

TAX FLASH NEWS

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OECD – Programme of work to develop a consensus based solution to the tax challenges arising from the digitalisation of the economy

The tax challenges of the digitalisation of the economy were identified as one of the main areas of focus of the Organisation for Economic Co-operation and Development (OECD)/G20 Base Erosion and Profit Shifting (BEPS) Project, leading to the 2015 BEPS Action Plan 1 Report.

From a direct tax perspective, the Action Plan 1 Report observed that digitalisation raised a series of broader tax challenges, identified as ‘nexus, data and characterisation’. These challenges, however, were acknowledged as going beyond BEPS, and were described as chiefly relating to the question of how taxing rights on income generated from cross-border activities in the digital age should be allocated among jurisdictions.

Following a mandate by G20 countries in March 2017, the Inclusive Framework (IF), working through its Task Force on the Digital Economy (TFDE) delivered an Interim Report in March 2018¹. The Interim Report provided an in-depth analysis of new and changing business models that enabled the identification of three characteristics frequently observed in certain highly digitalised business models, namely *scale without mass, heavy reliance on intangible assets, and the importance of data, user participation and their synergies with intangible assets*.

With further deadlines to be met, the IF intensified its work after the delivery of the Interim Report, consistent with the analysis included in the Action 1 Report as well as the Interim Report. While members made suggestions on how the work could be taken forward to achieve progress towards a

consensus-based solution, some proposals focused on the allocation of taxing rights by suggesting modifications to the rules on profit allocation and nexus, other proposals focused more on unresolved BEPS issues.

The Policy Note and the Consultation document

On 29 January 2019, OECD released a ‘Policy Note’ which, amongst other things, has dealt with a number of proposals to address the tax challenges of the digitalisation of the economy. The TFDE agreed to examine four proposals involving two pillars which could form the basis for consensus; Pillar One focuses on the allocation of taxing rights (the new taxing right), and seeks to undertake a coherent and concurrent review of the profit allocation and nexus rules (three proposals have been articulated to develop a consensus-based solution on how taxing rights on income generated from cross-border activities in the digital age should be allocated among countries, namely, the ‘user participation’ proposal, the ‘marketing intangibles’ proposal and the ‘significant economic presence’ proposal); and Pillar Two focuses on the remaining BEPS issues and seeks to develop rules that would provide jurisdictions with a right to ‘tax back’ where other jurisdictions have not exercised their primary taxing rights or the payment is otherwise subject to low levels of effective taxation.

Thereafter, OECD published the consultation document on 13 February 2019 that also aimed to deal with addressing the tax challenges of the digitalisation of the economy. The consultation document sought input from external stakeholders on the specific proposals examined under Pillar One and Pillar Two.

¹ Tax Challenges Arising from Digitalisation – Interim Report 2018. For the detailed Flash News click on the following link: <http://www.in.kpmg.com/TaxFlashNews-INT/KPMG-Flash-News-OECD-interim-report-on-the-Tax-Challenges-Arising-from-Digitalisation-1.pdf>

OECD's Programme of work

OECD has now released the 'Programme of work', which along with the public consultation process and inputs received from various stakeholders, highlights important areas that need to be discussed among the members of IF.

Although further work will be conducted in parallel to reach a political agreement on the objective and scope of a unified approach out of the three proposals under Pillar One, the 'Programme of work' would deal with the technical issues that need to be resolved and are grouped in the following three categories: 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.

The IF expressed its concern that a proliferation of uncoordinated and unilateral actions would not only undermine the relevance and sustainability of the international framework for the taxation of cross-border business activities, but will also more broadly adversely impact global investments and growth.

This economic and political context is at the foundation of the 'Programme of work' for each Pillar outlined in this report, which has been developed by IF with a view to reporting progress to the G20 Finance Ministers later this month and delivering a long-term and consensus-based solution in 2020. The work programme contained in this paper provides a path to finding such a solution and will also require an early political steer informed by an economic analysis and impact assessment of the possible designs of a solution. The details of the work are discussed in greater detail in the ensuing paragraphs.

Pillar 1 - New profit allocation and nexus rules

The new taxing right requires a method to quantify the amount of profit reallocated to market jurisdictions and a method to determine how that profit should be allocated amongst the market jurisdictions entitled to tax under the new taxing right.

New profit allocation rules

The different methods to determine the profit subject to the new taxing right that would be further explored, including the possible use of more simplifications to

minimise compliance costs and disputes. The same are discussed as follows:

Modified residual profit split method –

The Modified Residual Profit Split (MRPS) method would allocate to market jurisdictions a portion of an MNE group's non-routine profit that reflects the value created in markets that is not recognised under the existing profit allocation rules. It involves the following four steps:

- determine total profit to be split;
- remove routine profit, using either current transfer pricing rules or simplified conventions;
- determine the portion of the non-routine profit that is within the scope of the new taxing right, using either current transfer pricing rules or simplified conventions; and
- allocate such in-scope non-routine profit to the relevant market jurisdictions, using an allocation key.

Fractional apportionment method

The fractional apportionment method involves the determination of the amount of profits subject to the new taxing rights without making any distinction between routine and non-routine profit. One possible approach to assess the profit derived by a non-resident enterprise is to take into account the overall profitability of the relevant group (or business line). This method would involve the following three steps:

- determine the profit to be divided,
- select an allocation key, and
- apply this formula to allocate a fraction of the profit to the market jurisdiction(s).

Distribution-based approaches

In contrast to the MRPS method, this approach could address, in addition to non-routine profit, profit arising from routine activities associated with marketing and distribution. The approach here is to specify a baseline profit in the market jurisdiction for marketing, distribution and user-related activities.

Other options might also be considered, for example, the baseline profit could increase based on the MNE group's overall profitability. Through this mechanism, some of the MNE group's non-routine profit would be reallocated to market jurisdictions. The baseline profit could also be modified by additional variables to accommodate, for instance, industry and market differences.

Explore the use of business line and regional segmentation

Since the profitability of a MNE group can vary substantially across different business lines and regions, with a view to avoid unintended outcomes and distortions, and ensure a proper balance between

simplicity and precision, this approach will explore the possibility of determining the profits subject to the new taxing right on a business line and/or regional basis.

Consideration would be given to a) the information MNE groups already prepare (e.g. for accounting, securities law, or regulatory purposes); b) the extent to which this information could be used reliably to segment MNE groups by business line; and c) any other required information.

Design scoping limitations

This approach will explore different limitations that could operate either by reference to the nature (e.g. safe harbours, and/or other criteria) or the size (e.g. thresholds based on revenue, etc.) of a given business. To the extent that the activities and assets within the scope of the new taxing right would not be undertaken or exploited by all businesses, scope limitations may be appropriate.

Develop rules on the treatment of losses

This approach will explore the different options available for the treatment of losses under the new taxing right. The option would involve exploring issues and options in connection with the design of rules for the treatment of losses.

New nexus rules

This would involve developing a new non-physical presence nexus rule to allow market jurisdictions to tax the measure of profits allocated to them under the new profit allocation rules and would require an evaluation of the relative merits of alternative approaches, that includes amendment to the definition of a Permanent Establishment (PE) in Article 5 and ensuing changes to Article 7 of the OECD Model Convention.

The proposals discussed above, may, envisage reallocating taxing rights over a proportion of an MNE group's profit, rather than over the profit from specific transactions or activities undertaken by particular separate entities. This leads to a question of how source jurisdiction would allocate the taxing rights and how residence jurisdictions would provide relief from double taxation of the relevant income. This report would explore the effectiveness of the existing treaty (and domestic law) provisions and the need to develop new or enhanced provisions.

The implementation of any of the approaches would first require identifying the taxpayer on whom the tax liability would rest along with the filing obligations. 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. The report would need to examine, and develop recommendations to address, these enforcement and collection issues.

Any proposal seeking an allocation of taxing rights over a portion of a non-resident enterprise's business profits in the absence of physical presence and computed other than in accordance with the arm's length principle would require changes to existing tax treaties if they are to be successfully implemented.

Pillar 2 – Global anti-base erosion proposal

The global anti-base erosion (GloBE) proposal is based on the premise that in the absence of multilateral action, there is a risk of uncoordinated, unilateral action, both to attract more tax base and to protect existing tax base, with adverse consequences for all countries, large and small, developed and developing as well as taxpayers. The proposal seeks to address the remaining BEPS challenges through the development of the following two inter-related rules:

- an **income inclusion rule** that would tax the income of a foreign branch or a controlled entity if that income was subject to tax at an effective rate that is below a minimum rate; and
- a **tax on base eroding payments** that would operate by way of a denial of a deduction or imposition of source-based taxation (including withholding tax), together with any necessary changes to double tax treaties, for certain payments unless that payment was subject to tax at or above a minimum rate.

Income inclusion rule

Further work would be carried out to explore an inclusion rule that would impose a minimum tax rate. In general terms, it is contemplated that this rule would apply where the income is not taxed at least at the minimum level, that is, it would operate as a top up to achieve the minimum rate of tax. Work would also be carried out on an approach using a fixed percentage rather than a percentage of the parent jurisdiction's CIT rate or a range or corridor of CIT rates. With a view to improve compliance and administrability for both taxpayers and tax administrations and to neutralise the impact of structural differences in the calculation of the tax base, further simplifications would be explored. One simplification could be to start with relevant financial accounting rules subject to any agreed adjustments as necessary.

Tax on base eroding payments

The second key element of the proposal is a tax on base eroding payments that complements the

income inclusion rule by allowing a source jurisdiction to protect itself from the risk of base eroding payments. More specifically, this element of the proposal would explore:

- an *undertaxed payments rule* that would deny a deduction or impose source-based taxation (including withholding tax) for a payment to a related party if that payment was not subject to tax at a minimum rate; and
- a subject to tax rule in tax treaties that would only grant certain treaty benefits if the item of income was subject to tax at a minimum rate.

Rule co-ordination, simplification, thresholds and compatibility with international obligations

Further work will also be required on rule co-ordination, simplification measures, thresholds and carve-outs to ensure the proposal avoids the risk of double taxation, minimises compliance and administration costs and that the rules are targeted and proportionate. In this context it is important to analyse the interaction between this proposal and other BEPS Actions.

Economic Analysis and impact assessment

An in-depth economic analysis will be carried out of the impact of each of the proposals throughout the entire period of the 'Programme of work'. The timing of this work will need to be phased in such a way as to deliver members of IF with the information required to take decisions at key milestones. Building upon the preliminary economic analysis already undertaken, the 'Programme of work' will require further analysis to be provided to members of the IF by the end of 2019. Continued work will be carried out during 2020, to ensure that the IF can be kept fully informed of the impact of key technical decisions relating to the design of the proposals.

Organisation of the future work and the next steps

The work towards a consensus-based solution will proceed along the following separate (but connected) tracks, viz; the Steering Group will continue the process aimed at reaching an agreement on a unified approach to addressing the issues of profit allocation and nexus under Pillar One and agreement on the key design elements of the GloBE proposal under Pillar Two; the subsidiary bodies will provide technical input on certain issues that may arise in the course of developing a consensus-based

solution as well as the preparation of final reports that will determine the details of the agreement reached by the Inclusive Framework; and an economic analysis and impact assessment of the proposals under the two pillars would be provided.

Further work would be continued to be carried out on the development of a unified approach under Pillar One and the key design elements of the GloBE proposal under Pillar Two so that a recommendation on the core elements of long-term solution can be submitted to the Inclusive Framework for agreement at the beginning of 2020. Throughout 2020 IF, Steering Group and Working Parties will work on agreeing the policy and technical details of a consensus-based, long-term solution to the challenges of the digitalisation of the economy and will deliver a final report by the end of 2020.

Our comments

The current international tax rules have their own set of limitations not only with respect to the highly digitalised businesses but also vis-à-vis other aspects of the economy and trade. Digitalisation has changed the ways of doing existing businesses.

After the consultation process with the stakeholders throughout 2018, OECD in quick succession has released the Policy Note followed by the consultation document and now the 'Programme of work' wherein OECD has in a concrete form laid out proposals (in a two pillar approach) which would be evaluated to arrive at conclusive steps on the measures to be adopted to address the tax challenges of the digitalisation of the economy.

While an attempt is being made by OECD to work out concrete proposals to address the challenges of the digital economy, the timeline is extremely ambitious given the need to revisit fundamental aspects of the international tax system. It is, however, reflective of the political imperative that all members of the IF attach to finding a timely resolution of the issues at stake.

On the lines of BEPS Action Plan 1 report which suggested that countries could introduce any of the three options analysed by the said report, in their domestic law as additional safeguards against BEPS, from an India perspective, there has been much development. India introduced an 'Equalisation Levy' (EL) in 2016. Further, India has also amended the nexus rules for taxation of business income of a non-resident in India in the domestic law by incorporating the concept of Significant Economic Presence (SEP) in 2018 to enlarge the scope of 'business connection'. Earlier Israel had introduced the concept of SEP in 2016 to address the challenges of the digital economy. India has also adopted several other measures emanating out of

the other BEPS Action Plans².

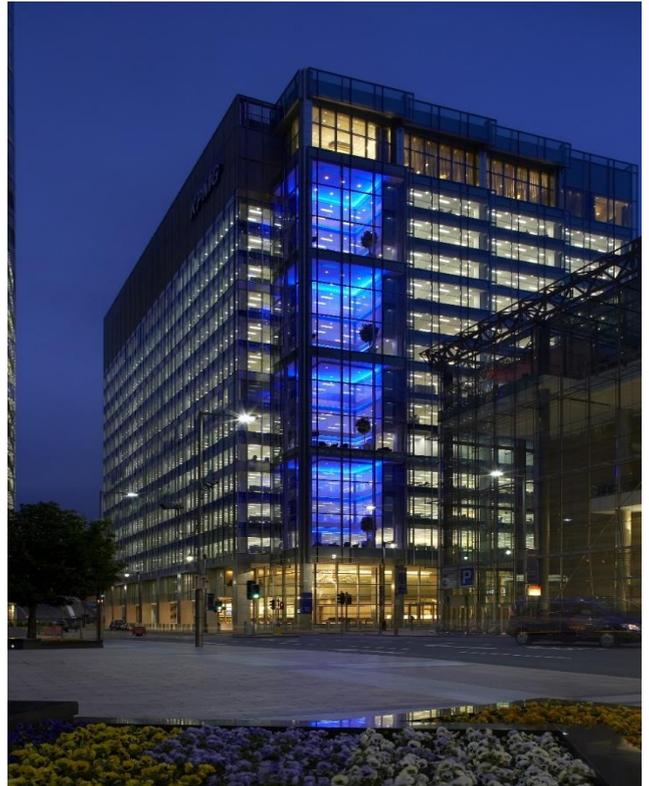
The report also stated that countries may wish to impose these measures to address digital economy related BEPS concerns if they believed that the BEPS concerns are not adequately addressed by OECD's recommendations, or as a 'stop-gap' measure until the OECD's recommendations are fully implemented, provided they respected existing treaty obligations, or provisions in their bilateral tax treaties. The manner in which the EL and SEP provisions are introduced, it appears that the EL and SEP provisions are not on a temporary basis and there is no indication that these would be reviewed once the OECD recommendations are fully implemented.

Pursuantly, one has witnessed that countries/regions (for e.g. European Union, Australia, U.K. Spain, Austria, etc.) have contemplated to introduce a tax on digital transactions. These measures are proposed to be introduced by each country independently to secure the respective country's tax base from being eroded. These proposals have been greeted with mixed responses so far with the biggest opposition being from the U.S. which is opposing the developments adopted by these countries amounting to unilateral un-co-ordinated measures.

The report recently released by OECD highlights that there are several issues that would emanate out of the two pillar proposals and that it would require examination and evaluation of several aspects to ensure that not only do the proposals address the BEPS concerns but there is also a need to ensure that they also align themselves to administrative and international obligations' compatibility.

The report also states that any proposal that would require changes to the existing tax treaties (in the absence of physical presence and computed other than in accordance with the arm's length principle) to introduce the new nexus and profit allocation rules would need to address the challenges that arise in relation to the elimination of double taxation and the resolution of associated disputes and that various options would have to be evaluated while dealing with the issues. This calls for a lot of deliberation as there seems to be a lot of divergent views amongst the members of IF when it comes to adopt one of the three proposals ('user participation', 'marketing intangibles' and 'SEP') under Pillar one.

The release of 'Programme of work' by OECD seems to suggest that there is a lot of unfinished agenda in terms of BEPS Action Plan 1. Dealing with the finer nuances of the different proposals seems to be an overwhelming task particularly when the political outline of different countries (more than 100 members of the IF) would have an influential role to play in determining the course of action to address the tax challenges of the digitalisation of the economy.



² For e.g. Interest Limiting deductions under Action Plan 4, Patent Box Regime under Action Plan 5, Treaty abuse provisions under Action Pan 6, etc.,

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