KEY POINTS

- The rise of digital businesses and the digitalisation of the wider economy means that revenue can increasingly be generated with little presence in a jurisdiction – something the current international tax system is not equipped to deal with.
- Various jurisdictions have been taking steps to tackle this including the introduction of new taxes aimed at the digital economy.
- The OECD is now considering ways the tax system could be improved in a more co-ordinated way.
- The OECD proposals are being driven by digitalisation but could fundamentally change the way in which *all* international companies and businesses are taxed, impacting on where they locate their operations and the way in which cross-border finance transactions are structured.

Feature

Authors Michael Alliston and Bart Le Blanc

BEPS 2.0: a new international tax system

The OECD is working on proposals to radically change the international tax system. The driver for this is the rise of the digital economy and the ability of businesses to generate revenue without a physical presence; the potential implications could go far wider than just the digital economy though with implications for all businesses. As such the changes being proposed should be of significance and concern to the finance and banking sector.

INTRODUCTION

In 2012 the OECD were asked by the G20 to put together an action plan to deal with perceived gaps in the global tax system which were allowing multinational companies to shift profits to low tax jurisdictions. This action plan was called BEPS (base erosion and profit shifting) and while it was initially received with some scepticism it has resulted in wide reaching changes in the way in which companies are taxed. The corporate interest restriction rules, the multilateral amendment of hundreds of double tax treaties, the hybrid mismatch rules, country by country reporting – these are all changes that form part of the original BEPS programme.

While the implementation of the BEPS project is still running its course, the OECD has now started an even more ambitious project, a BEPS mark 2.0, which is not just about plugging gaps in the tax system but could fundamentally alter the way in which jurisdictions tax companies. The driver is the digital economy – but the repercussions are much wider – and may have a very significant impact on both borrowers and lenders.

ISSUES WITH TAXING THE DIGITAL ECONOMY

The current international system of business taxation developed through the 19th and 20th centuries for "brick and mortar" businesses which need a physical presence, such as an office, a shop or a factory, in order to generate revenue. Inevitably then, it has struggled to adapt to the digitalisation of the economy and the increasing importance to businesses of intangible assets, user participation and the collection of data.

With digitalisation new business models have arisen and the assets of businesses no longer need to be located in the jurisdiction in which revenue is generated. Sellers can use virtual platforms to distribute their products without a shop or forecourt. Social media platforms can generate advertising revenue from the remote collection of data from users. Businesses can provide their services entirely digitally.

Accordingly, employees and assets for digital businesses can be highly mobile and can be located in countries with low (or no) tax but still generate revenue in traditional "market jurisdictions". This mobility has driven concern that digital businesses are benefitting from the infrastructure and market of jurisdictions without contributing financially to that infrastructure or market.

While the political focus has been on large digital-focussed companies such as social media platforms and online marketplaces, the digitalisation of the economy is a wider trend with 20% of businesses in the UK with 10 or more people now making e-commerce sales, while in other jurisdictions, in particular Australia, Indonesia and Brazil, the figure is considerably higher.

UNILATERAL MEASURES

The taxation of the digital economy has been moving steadily up the political agenda as the impression is that digital companies pay less taxes in the countries where they make their sales than "bricks and mortar" companies because of their limited local presence.

Countries have sought different ways to address the perceived problem. A number of countries have introduced a tax specifically targeting digital businesses. Table 1 overleaf highlights some of the aspects of these "digital taxes" being introduced in countries such as the UK, France and Italy.

In some jurisdictions, such as Israel and India, the approach has been to introduce deeming provisions to ensure that digital businesses are treated as having a taxable presence.

Countries such as the UK and Australia have introduced anti-avoidance measures targeting digital businesses which artificially structure themselves to avoid a taxable presence. The particular focus of these measures were commissionaire arrangements whereby the digital business would negotiate documents in the market jurisdiction but would then ensure they were signed outside the jurisdiction.

There is also a group of countries, such as Singapore, which have amended their indirect taxes (VAT, GST etc) to specifically target digital services.

Lenders and borrowers should be aware of these new measures as they could represent an additional element of tax leakage which will need to be modelled for. Having said that the taxes are intended to be focused and will

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Michael Allison is a tax partner in the London office of Norton Rose Fulbright. He advises on a wide range of corporate tax matters, including M&A, corporate reorganisations, capital markets transactions and financings. Email: michael.alliston@nortonrosefulbright.com

TABLE 1: SOME OF THE JURISDICTIONS THAT HAVE INTRODUCED A DIGITAL TAX

Country	Scope	Rate	Date in force
UK	Applies to social media platforms, search engines and online marketplaces with revenues of £500m globally and £25m in the UK	2%	April 2020
France	Online advertising, sale of personal data for advertising and peer to peer platforms with revenues of €750m globally and €25m in France	3%	Retrospective from January 2019
Italy	Online advertising, transmission of user data and provision of a digital interface allowing users to interact with revenues of €750m globally and €5.5m in Italy	3%	To be confirmed
Spain	Online advertising, online platforms and sales of user data with revenues of €750m globally and €3m in Spain	2%	To be confirmed but could be retrospective to January 2019
Poland	A virtual taxable presence for companies that meet thresholds for revenue, users, and contracts for digital services; and targeting revenue from services like online advertising and user data	3%	2020
Hungary	Tax applied to sales from advertising exceeding HUF100m. Application of tax is subject to an appeal to the European Court of Justice by Google.	7.5%	July 2017
India	Withholding tax applied on payments to non-residents providing digital advertising services.	6%	2016

not apply to businesses outside the narrow range of digital businesses at which they are targeted. The more significant development is the international proposals which seek to deal more radically with the digitisation of the economy.

OECD PROPOSALS

There is a fear that countries acting unilaterally to tackle the perceived gap in the international tax system could be highly detrimental with double taxation, uncertainty for businesses and disproportionate compliance obligations all possible, if not likely. It may also be that the unilateral measures are subject to legal challenge on the basis of principles such as state aid and discrimination.

As a result there has been a push to develop an international consensus with respect to the changes to adapt the international tax system to the digital economy. This project was originally spearheaded by the EU but the mantel has now been taken on by the OECD and on 31 May 2019 the OECD produced a programme of work outlining the proposed areas of focus (Programme). This Programme was a consensus document which had been approved by the 129 jurisdictions involved in the OECD process.

The Programme has two complimentary avenues of attack (referred to as "pillars").

PILLAR ONE: REVISED NEXUS AND PROFIT ALLOCATION RULES

The first pillar looks at whether the allocation of taxing rights between countries should be changed so that the market jurisdiction (being that of the customer or user) receives a greater share of the taxing rights than is currently the case.

Various options are proposed for determining the re-allocation of profits to the "market jurisdiction". The first is a "modified residual profit split" which would look to identify the "non-routine profits" of a business (using either existing transfer pricing rules or other method) and then allocating these, for example, on the basis of revenue. "Fractional apportionment" would be a more significant change and would apportion the entirety of a business' profits on the basis of a formula which would take into account, for example, sales, assets and employees in each country. Finally a "distribution-based approach" would be a simpler method which would look to allocate profit on the basis of a group's marketing, distribution and user-related activities in a jurisdiction.

In addition to proposing a revised profit allocation, pillar one also envisages a new nexus for jurisdictions to exercise taxing rights. This would be based on a business having a "remote but sustained and significant involvement in the economy of a jurisdiction". Double tax treaties would then need to be amended to reflect the revised nexus as they would otherwise override any domestic changes. This then is another reason why international consensus is needed – while jurisdictions can seek to expand the scope of their taxing rights, if the home jurisdictions of the relevant companies (so in particular the US) do not agree the relevant treaties will revert to the existing taxing nexus which requires the company to have a physical presence. In the context of financial institutions with overseas representative offices any change to the permanent establishment rules will need to be monitored closely.

PILLAR TWO: GLOBAL ANTI-BASE EROSION

The second pillar focuses on the original BEPS *raison d'etre* of tackling the drivers for companies artificially shifting their profits for tax reasons. The concern is that even with the BEPS changes mobile digital businesses will still be moved to low tax jurisdictions resulting in a harmful "race to the bottom" with jurisdictions competing

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Bart Le Blanc is a tax partner in the Amsterdam office of Norton Rose Fulbright. He heads the transfer pricing practice and has over 17 years of experience of international corporate taxation. Email: bart.leblanc@nortonrosefulbright.com

against each other to lower their tax rates. In this respect the OECD reports that the average corporation tax rate has fallen from 28.6% in 2000 to 21.4% in 2018 (and many jurisdictions including the UK and France are still in the process of reducing their rates further). The OECD argue that it is developing countries that are most likely to lose such a race as they are less able to raise funds through other means (such as taxes on property, wealth and other less mobile forms of income).

The proposals grouped together under the second pillar look to limit the distortive impact of corporation tax on investment and business location decisions. Two rules are being considered: an income inclusion rule and a tax on eroding base payments – together these are referred to as global anti-base erosion or the catchier "GloBE".

Income inclusion rule

Under the income inclusion proposals all income would be subject to a minimum tax and where a company is taxed on income below that rate there would be a top-up tax to pay.

This rule is stated as applying to all income and would thus go beyond just the digital economy. As such this proposal has faced some robust criticism. One of the key supporters of the second pillar though is the US with the Treasury Secretary Steve Mnuchin stating that this is their preferred route – not least because the US already has a form of a minimum tax through the Global Intangible Low Tax Income (GILTI) rule introduced by President Trump. It is also understood that China supports this over the pillar one mechanisms.

In the context of finance transactions such a rule could greatly impact the way in which groups structure their financing needs and remove some of the very common and simple arbitrage structures that multinational groups use to take advantage of the differing tax rates in the jurisdictions in which they operate. Meanwhile for lenders such a rule would remove their own tax position as a driver in determining which jurisdiction to advance a loan from.

There is still though much work to be done on these proposals including who would get any additional tax (whether it would be the jurisdiction of the shareholder (which would not assist developing countries) or an apportionment across the group), practical issues around implementing such a tax and the actual minimum rate.

Tax on eroding base payments

Another aspect of pillar two is an exploration of whether jurisdictions should be allowed to protect themselves from payments made to low-tax jurisdictions. This would either be through denying deductions on payments made to a related entity in another jurisdiction if they are not "sufficiently taxed" in the hands of the recipient or only allowing payments to receive the benefit of treaty relief from withholding tax if it was subject to tax at a minimum rate. These changes unlike the income inclusion rule are targeted at payments between related parties and as such should not impact on payments between unrelated borrowers and lenders.

IMPACT ON FINANCE AND BANKING

The rewriting of the international tax rules would have significant implications for finance and banking. For both borrowers and lenders there would be a need to consider the efficacy of their internal structures and whether the changes to the definition of permanent establishment under pillar one or the pillar two GloBE proposals mean that restructuring will be needed or desirable. Lenders will also need to consider their lending covenants and the impact on these where they are given on a post-tax basis. From a due diligence perspective lenders may also be concerned to ensure that borrowers are aware of the proposals and have considered the potential impact. For borrowers that are involved in the digital economy this will inevitably require greater activity than for more traditional borrowers but even they will need to keep an eye on the proposals as they develop.

NEXT STEPS

The OECD proposals represent a wide-ranging programme of work for fundamentally altering the way in which the global tax system operates. The stated aim is to develop a unified approach by the beginning of 2020 with the delivery of a final report by the end of 2020. Given the potential impact of the changes being suggested this is an extremely challenging timetable in which to obtain consensus across the 129 jurisdictions involved. Given the success of the OECD in developing and implementing BEPS mark 1.0 the possibility that it will happen should not be entirely dismissed and borrowers and lenders should therefore engage with the proposals as part of their forward-looking risk management. ■

Further Reading:

- Withholding tax – the impact of the OECD Multi-lateral Instrument (2017) 11 JIBFL 713.
- Implementation of the OECD's Common Reporting Standard in Brazil (2017) 7 JIBFL 441.