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TAX FLASH NEWS

15 October 2019

OECD releases public consultation document on a 'unified approach' for taxing the digital economy

Following a meeting on 1 October 2019 of the Organisation for Economic Co-operation and Development (OECD) Task Force on the Digital Economy (TFDE), the OECD on 9 October 2019, released a public consultation document[1]. It sets out a proposal for a unified approach to the nexus and profit allocation challenges arising from digitalisation. It seeks comments[2] from the stakeholders on a number of policy issues and technical aspects. The comments provided will assist members of the Inclusive Framework in the development of a solution for its final report to the G20 in 2020.

Background

The taxation of enterprises that use digital technology has been high on the international political agenda and is a key topic of focus in the broader context of the fight against Base Erosion and Profit Shifting (BEPS) and the perceived mismatch between taxation and value creation.

In October 2015, OECD released the final report on Action Plan 1, 'Addressing the Tax Challenges of the Digital Economy', together with the final reports on the other 14 elements of the Action Plan on BEPS. The Action Plan 1 provides OECD's observations regarding the digital economy and recommended next steps to address the tax challenges presented by its evolution. It states that special rules designed exclusively for the digital economy would prove unworkable, broadly stating that the digital economy cannot be ringfenced because it 'is increasingly becoming the economy itself,' and summarises key features of evolving digital business models that OECD considers relevant for the overall BEPS analysis It also considers broader direct and indirect tax challenges raised by the digital economy and evaluates options to address those challenges. However, it does not recommend any of the options analysed and leaves it up to individual countries to introduce any of them as additional safeguards against tax challenges of digitalisation.

In March 2018, OECD released a document 'Tax Challenges Arising from Digitalisation - Interim Report 2018' (the Interim Report) as a follow up to BEPS Action Plan 1. The Interim Report sets out the Inclusive Framework jurisdictions' agreed direction of work on digitalisation and the international tax rules through 2020. The Interim Report does not make any specific recommendations to countries, indicating instead that further work will need to be carried out to understand the various business models operated by enterprises offering digital goods and services, as well as digitalisation more broadly. However, despite the technical complexity and the diverse positions, the Inclusive Framework jurisdictions agreed to undertake a coherent and concurrent review of the rules and achieve a consensus-based solution by 2020.

In January 2019, OECD released a Policy Note communicating that the renewed international discussions were going to focus on two central pillars, one pillar addressing the broader challenges of the digitalization of the economy and focusing on the allocation of taxing rights, and a second pillar addressing remaining BEPS concerns. Following the Policy Note, OECD released, in February 2019, a Public Consultation Document describing the two pillar proposals at a high level, received extensive comments from stakeholders, and held a public consultation in March 2019.

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[1] Secretariat proposal for a Unified Approach under Pillar One (the Proposal)

[2] The stakeholders are invited to send their comments by 12 November 2019, by email to TFDE@oecd.org in word format.

In May 2019, OECD released the 'Programme of Work to Develop a Consensus Solution to the Tax Challenges Arising from the Digitalisation of the Economy' (the Workplan). Under the timeline set forth in the Workplan, an outline of the architecture of a long-term solution to address the challenges of the digitalisation of the economy is to be submitted to the BEPS Inclusive Framework for agreement in January 2020 and work will continue to flesh out the policy and technical details of the solution throughout 2020 to deliver consensus agreement on new international tax rules by the end of 2020.

On 9 October 2019, OECD released a public consultation document with a proposal developed by the OECD secretariat for a 'unified approach' under Pillar One.

A 'unified approach' under Pillar One

While there is some variation in how the three proposals of Pillar One address the challenges of the digital economy, the OECD paper highlights a number of commonalities between each approach. In particular, each of the proposals in Pillar One would grant greater taxing rights over the profits of businesses to the user/market jurisdiction and would therefore require a new nexus rule that would not be based on physical presence in the user/market jurisdiction. In seeking to relocate taxing rights, the suggested approaches would go beyond the arm's length principle while aiming for simplicity and increased tax certainty.

The OECD consultation document attempts to take these commonalities and use them to identify the key features of a possible long-term solution, which would include the following:

Scope

The allocation of a new taxing right to market jurisdictions through new nexus and profit allocation rules would recognise that in today's globalised and increasingly digitalised economy a range of businesses can project themselves into the daily lives of consumers (including users), interact with their consumer base and create meaningful value without a traditional physical presence in the market.

Thus, the proposed 'unified approach' should be focused on large consumer-facing businesses. It would also suggest that some sectors (for example, extractive industries and commodities) would be carved-out. Further discussion should take place to articulate and clarify this scope, including consideration of how a consumer-facing business might be defined and how the concepts of consumer products or consumer sales would deal with the supply of goods and services through intermediaries, the supply of component products and the use of franchise arrangements. It should be considered that whether other sectors (e.g. financial services) should also be carved out, taking into account the tax policy rationale as well as other practicalities. Such discussion should also include consideration of size limitations, such as, the Euro750 million revenue threshold used for country-by-country reporting requirements.

New nexus rule

The Proposal elaborates the new nexus rule which would address all cases where a business has a sustained and significant involvement in the economy of a market jurisdiction, such as through consumer interaction and engagement, irrespective of its level of physical presence in that jurisdiction. The simplest way of operating the new rule would be to define a revenue threshold in the market (the amount of which could be adapted to the size of the market) as the primary indicator of a sustained and significant involvement in that jurisdiction. The revenue threshold would also take into account certain activities, such as online advertising services, which are directed at non-paying users in locations that are different from those in which the relevant revenues are booked.

This new nexus would be introduced through a standalone rule, on top of the permanent establishment rule to limit any unintended spill-over effect on other existing rules. Further a revenue threshold would not only create nexus for business models involving remote selling to consumers but would also apply to groups that sell in a market through a distributor (whether a related or non-related local entity). This would be important to ensure neutrality between different business models and capture all forms of remote involvement in the economy of a market jurisdiction.

New and revised profit allocation rules

Once it is determined that a country has the right to tax profits of a non-resident enterprise under the new nexus approach, the next question would be how much profit should be allocated to that jurisdiction. The Proposal describes a new profit allocation rule that is applicable to taxpayers within the scope of the 'unified approach' and would operate regardless of whether taxpayers have an in-country marketing or distribution presence (a permanent establishment or a subsidiary) or sell through unrelated distributors.

The Proposal suggests that the new rules, taken together with existing transfer pricing rules, will need to deliver the agreed quantum of profit to market jurisdictions and it should be simple, avoid double taxation, and significantly improves tax certainty relating to the current position.

The Proposal for a 'unified approach' under Pillar One proposes a three-tier mechanism for allocating profits.

Three-tiered mechanism

Amount A – a new profit allocation rule

The first type of profit, Amount A, would reallocate a portion of the deemed residual profit of a multinational business (on a group or business line basis) to market jurisdictions irrespective of the location and/or residence of that business, consistent with the creation of a new nexus unconstrained by physical presence requirements. The same is to be determined as follows:

- The starting point for the determination of Amount A would be the identification of the MNE group's profits. The relevant measure of profits could be derived from the consolidated financial statements under the accounting standards of the headquarters jurisdiction prepared in accordance with the Generally Accepted Accounting Principles or the International Financial Reporting Standards.

- The second step in calculating Amount A would seek to approximate the remuneration of the routine activities based on an agreed level of profitability. In broad terms, these are profits which, by analogy to the residual profit split method, would be regarded as rewarding routine functions. They are accordingly excluded from the calculation of the pool of profits from which the allocation to market jurisdictions would be made.

- Once profits in excess of the stipulated level of profitability are deemed to be the group's non-routine profits, determine the split of those deemed non-routine profits between the portion that is attributable to the market jurisdiction and the portion that is attributable to other factors such as trade intangibles, capital and risk, etc.

- The final step of the proposed approach would be to allocate the relevant portion of the deemed non-routine profit among the eligible market jurisdictions. This allocation should be based on a previously agreed allocation key, using variables such as sales. The selected variables would seek to approximate the appropriate profit due to the new taxing right.

An important aspect of this approach would be to determine the level of profitability to be taken as representing 'routine' profits and also determine the portion or percentage of the deemed non-routine profit that should go to the market jurisdictions, through an allocation key based on sales. The level of profitability and the split of the non-routine profits could be determined using a variety of approaches, but, as illustrated in the discussion above, a simplified approach could be to agree on a formula through the application of fixed percentages, possibly with variances by industry.

Amount B

Activities in market jurisdictions, and in particular distribution functions, would remain taxable according to existing rules (e.g. transfer pricing under the arm's length principle and permanent establishment allocation under Article 7). The second type of profit would seek to establish a fixed return (or fixed returns, varying by industry or region) for certain 'baseline' or routine marketing and distribution activities taking place in a market jurisdiction. However, given the large number of tax disputes related to distribution functions, the possibility of using fixed remunerations would be explored, reflecting an assumed baseline activity. Appropriate and negotiated fixed returns could provide certainty to both taxpayers and tax administrations and reduce the dissatisfaction with the current transfer pricing rules.

Amount C

Any dispute between the market jurisdiction and the taxpayer over any element of the proposal should be subject to legally binding and effective dispute prevention and resolution mechanisms. This would include those cases where there are more functions in the market jurisdiction than have been accounted for by reference to the local entity's assumed baseline activity (which is subject to the fixed return in B above), and that jurisdiction seeks to tax an additional profit on those extra functions in accordance with the existing transfer pricing rules.

The document also states that the interaction between Amount A and Amount C must be clearly defined to avoid a situation where profit under Amount A would be also allocated to a market jurisdiction under Amount C (due to functional activity in that jurisdiction).

Further work on certain aspects of the detailed interaction of Amounts A and C would therefore be warranted.

Next steps

A public consultation is scheduled for 21/22 November 2019 to engage with business and other stakeholders. OECD accepts that there are number of areas in which further work will be required and has invited the public comments, specifically in relation to the proposed scope of the unified approach, the new nexus rules, the calculation and determination of Amounts A, B and C and appropriate measures for dispute resolution.

Another separate public consultation meeting on Pillar Two issues will be organised in December 2019, and the related public consultation document is expected to be released in early November 2019.

The OECD proposal indicates that the goal would be to advance towards a unified approach for approval by next meeting of the OECD Inclusive Framework in January 2020 with the final proposals in respect of Pillars one and two ready for the G20 meeting in Riyadh in November 2020.

Our comments

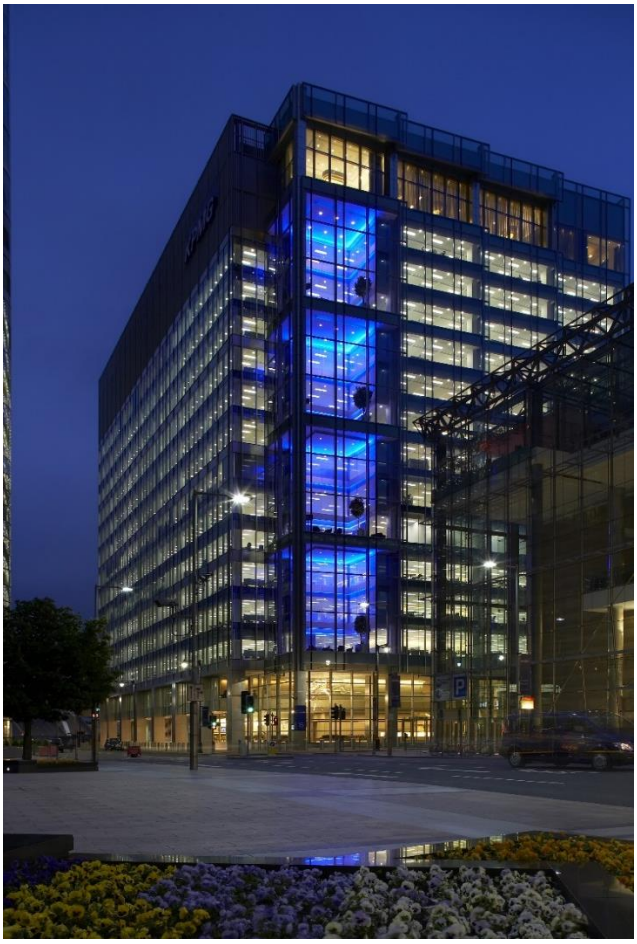
This OECD's proposal for taxation of digital economy is aimed at reaching a consensus based solution for addressing the tax challenges of digitalisation. The proposals are intended to apply to highly digitalised businesses as well as other consumer focused businesses who use digital tools for developing their customer base. It considers that higher profit, beyond those determined based on arm's length principle needs to be allocated to market jurisdictions.

If the suggestions provided in the proposal are accepted, there will be a shift of taxing rights on the profits arising on account of digital business. This will largely impact the major technology driven companies. Such companies may require to pay higher taxes in a market jurisdictions like India.

The OECD proposal provides 'sales' as the new nexus. India has already proposed profit attribution rules based on a formulatory apportionment with sales being a factor. It is important to note that the CBDT profit attribution paper proposed a shift from the ALP principles. Whereas, the OCED proposal stated that the new measures have to coexist with the ALP principle with minimal disruptions.

The proposal for a new nexus rule based on a revenue threshold is in line with the SEP provisions introduced by India. Further the blend of existing transfer pricing principles and formulary allocation rules will be helpful. However, a calculation of non-routine profits may pose challenges.

In view of the OECD proposal, it would be interesting to see whether India will reconsider its stance on arbitration to provide more certainty.



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