OECD consultation to reshape the international tax system for the digitalised age commences

15 February 2019

In brief

The OECD released a detailed consultation document on 13 February 2019, commencing a 17 day window for stakeholders to submit comments before a public consultation in March on proposals to address the tax challenges arising from the digitalisation of the economy. This followed nearly two years of work, and with less than 18 months remaining until final recommendations will be made, the release of an Inclusive Framework policy note on 29 January 2019 foreshadowed this formal consultation. That note outlined at a high level the four options (under two pillars) that will form the basis of the final year of the OECD's work in this area (see our tax policy bulletin detailing the policy note and background).

More depth of analysis is now included on each of the options under consideration, all of which would radically alter the allocation of taxing rights between countries for all international businesses. The options are being examined by 127 countries of the OECD Inclusive Framework on a 'without prejudice' basis, and are broadly:

- Measures to address base-eroding payments (investor pickup, and restrictions in tax deductibility / treaty benefits, where other countries levy low rates of tax on income or gains); with
- New rights to tax profits based on either (or a combination of) specific proposals focused on attributing value to:
  - Marketing intangibles
  - User participation
  - Significant economic presence

The note signals an expectation of significant changes in both the allocation of taxing rights between countries across the whole economy, and the ability of businesses to benefit from low effective tax rates in some jurisdictions. How significant the final, consensus-based measures will be depends on the countries of the Inclusive Framework finding ample common ground - something that still seems elusive but is usually reached at some level.

In the meantime, unilateral measures continue, increasing the pressure on businesses in scope, and on governments to reach and implement this agreement.

This tax policy bulletin looks at each of the four proposals under the two pillars being discussed, as well as the consultation document itself, and next steps, as well as some other relevant tax policy developments outside of the OECD direct tax process.

In detail

Background

In 2012, *Addressing the Tax Challenges of the Digital Economy* was the first Action Item under the ambitious G20/OECD Base Erosion and Profit Shifting (BEPS) Project. In a 2015 Final Report, the OECD concluded that for direct taxes, its actions under the other 14 BEPS Action Items would *"substantially address the BEPS issues exacerbated by the digital economy at the level of both the market jurisdiction and the jurisdiction of the ultimate parent company, with the aim of putting an end to the phenomenon of so-called stateless income."*

However, the OECD's conclusions in 2015 also recognised that the digitalisation of the economy poses broader tax challenges than simply exacerbating existing BEPS challenges, and in 2017 the G20 requested that the OECD (with input of the now 127 countries of its Inclusive Framework) accelerate its scheduled 2020 review, and deliver instead an interim report in 2018 and a final report in 2020.

Following nearly two years of work, including a detailed interim report in 2018 (see our tax policy bulletin) since the G20 mandate was issued, and with less than 18 months remaining until final recommendations will be made, the release of an Inclusive Framework policy note (see our tax policy bulletin) on 29 January 2019 outlined at a high level the four options (under two pillars) that will form the basis of the OECD's final year of work in this area, and foreshadowed the release of a formal consultation.

Consultation document

The OECD released a more detailed consultation paper on 13 February 2019, commencing a brief 17 day window (to 1 March) for stakeholders to submit written comments before a public consultation on 13 and 14 March 2019.

While the recent policy note referred to two 'pillars,' this term is not used in the formal consultation document. Instead, two chapters are included covering 'Revised profit allocation and nexus rules' and 'Global anti-base erosion proposal' (Chapters 2 and 3, respectively).

Each chapter illustrates the challenges that members have identified, then details the proposals that the Inclusive Framework countries are examining on a 'without prejudice' basis, before concluding with a few specific questions on which the OECD invites comment.

Observation: While much more depth on the options under consideration are included, there clearly is significant work ahead, and it will be challenging for stakeholders to respond meaningfully in such a short window. The consultation questions under chapter 2 are very general, focusing on broad design considerations and what behavioural responses might be, indicating much less certainty over direction than chapter 3, where the questions revolve much more around resolving detailed technical challenges that await.

Revised profit allocation and nexus rules

Overview

The OECD is considering three proposals, which *"have the same over-arching objective... to recognise, from different perspectives, value created by a business's activity or participation in user/market jurisdictions that is not recognised in the current framework for allocating profits".*

A significant question that separates the three proposals is whether 'remote' participation is a feature only of highly digitalised businesses, or a broader range of international businesses.

The proposals are said to have some commonalities, and accordingly, the OECD is considering some design elements (such as a mechanism to allocate 'residual' profits) in an aligned way.

The paper also notes that nexus and profit allocation will be examined closely together, to avoid a repeat of the challenges that arose under BEPS Action 7, where a permanent establishment threshold was agreed before profit attribution guidance was finalised, and is said to have resulted in limited additional profits being allocated to the source jurisdictions where the functions undertaken in that jurisdiction took on limited risks.

Observation: There is significantly more detail on the user participation proposal and the marketing intangibles proposal than the significant economic presence proposal. The document notes that the first two have greater similarity and potentially therefore could be reconciled into one proposal more easily than the significant economic presence proposal.

Interestingly, the marketing intangibles proposal suggests that taxing rights should be changed to allow market jurisdictions to tax 'marketing intangible' profits (or losses) regardless of physical presence or activities, thus *"despite a different conceptual starting point it would get to a result similar to that which would be achieved using the user participation proposal."*

The document recognises several challenges with each of the proposals, including particularly the calculations themselves and the trade-off between calculating the value generated and the need for a more pragmatic approach (e.g. formula based). How such approaches will be reconciled in a multilateral context remains to be seen; any such system would be very different from the existing international tax framework and may require new instruments instead of relying on updates to existing ones with guidance revisions.

A: User participation

The user participation proposal contemplates that the activities and participation of 'users' (of online platforms) are a critical component of value creation, both in absolute and relative terms.

The document suggests this is the case predominantly for social media platforms, search engines, and online marketplaces, because either the content, the size of the network, or both, are determined by these users. These three business models are the same as those identified by the UK in its 2017 and 2018 discussion documents, and subsequently targeted by the UK's Digital Services Tax (currently also under consultation).

The proposed four stage profit allocation mechanism is to:

- calculate the 'residual' profits of a business (the remainder after all routine functions have been rewarded)
- attribute a proportion of the residual to the user base (either a pre-agreed percentage or thorough analysis)
- allocate between user jurisdictions based on an agreed allocation metric (e.g. revenues), and
- give rights to jurisdictions to tax these profits, irrespective of whether existing activities result in a taxable presence there.

Observation: A broader economic challenge to this proposal found later in the document speculates that users are third parties, and therefore their contributions may not constitute value created by the business (instead they are remunerated via free services). This implies that the VAT system may be a more appropriate vehicle to tax these interactions, although this is unlikely to persuade proponents of the user participation proposal.

In addition, as digitalisation impacts more businesses, the document questions whether there is a difference in value creation for specific highly digitalised business models only. While perhaps the most limited of the three proposals in chapter 2 (in terms of the number of businesses directly impacted), the digitalisation of the economy could result in many more businesses coming inside this 'ring fence' in the future.

B: Marketing intangibles

The marketing intangibles proposal contemplates a solution that applies to a much broader range of businesses, noting that remote (or limited) access to markets can allow development of user bases, customer bases and other marketing intangibles for all businesses.

The document argues that customer data and relationships contribute toward the development of brand and other marketing intangibles through this interaction. It states that 'trade' intangibles differ from 'marketing' intangibles, as the former does not require an intrinsic link to the market jurisdiction (the example given is an efficient engine, which will perform in the same way regardless of where it is sold).

Marketing intangibles are explicitly said not to include favourable demand conditions such as a stable population with financial means to purchase.

Two options, suggested as mechanical ways to achieve an allocation to the market jurisdiction (with an allocation of these calculated profits to each 'market' jurisdiction based on an agreed metric (e.g. revenues or users)) involve the use of:

- transfer pricing rules, based on updated assumptions that marketing intangibles (and risks) can be determined and thus are allocated under the current rules, and that they thus could be reallocated to market jurisdictions - relying on analysis of contribution to profit that they provide, or
- a residual profit split following allocation to routine functions (with both the routine allocation and the profit split itself being either functional or formulaic).

Observation: Interestingly, this is the only one of the three proposals that explicitly recognises that losses (as well as profits) may need to be split.

The OECD recognises a challenge that the intrinsic link cited is questionable, especially where activities are undertaken outside a jurisdiction, supplies are business-to-business (with limited customer data reliance), or where no localisation is performed. However, the proposal is potentially more 'future-proof' than the user participation proposal to the extent it seeks to find ways that profits from all business intangibles could be redistributed based on interactions rather than specific digital activities.

C: Significant economic / digital presence

The sufficient economic presence (SEP) proposal notes that SEP was originally mooted in the BEPS Action 1 Report in 2015, and notes that while sustained revenues would be an important factor in determining whether a business had a SEP in a jurisdiction, revenues alone do not always equate to a purposeful and sustained interaction, and this alone would not be sufficient to establish nexus.

Suggestions for secondary factors include:

- users
- volume of digital content derived
- billing and collection in local currency (/local form of payment)
- local language website
- responsibility for delivery and/or support services, and
- sustained marketing activities.

A fractional apportionment method such as that put forward in the BEPS Action 1 Report would require three successive steps, each of which has been furthered with brief methodological suggestions:

- definition of the tax base to be divided (e.g. MNE global profit margin multiplied by local sales)
- determination of the allocation keys to divide that tax base (e.g. sales, assets, employees or, where relevant, users), and
- weighting of these allocation keys.

In keeping with the suggestion from the OECD's recent webcast that this method is intended to be simple to administer, other simplified methods such as deemed profit attribution (possibly by sector, degree of integration and type of product/service, although each adds further complexity) could also be applied, and countries are considering whether a withholding tax could be used as a collection mechanism.

Observation: There is significantly more detail on the user participation proposal and the marketing intangibles proposal. They have more similarities and potentially therefore could be reconciled into one proposal more easily than the SEP proposal.

The proposal seems to mirror a global formulary apportionment much more closely than the other two proposals in chapter 2, relying on agreement of specific metrics on which to allocate taxing rights based on broader principles with corresponding profits allocated based on facts and circumstances within this framework.

Global anti-base erosion proposal

Rationale

While Chapter 3 only puts forward one proposal, it contains several elements that would need to work together, in particular an income inclusion rule, and a backup deduction denial rule.

It focuses on the perceived need for still stronger rules to address BEPS, claiming that existing rules do not provide comprehensive solution to the risk of moving profits to low or no tax jurisdictions, particularly in relation to intangibles (which are prevalent in the digital economy, even though there is recognition that the 'digital economy' should not be ring fenced).

Income inclusion rule

The income inclusion rule would allow taxation of income of a business's controlled entities or branches that are subject to low effective tax rates. This would apply through direct attribution where there is a significant shareholding (e.g. 25%+) or denial of branch exemptions. It is intended to supplement rather than replace existing CFC rules. Technical issues under consideration include:

- calculation of minimum rates
- control tests and entities in scope
- mechanism for assessing whether tax paid is below the minimum (i.e. the ETR test)
- decision whether to tax at the minimum rate or shareholder domestic rate
- safe harbors
- thresholds
- income attribution mechanisms
- double taxation mechanisms, and
- EU law compatibility.

Tax on base-eroding payments

A tax on base-eroding payments would deny deductions or treaty relief where payment is subject to a low effective rate on receipt through two complementary rules.

An undertaxed payments rule:

- applicable to payments where there is (e.g. 25%) common ownership
- would take withholding tax into account

- would include imported mismatch-type rule to deal with conduit arrangements
- may include some consideration of 'substance' of recipient, and
- requires additional design discussions around the scope, ownership threshold, mechanics, international obligations, and whether full or graduated denial is appropriate.

A subject-to-tax rule:

- would apply to treaty benefits otherwise granted under Articles 7 (business profits), 9 (associated enterprises), 10 (dividends), 11-13 (interest, royalties, and capital gains), and 21 (other income)
- would apply to income or gains where (e.g. 25%) common ownership but a broader scope could be explored for Articles 11-13 (interest, royalties, and capital gains), and
- requires additional design discussions around impact on tax exemptions (e.g. participation exemption), information available to taxpayers, and impact on different categories of taxpayers (e.g. individuals, funds, charities).

Observation: Countries will need to change treaties and implement domestic laws to ensure the rules are comprehensive and do not result in double taxation. The OECD recognizes that the rules will need to be coordinated. The OECD is also considering additional rules for 'thickly capitalised' entities (those having lower gearing than a third party in similar economic circumstances), but these are not spelled out. While the global anti-base erosion proposal contains some detail, several broader questions remain under consideration while the proposal is being developed, including:

- which entities should be in scope
- impact of behavioural changes, and
- the role of substance and desire not to impact business decisions.

Double taxation and dispute resolution

Both the policy note and the webcast were clear that members of the Inclusive Framework are committed to ensuring that new rules should result in neither taxation when there is no economic profit, nor double taxation.

This was stressed through recognizing the important need for effective dispute prevention and dispute resolution tools.

Also mindful of compliance and administrative burdens, the OECD states that the proposals will be designed to be as simple as possible, and simplification measures will be considered as part of the overall project.

Observation: The OECD recognises the importance of certainty and avoiding double taxation and states that a commitment to ensuring mechanisms to relieve double taxation and manage disputes will be discussed at the outset. This commitment is perhaps the area where there is the most agreement, since it is included in all four proposals. However, relieving double taxation requires one or more countries to cede rights, so agreeing the detail remains a political challenge.

Unilateral measures observed

The OECD Action 1 Final Report did not recommend unilateral measures in October 2015, but it did state that some members of the Inclusive Framework were interested in pursuing them. In particular, withholding taxes, equalisation levies and significant economic presence (nexus rules) were noted as measures that may be pursued as long as members were mindful of treaty obligations while implementing them.

The OECD's interim report of March 2018 observed that there was no consensus on whether interim measures were necessary, so outlined some design considerations for countries that decided to introduce them unilaterally.

In particular, the OECD interim report observed the following interim measures to date:

- India's equalisation levy on digital advertising; a 6% revenue tax in force since June 2016
- Slovakia and Israel's domestic permanent establishment threshold changes
- France's tax on distribution of audiovisual content
- UK/Australia's Diverted Profits Taxes, and
- Australia's Multinational Anti-Abuse Law.

Since the interim report, several more measures have been proposed and/or introduced by OECD members and beyond.

Observation: Many of the unilateral measures have different scopes, exclusions, and thresholds - and will apply to different businesses. These warrant a separate analysis. The complexity for businesses in scope to comply with these rules when many enter into force will be a significant challenge, and the risk of double taxation is high absent agreement on these key points.

VAT/GST

Similar to corporate tax, antiquated VAT/GST law has also been struggling to keep up with the challenges posed by the rapid digitalisation of the economy, both in terms of the place of taxation and the effective collection of VAT/GST on sales of goods and services facilitated by the internet.

However, as set out in BEPS Action Item 1, the longstanding OECD VAT/GST work on the International VAT/GST Guidelines provides an effective solution to these challenges, and creates a level playing field for businesses, based on applying the destination principle together with a simplified vendor registration and collection model. Notwithstanding this, there still remain a number of significant issues to address such as the consistent application of the OECD-led approach to enable businesses to operate at scale whilst handling the rapidly growing number of compliance requirements.

Furthermore, note also that taxes do not operate in isolation, and so any changes to corporate tax and transfer pricing rules as regards the allocation of taxing rights could also potentially impact VAT/GST, as to differences in where goods and services are effectively taxed and at what value.

Therefore, throughout the course of the OECD process it will be vital to consider and critically assess whether and how any alterations made to the direct tax framework could have unintended and adverse consequences on the indirect tax world.

For more details, see our indirect taxes policy bulletin.

Next steps

The short written consultation window will end on 1 March 2019. A public consultation will then take place on 13 and 14 March 2019 which will influence the scoping and work plan that will be presented to the full Inclusive Framework and the G20 Finance Ministers in May and June 2020 respectively.

The OECD technical work will then continue throughout 2019, led by its Task Force on the Digital Economy.

Observation: The OECD timetable is very tight, with little time available for public comment (only 17 days from the consultation document's release). If businesses want to engage in this process, speed is of the essence.

The takeaway

Change is coming in the way international businesses are taxed, potentially including businesses that operate in few countries, yet export goods and services to many. Already we are observing a broad range of unilateral measures as countries address the challenges that they see with the tax system in the digital age. Some are targeted only at so-called 'highly digitalised' businesses but others are broader and likely to affect all international businesses.

The alternative to a number of uncoordinated unilateral measures is an aligned international solution. The four options on the table will significantly impact all businesses, especially as globalisation and digitalisation change operating models further. The consultation in February and March 2019 is a key opportunity for businesses to contribute to this debate - and the four options on the table - before the OECD commences work on technical solutions that could garner this global agreement.

Let's talk

For a deeper discussion of how these issues might affect your business, please call your usual PwC contact. If you don't have one or would otherwise prefer to speak to one of our global specialists, please contact one of the people below:

Stef van Weeghel, Amsterdam
+31 (0) 88 7926 763
stef.van.weeghel@pwc.com

Phil Greenfield, London
+44 (0) 20 7212 6047
philip.greenfield@pwc.com

Dave Murray, London
+44 (0) 7718 980 899
david.x.murray@pwc.com

Aamer Rafiq, London
+44(0)20 721 28830
aamer.rafiq@pwc.com

Edwin Visser, Amsterdam
+31 (0) 887923611
edwin.visser@pwc.com

Pam Olson, Washington
+1 (202) 414 1401
pam.olson@pwc.com

Will Morris, Washington
+1 (202) 312 7662
william.h.morris@pwc.com