system.’ To meet it, there will need to be political engagement and endorsement ‘as the interests at stake for members go beyond technical issues and will have an impact on revenues and the overall balance of taxing rights.’ In the first place, the ‘outlines of the architecture’ will need to be agreed by January 2020.

How are nexus and profit allocation rules treated in the Report?

Pillar One of the Report addresses the need for a revised approach to ‘nexus’ for tax purposes. This stems from the perception that the current approach (based on the permanent establishment definition) falls short in failing to recognise value created by business activities taking place (remotely) in a market jurisdiction, whether through user participation, marketing intangibles or some other significant economic presence.

Although raising distinct questions, the three proposals considered in Pillar One have important common policy features in that they all contemplate using this approach to nexus for tax purposes as well as using modified profit allocation rules. The technical issues to be resolved under this part of the programme are grouped into three ‘building blocks’:

- different approaches to determine the amount of profits subject to the new taxing right and the allocation of those profits among the jurisdictions
- the design of a new nexus rule that would capture a novel concept of business presence in a market jurisdiction reflecting the transformation of the economy, and not constrained by physical presence requirement, and
- different instruments to ensure full implementation and efficient administration of the new taxing right, including the effective elimination of double taxation and resolution of tax disputes

A new profit allocation rule would require a method to quantify the amount of profit to be reallocated and a method to determine that reallocation among market jurisdictions, bearing in mind the need to avoid unnecessary complexity and uncertainty. Work in this area will focus on a number of options and features including:

- a modified residual profit split method (MRPS) to allocate to market jurisdictions a portion of a multinational group’s non-routine profit that reflects the value created in markets not recognised under conventional profit allocation rules
- a fractional apportionment method (FAM) which would apply to routine and non-routine profits alike and require the selection of an ‘allocation key’ to allocate a fraction of the profits to market jurisdictions
- distribution based approaches which will consider the way in which routine profits around marketing and distribution activities might be captured and allocated to market jurisdictions (reducing current controversies associated with the proper transfer pricing of such activities)
- exploring the use of business line and regional segmentation in the determination of profits subject to the new taxing rights, as well as potential limitations to the scope of these rules by reference to the nature or the size of a given business
- considering how to deal with losses under such an approach

Development of a new nexus rule based around the concept of ‘remote taxable presence’ together with the concept of ‘taxable income sourced in a jurisdiction’ could be by way of amendment of the current definition of a permanent establishment or introducing a new standalone provision, but either way it will require
evaluation and development of indicators of a group’s ‘remote but sustained and significant’ involvement in
the market economy. Such indicators are likely to include local revenue thresholds (over time) and a range of
additional indicators which would demonstrate a link beyond mere selling.

The Report also recognises that these proposals may result in reallocating taxing rights over a proportion of
a group’s profit, rather than by reference to particular transactions or activities carried out by specific entities.
Such an approach would lead to questions as to how residence jurisdictions might provide relief from double
taxation and whether new double tax relief mechanisms will need to be developed, including the possibility of
a multilateral approach.

Finally, the Report recognises that significant administrative issues need to be addressed. Implementation of
any of the approaches would first require identifying the taxpayer who bears the tax liability and the filing obli-
gations. Where the tax liability is assigned to an entity that is not a resident of the taxing jurisdiction, it would
be necessary to address the required enforcement and collection arrangements. Work in this area will con-
sider the use of simplified registration-based collection mechanisms as well as withholding tax obligations.

What is the global anti-base erosion proposal?

Pillar Two would provide a right for jurisdictions to tax profits where they have been shifted to entities subject
to no or very low taxation in ways not caught by the existing BEPS rules. Although this approach is informed
by the view that profit shifting is particularly acute in connection with intangibles, prevalent in the digital econ-
omy, the proposal is not limited to highly digitalised businesses.

Two inter-related rules are being developed under this pillar:

- an income inclusion rule to tax the income of a foreign branch or controlled entity if that income
  is subject to tax at an effective rate below a minimum level (supplementing any CFC rules), and
- a tax on base eroding payments rule that would deny a deduction or impose source-based tax
  (including withholding taxes) for certain payments unless those payments are subject to tax
  above a minimum rate

The OECD will be exploring the use of an income inclusion rule that, in effect, imposes a minimum tax rate
thereby reducing the incentive to allocate returns to low taxed entities. It is expected that the rule will operate
to top-up the tax to the minimum rate, but the Report also considers that there may be exceptions (such as in
the case of harmful preferential regimes) where income would be taxed at the full domestic rate. The mini-
imum rate is expected to be based on a fixed percentage, rather than one based on each country’s corporate
income tax rate, to reduce complexity.

The second element is a tax on base eroding payments such as:

- an undertaxed payments rule which would deny a deduction or impose source based taxation
  for a payment to a related party where the payment wasn’t subject to minimum taxation, and
- a subject to tax rule in tax treaties that would only grant certain treaty benefits if the item of in-
  come was subject to tax at the minimum rate

These rules would raise a large number of issues. They would need to be implemented by both domestic
and treaty changes and will need ‘co-ordination or ordering rules’ to prevent double taxation. Issues over de-
termination of the tax base, use of withholding taxes, compatibility with international obligations, prioritisation
and simplification will all be on the OECD’s agenda. However, ultimately the aim of these rules will be to
change taxpayer behaviour.

What does the Report mean for multinational corporations (MNCs)?

There currently remains uncertainty as to how consensus will be reached in the ambitious timeframe, making
it challenging for MNCs to prepare and plan for such change. The uncertainty is particularly real given that
the debate and the reaching of a consensus will very much be a political matter. Despite this uncertainty
however, it will be critical for MNCs to proactively consider what practical measures can be taken now. For
example:
while the scale of the impact of the proposals in the Report are to be evaluated at the macro level by the OECD, the tax department of MNCs should also consider the impact for their own businesses to manage their own internal stakeholders as well as to consider what practical limitations there may be (eg segmented data) on implementing the potential new rules in the future. This exercise should also help MNCs form a view on how and whether they could get involved in the OECD policy discussions.

over recent years, many MNCs have strengthened and centralised their own tax management structures particularly in the compliance and controversy areas which historically may have been managed at the local level. Those who have centralised their structure have done so to ensure that a globally consistent and strategic approach is taken to issues that are not (or are no longer) a single jurisdiction matter. This will increasingly be important as the proposals on the taxation of the digital economy progress further, as the impact of the change is likely to be multilateral. Each MNC should therefore reassess its current balance between central control and local empowerment, as well as its overall controversy strategy, to (re)enforce an effective internal management structure that is fit for the future.

What are the next steps?

The Report was endorsed by the G20 Finance Ministers during the 8–9 June 2019 ministerial meeting in Fukuoka, Japan. The OECD will now take forward the task of developing options for the new rules contemplated by the Report and reaching a consensus among member jurisdictions. The OECD’s aim is to present recommendations at the start of 2020, but there is recognition that new technical issues may yet emerge as the work advances. A number of working parties have been set up to take forward discrete parts of the project and a further report on progress is expected in December 2019.

One key issue, once nexus is defined, will be the determination of new profit allocation methods that—more likely than not—will deviate from the arm’s length standard and be formulary or fractional. The success of the sweeping changes that are considered to accommodate the digital economy will largely depend on the extent to which the resulting income allocation is considered ‘fair’.

However, it should be noted that while the Report sets out a number of proposals for reform, these proposals do not (yet) represent a consensus view and are intended to provoke comment and analysis more widely with a view to informing the recommendations to be put forward at the start of 2020.

The technical work by the working parties will also be complemented by an impact assessment of how the proposals will affect government revenue, growth and investment, since there is recognition that political agreement on a comprehensive and unified solution should be reached as soon as possible, ideally before the end of 2019, to ensure adequate time for completion of the technical work during 2020.

Clearly, there are several strands to the debate on the taxation of the digital economy, and therefore the OECD’s programme will need to be considered alongside the unilateral actions considered or taken by various countries as well as the European Commission’s work on the matter.

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