Primer

Digital taxation: a bluffer's guide

Speed read

Against a proliferation of unilateral measures worldwide aimed at the digital economy, the OECD seeks international consensus to implement a radical new proposal that will reallocate (and perhaps enlarge) the tax pie between nations. 'Pillar 1' of the OECD's proposals would transform the tax pie into two-tier gateau (routine profit beneath and residual profit on top); whereas, BEPS revisited (aka 'pillar 2') looks to introduce some form of super controlled foreign company rule to stop profit diversion, and a race-to-the-bottom dropping of tax rates by local tax authorities. But pillars 1 and 2 do not just involve digital companies, but all MNEs that face consumers.

Eloise Walker
Pinsent Masons
Eloise Walker is a partner at Pinsent Masons. A specialist in corporate tax, finance and investment funds, she advises corporate and financial institutions on UK and cross-border acquisitions and mergers, reconstructions, corporate finance, joint ventures and on/offshore establishments. Email: eloise.walker@pinsentmasons.com; tel: 020 7490 6169.

This article is a basic primer on 'the taxation of the digital economy', the story so far, and what 'pillar 1' and 'pillar 2' mean, so you can avoid reading the consultations to date and focus on what happens next. Although we will discuss digital taxation, the most important point to take away is that the approach of the Organisation for Economic Cooperation and Development (OECD) – enshrined in pillar 1 and pillar 2 – are not really about digital taxation at all, but radically changing the system of international taxing rights across all consumer-facing industries.

But before we plunge into that, it is important to start at the beginning, because it informs the foundational assumption of the tax authorities, and the OECD, attempting to address a perceived problem.

The flaw in 'permanent establishment'

Once upon a time, roughly a century ago, the concept of 'permanent establishment' was born, and international conventions have used it ever since to determine whether a corporation resident in country A should be taxable in country B where it does business. In simplistic terms, if you had customers in country B, but had no physical branch or dependent agent on the ground in country B selling to them, you had no taxable permanent establishment – you were trading *with* country B but not trading *in* it.

The permanent establishment concept, however, is flawed in the eyes of 21st century governments. It was not designed with a digital economy in mind, and ignores a modern online 'business', such as social media generated value chains, web-based marketplaces or advertising-linked search engines, that have no physical presence where their customers/users are based. Consequently, if you are a US online market place worth billions and you bring together buyers and sellers across the world, you pay no tax outside the US because you have no permanent establishment anywhere. But, say non-US revenue authorities, where there are customers there must be value, and assuming my customers generate your value, I must be entitled to tax you.

Unilateral measures

Cue the UK's digital service tax (DST), and other unilateral measures from tax authorities worldwide, to address this 'problem'. Are they grabbing extra tax revenue under the guise of preventing 'avoidance', or are they addressing a lacuna in the definition of 'permanent establishment'? You decide, but the key point is that all these unilateral measures are different, and they address different things.

The UK proposes to introduce its DST from April 2020. Draft legislation and guidance were published but paused for the general election. When it goes ahead as proposed (indications at the time of writing are that it will), it imposes a 2% tax on the UK revenues of search engines, social media platforms and online marketplaces to the extent such revenue is linked to UK users, if global revenues (from in-scope activities) exceed £500m and over £25m of those revenues are derived from UK users.

The UK's DST has met much resistance, largely because it was originally defined so widely as to force any business with a digital presence (i.e. almost every big business) to go through a costly compliance exercise to work out what was in-scope. Certain measures have been incorporated to alleviate this – such as simplification around administration (introducing calculation/reporting at group level), exemptions for financial and payment services, an alternative method of charge to act as a safe-harbour, and some alleviation of double taxation – but its biggest problem is that the underlying concept of 'user participation' remains difficult to define and is unpopular with other tax authorities. This means that whatever solution is adopted internationally – and the UK has intimated that it will abide by the consensus – will not resemble DST. Even the EU proposals (stuck in a squabble between member states), which also attacked revenue where users play a major role in value creation, did so in a different way and with a different target – online advertising space, digital intermediary activities, and sale of user-generated data and content.

France's DST, by contrast, comes at the problem from a different angle again, applying a 3% digital services tax (backdated to 1 January 2019) on platforms enabling user interaction and on digital advertising revenue. Other unilateral measures are proposed by a range of countries from Italy to India, Canada to Uganda. Everyone wants their slice of the pie (provided it is calculated under rules making their slice bigger).

OECD response

Cue a heroic attempt by the OECD to stop the squabbling and find a new method of taxation, before the world of international taxation descends into total chaos. We have so far seen reports, policy papers and consultations that show an impressive turn of speed for the OECD, who aim to have an agreed approach by the end of 2020.

So, what are pillar 1 and pillar 2 about? Although published under a banner labelled 'tax challenges arising from the digitalisation of the economy', pillars 1 and 2 are not actually ring-fenced to digital service taxation but instead come at the perceived problem from a wider angle aimed at all multinational enterprises (MNEs) that have consumer-facing businesses. Whether the OECD aims to re-allocate taxing rights (the same tax pie, but with different slices) or increase tax take (make a bigger tax pie) is debatable, but this tension is reflected in the development of the proposals.

Pillar 1

Pillar 1 started out as a question of how to re-allocate taxing rights, with three very different proposals considered:

- user participation;
- marketing intangibles; and
- significant economic presence.

You will recognise the 'user participation' term from the UK's DST. The idea is to change the profit allocation rules to reflect value created by, for example, an active and engaged user base sharing their data and content contributions. Despite its benefit of being at least notionally connected with digital business, it proved unpopular with other countries involved in the discussions, given the inherent problem in trying to define what it is.

'Marketing intangibles' is an even more amorphous concept that is very difficult to pin down and hits a wider range of businesses. The idea here is that income should be attributable (and taxable) where linked to brands, trade names, customer data and other intangibles in each market where business is conducted.

'Significant economic presence' would have involved changing the definition of permanent establishment to encompass a new limb, established through factors including revenue generation, the existence of a user base or sustained marketing activities.

However, in the latest consultation, a new idea emerged: 'deemed residual profit'. This would add an overlay so that all the countries where multinationals operate (so-called 'market jurisdictions') would have a new taxing right over a portion of each MNE's 'non-routine profit'.

The formulaic calculation is complex (involving amounts A, B and C), but the concept encapsulates the idea of there being profit remaining after allocating deemed routine profit to the countries where activities are performed. This is a rather radical idea, effectively transforming the tax pie into a two-tier gateau with routine profit underneath and residual profit on top.

It would apply to all MNEs that are large digital or consumer-facing businesses, possibly using the £750m revenue threshold used for country-by-country reporting. It would trigger wherever an MNE has a 'sustained and significant involvement in the economy of a market jurisdiction', maybe tested by revenue threshold in that jurisdiction. The latest news as at 31 January is that the gateau's top tier (amount A) will catch:

- 'automated digital services' (e.g. online search engines, social media platforms and cloud computing); and
- 'consumer-facing businesses' selling goods and services, but only those that have 'significant and sustained engagement' – it is uncertain what this means as yet: clearly more than mere sales and perhaps where some brand value is involved (e.g. mobile phones, clothes, food and hotel franchises).

The two categories are to be tested through slightly different factors, and with businesses selling intermediate components being (mostly) carved out.

Fortunately, the OECD recognises that this idea is likely to result in a great deal of dispute between market jurisdictions and taxpayers as each tax authority tries to grab a bigger slice of the two-tier gateau, so it would have to be introduced subject to 'legally binding and effective' dispute prevention and resolution mechanisms, and possibly a new multilateral instrument to govern how the top tier of the gateau is split.

Pillar 2

If you missed the OECD's 'base erosion and profit shifting' (BEPS) 15-point action plan a few years ago, this was a motley collection of anti-avoidance measures that were promulgated under a banner of stopping MNEs from shifting profit to low-tax jurisdictions and obtaining 'excessive' deductions from their taxable profits. Pillar 2 is BEPS action point 1 revisited, but although lumped under the same 'tax challenges arising from the digitalisation of the economy' banner, pillar 2 is actually a completely different topic tackling a separate problem: the underlying assumption here being that MNEs are still managing to shift profits to low tax countries, and fiscal authorities are engaging in a race-to-the-bottom competition, lowering corporate tax rates in a bid to encourage offshore investment.

Pillar 2 seeks to tackle these problems with a sort of glorified controlled foreign company rule with extra add-ons, called the 'global anti-base erosion' (GloBE) proposal. The idea behind GloBe is to allow other jurisdictions to overlay extra tax where local tax rates are below a minimum rate, through one or more of the four rules proposed:

- an 'income inclusion rule' – to pull income from country X to be taxed again in country Y where that income is taxed below a minimum rate (to be set) in country X;
- an 'undertaxed payments rule' – to tax base eroding payments by denying deductions in country X for payments to a related party if that payment is not subject to tax in country Y at or above a minimum rate, which may be combined with the 'subject to tax' rule;
- a 'subject to tax' rule – to impose withholding tax in country X or adjust eligibility for treaty benefits where a payment is not subject to tax in country Y at a minimum rate (and note this one especially might apply to third party interest and royalties); and
- a 'switch-over rule' – to be introduced into tax treaties to permit a residence jurisdiction country Y to switch from an exemption to a credit method where the profits attributable to a permanent establishment (PE) in country X or derived from immovable property in country X, which is not part of a PE, are subject to an effective rate in country X below the minimum rate.

Once it is decided which, or which combination, of these variations are to be progressed, they will be implemented by changes to domestic law and tax treaties, with some form of a coordination or ordering rule to avoid double taxation where more than one jurisdiction seeks to apply these rules to the same structure. Much remains to be decided around how the technical aspects of GloBE will be set, not least what the minimum tax rate is to be.

Next steps

So, what is next? The political climate will have a profound bearing on what change is implemented, and how fast it can be done, with the US exchanging letters with the OECD in December proposing the rules contain safe-harbours (an idea which is yet to be discussed), and threatening a trade war with France over its tax if a solution is not found this year. Similar threats are made against the UK regarding DST, at the very time the UK will be trying to lock down a US trade deal post Brexit.

However, as at 31 January the OECD (and the 137 countries involved) are committed to agreement on the key policy features by early July and finding a consensus by the end of 2020. Given that plan B is an international trade war, implementing plan A becomes the only viable option... ■