Q&A

OECD's consultation on the tax challenges of digitalisation

Speed read

The OECD has issued its public consultation document on taxing the digital economy. The paper sets out three proposals for revising the profit allocation and nexus rules: user participation; marketing intangibles; and significant economic presence. The document also sets out two proposals to address global anti-base erosion by ensuring that internationally operating businesses pay a minimum level of tax, namely: an income inclusion rule; and a tax on base eroding payments. The aim is to find an international consensus. Given the unilateral actions of countries introducing their own stand-alone solutions, time is short.

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What is the consultation?

On 13 February 2019, the OECD issued a public consultation document, *Addressing the tax challenges of the digitalisation of the economy* (see bit.ly/2tsaCg6), inviting comments on its proposals by no later than 6 March 2019.

The consultation follows publication of *Tax challenges arising from digitalisation: interim report 2018*, produced by the inclusive framework on BEPS, working through its Task Force on the Digital Economy. The interim report concluded that there should be a review of the impact of digitalisation on nexus and profit allocation rules.

The consultation period is very short, reflecting the time pressure on the OECD to offer a solution. Individual countries are pressing ahead with their own digital services taxes (for example, the UK, France and India), which the OECD understandably perceives as potentially harmful to all countries.

What is proposed?

The task force grouped the potential proposals being considered into two 'pillars'. The first is the revision of profit allocation and nexus rules and the second is the global anti-base erosion proposal. These proposals are not new but are now set out clearly in the consultation document.

What is the first pillar?

The first pillar addresses the profit allocation and nexus rules. Three different proposals are put forward to achieve the overriding objective of recognising value created by a business's activity or participation in user/market jurisdictions that is not recognised in the current framework for allocation of profits. The three proposals are referred to as user participation, marketing intangibles and significant economic presence.

1. The 'user participation' proposal

This proposal focuses on value created by digitalised businesses through developing an active and engaged user base, and soliciting data and content contributions from them. This proposal explicitly contemplates business models of social media platforms, search engines and online marketplaces – the obvious examples being Facebook, Google and Amazon. There is also a suggestion that the proposal could incorporate a range of additional restrictions based on the size of the business to reduce the administrative burden for both taxpayers and tax authorities.

As its name suggests, the proposal seeks to change profit allocation rules to accommodate the value creating activities of an active and engaged 'user base'. However, under this proposal the change in rules would be limited to business models which benefit from this type of 'user base', i.e. it is a more direct attack on businesses such as Facebook.

The mechanics would be applied by:

1. calculating residual profit (i.e. profits after routine activities have been allocated an arm's length return);
2. attributing a proportion of those profits to the value created by users, which could be determined though quantitative/qualitative information, or through a simple pre-agreed percentage; and
3. allocating those profits between user jurisdictions, based on an agreed allocation metric (e.g. revenues).

Step 2 clearly needs exploring: how should profits be fairly and correctly attributed to users? The task force acknowledges the difficulty here (relying on formulas which may not match a business's own perception of value generated by user participation) and notes that the proposal could be combined with 'a strong dispute resolution component'. Unfortunately, the OECD has a weaker track record on strengthening dispute resolution procedures (e.g. the mutual agreement procedure) than it does on creating the potential for double taxation.

2. The 'marketing intangibles' proposal

In contrast to the 'user participation' proposal, this would not apply only to certain highly digitalised businesses; rather it would have a wide scope in an effort to respond to the broader impact of digitalisation on the economy.

The thinking behind this proposal is that, at present, a MNE group can access a jurisdiction to develop a user/customer base and other marketing intangibles without creating a (significant) taxable presence in that jurisdiction. The proposal is based on the premise of an intrinsic functional link between 'marketing intangibles' and the market jurisdiction. Marketing intangibles, with their link to the market jurisdiction, are illustrated by contrasting them with trade intangibles. The example given in the paper is that of a (trade) patent used to build an efficient car engine, enabling it to achieve the same mileage in one country as it does in another, and does so regardless of who made or who bought it (i.e. where it was made or where it was purchased).

The proposal would be implemented by modifying existing transfer pricing rules and treaty rules to recognise marketing intangibles and require the risks associated with them to be allocated to the market jurisdiction.

The proposal would modify existing rules to require that non-routine or residual income of the MNE group is attributed to the market jurisdiction. The allocation of such non-routine income would be so allocated regardless of where in the MNE group legal title is held or functions of design etc. are performed.

Once the amount of income attributable to marketing intangibles is determined, it would be allocated to the relevant market jurisdiction(s) based on an agreed metric, such as sales or revenues. The task force suggests that to address concerns over significant controversy and double taxation, the proposal should offer taxpayers 'the possibility of early certainty on the taxation under this approach and come with a strong dispute resolution component'.

3. The 'significant economic presence' proposal

This proposal is based on the premise that digitalisation of the economy has enabled businesses to be heavily involved in the economic life of a jurisdiction without having a significant presence, rendering existing nexus and profit allocation rules ineffective.

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To address this, a taxable presence would arise when a business has significant economic presence, to be assessed on the basis of a range of factors that evidence a 'purposeful and sustained interaction with the jurisdiction via digital technology and other automated means'. The starting point would be revenue generated on a sustained basis, but nexus would only be established when this is combined with other factors and a link is established between the revenue generating activity of the non-resident business and its significant economic presence. The factors proposed are:

- the existence of a user base and the associated data input;
- the volume of digital content derived from the jurisdiction;
- billing and collection in local currency or with a local form of payment;
- the maintenance of a website in a local language;
- responsibility for the final delivery of goods to customers or the provision by the enterprise of other support services such as after-sales service or repairs and maintenance; and
- sustained marketing and sales promotion activities, either online or otherwise, to attract customers.

The task force contemplates that profit could be allocated to any significant economic presence based on a fractional apportionment method, applying three successive steps:

1. defining the tax base to be divided (for example by applying the global profit rate of the MNE group to revenue generated in the particular jurisdiction);
2. determining the allocation keys to divide that tax base (for example sales, assets and employees in the jurisdiction); and
3. weighting these allocation keys.

The task force suggests imposing withholding tax as a collection method and enforcement tool.

Under each proposal, there would also be an amendment to the nexus rules to give the relevant overseas jurisdiction taxing rights over the profit allocable to them. It does seem that the proposals to allocate taxing rights look suspiciously like a move to a consolidated corporate tax base, something that the EU for example has found extremely difficult.

What is the second pillar?

The second pillar is the global anti-base erosion proposal. This seeks to address the continued risk of profit shifting to entities subject to low or zero taxation (existing BEPS measures in the OECD's mind arguably do not go far enough).

Two inter-related rules are proposed, namely:

- an income inclusion rule, which would tax the income of a foreign branch or controlled entity if it was subject to a low effective tax rate in the foreign jurisdiction; and
- a tax on base eroding payments, which would deny deductions or treaty relief for certain payments unless they were subject to tax above a minimum rate.

The income inclusion rule

The income inclusion rule is essentially a minimum tax rule. It would operate by requiring a shareholder in a company to bring into account a proportionate share of the income of the company if that income was not subject to tax at a minimum rate. The rule would only apply to shareholders with a significant interest, the example given being 25%.

This sounds similar to existing controlled foreign company rules, a point which the task force acknowledges, noting that the income inclusion rule would supplement rather than replace a jurisdiction's CFC rules. Similar to, for example, the UK's CFC rules, the amount of income to be included would be calculated under domestic rules and shareholders could claim a credit for any underlying tax paid on the attributed income.

The income inclusion rule would build on the BEPS Action 3 recommendations and the task force expressly notes that it would draw on aspects of the US tax regime for taxing global intangible low-taxed income (GILTI).

The effect of the rule would be to ensure that the income of a MNE group would effectively be subject to a minimum tax rate and would thereby reduce the incentive to shift profits to jurisdictions for tax reasons.

Tax on base eroding payments

This rule would complement the income inclusion rule by protecting a source jurisdiction from the risk of base eroding payments out from it. There would be:

- an *undertaxed payments rule* denying deductions for payments to related parties if the receipt was not subject to tax at a minimum rate; and
- a *subject to tax rule* in tax treaties so that certain treaty benefits would only be available if the income is sufficiently taxed in the other state.

The undertaxed payments rule would deny deductions for certain payments made to related parties, unless the receipts by the related parties were subject to a minimum effective rate of tax. The task force suggests that the related party test could be a 25% common ownership test (matching the income inclusion rule discussed above).

The subject to tax rule would complement the undertaxed payments rule. It would deny treaty benefits under certain articles of double tax treaties: business profits, associated enterprises, dividends, interest, royalties, capital gains and other income.

Taking the interest article as an example, the subject to tax rule could deny treaty benefits in the source state if the residence state does not tax the interest at a minimum effective rate of tax. The task force notes that the rule could be limited to payments between related parties, but that a broader scope could be explored in the interest, royalties and capital gains articles.

What exactly are the questions for public comment?

The questions for public comment are very widely phrased, asking for a general view on the proposals and the extent of the problem; what the most important design considerations should be; and the best approaches to avoid complexity.

What are the key practical issues?

The consultation paper sets out clearly the possibilities that are being considered. The principles are clear but there is clearly a lot to be done in terms of the detail, in particular how to measure the profits to be allocated to jurisdictions.

One of the comments in the background to the global anti-base erosion proposal is that 'it does not tolerate that a modest level of substance can result in an allocation of a substantial amount of intangible and risk related returns to group entities that pay no or very little tax'. This gives a clear steer as to the direction of travel of tax policy in this area. It will become increasingly difficult to claim that profit is earned in low tax jurisdictions without having meaningful substance in those jurisdictions.

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A little like Mark Carney's 'forward guidance' on interest rates, the clear message from the OECD to multilaterals is to think carefully about any attempts to use low tax jurisdictions for tax structuring purposes. More complex tax legislation is on its way and operating in low tax jurisdictions will leave MNEs exposed to increasing risk of being taxed one way or another.

The OECD will need to take care to ensure that the proposals do not go too far. For example, could the UK's dividend exemption or substantial shareholding exemption potentially fall foul of the subject to tax rule so that treaty benefits would not apply?

What next?

The task force intends to produce a final report in 2020, aimed at providing a consensus-based long-term solution to the perceived problem. Consensus seems a long way off, but it can only be helpful that the OECD is setting out its proposals as there is always the hope that it will steer the existing unilateral actions of states (including the UK) consulting on and implementing their own unilateral solutions. ■

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- OECD's digital economy tax reform: the race to consensus (Tom Roth, Kate Alexander & Allen Tan, 7.2.19)
- Tax challenges of digitalisation: the view from the OECD (Pascal Saint-Amans, 13.12.18)
- The UK's proposed digital services tax (Helen Buchanan, Will Robinson, May Smith & Emily Szasz, 15.11.18)