# OECD considers new international tax framework

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# OECD considers new international tax framework to tackle challenges of digitalisation of the economy

**‘Re-conceptualisations of assumptions underlying the existing framework about the location at which an enterprise acts’**
*(Paragraph 66 of the OECD Public Consultation Document)*

Following the January publication of its Policy Note *Addressing the Tax Challenges of the Digitalisation of the Economy*, the OECD on 12 February released a consultation document to collect stakeholder views on the proposals contained within it.
Divided into two ‘pillars’ – one concerned with nexus and profit allocation, the other with the remaining BEPS issues – Pascal Saint-Amans (director of the OECD Centre for Tax Policy and Administration) believes that the suite of proposals is ‘a significant step forward toward resolving the tax challenges arising from digitalisation’.
With many countries introducing their own legislation on this topic, and with the EU proposals seemingly no closer to being implemented, the OECD’s goal of introducing a global solution in 2020 is increasingly pressing. However, given the current lack of consensus between the 128 Inclusive Framework members as to the best approach to take, significant questions remain.

# Diverging views and unilateral measures

**Almost a year ago, the OECD published its long-awaited interim report *Tax Challenges Arising from Digitalisation*. (Our briefing on this is available here.)**

Stark differences in opinions meant that it was not possible for the OECD to reach many firm conclusions in this report. Instead, it largely confined itself to describing the competing views of the Inclusive Framework members. Broadly speaking, countries were divided into three camps:

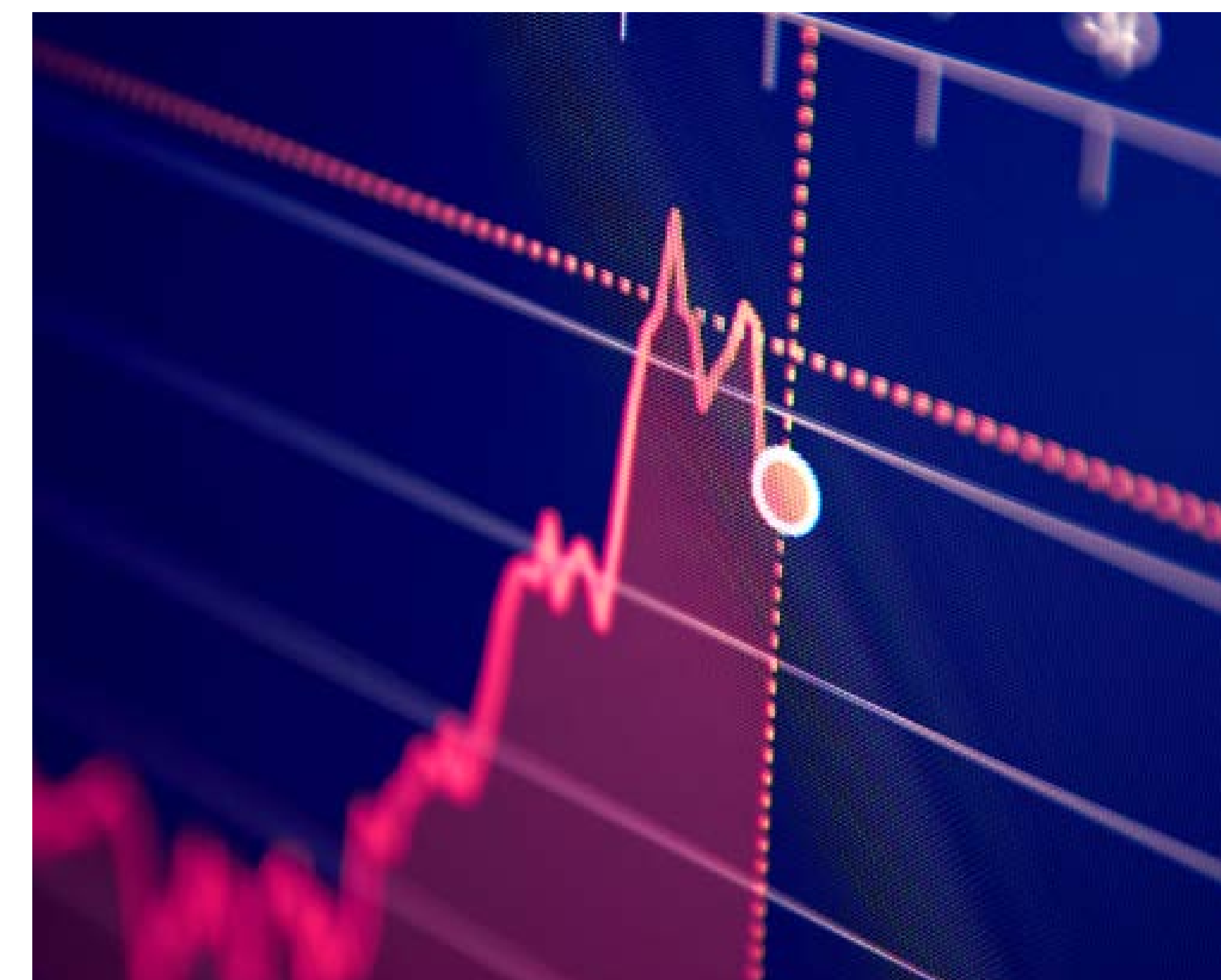
- those who believed that BEPS had addressed all key problems in the field of international taxation, such that no further reforms were appropriate at this stage;
- those who believed that although some problems remained post-BEPS, these were not specific to digital companies, such that any further reforms should be of general application only; and
- those who believed that digitalisation (and globalisation) were putting huge pressure on the existing international tax architecture, such that reforms targeted at highly digitalised companies were needed.

Despite these glaring differences, the Inclusive Framework members agreed to work towards a consensus-based solution by 2020, and according to the press release that accompanied the Policy Note, all countries have 'renewed their commitment' to this objective. That may be, but, in the meantime at least, the trend towards unilateral action in this space has shown no signs of abating.

In the past few months alone, developments in this regard have included:

- steps by Austria, France, Italy, Mexico, Spain and the UK towards the introduction of revenue-based digital services taxes;
- the introduction by Turkey of a 15 per cent withholding tax on payments made to foreign online advertising services providers;
- a discussion paper by the Australian Treasury on possible interim and longer-term measures to change the way the digital economy is taxed; and
- the introduction of audits in New Zealand to ensure that all foreign suppliers of remote services are paying the Goods and Services Tax due.

Such unilateral measures now exist (or are being considered) in every region across the globe. This is perhaps unsurprising – there is huge pressure on politicians to be (or at least be seen to be) active in this space, meaning that many nations feel they cannot wait for a global consensus to be reached before acting.



# Is the EU faltering?

**Although the EU has been a key proponent of legislative change in the digital space, its own proposals appear to have hit something of a stumbling block in recent months.**

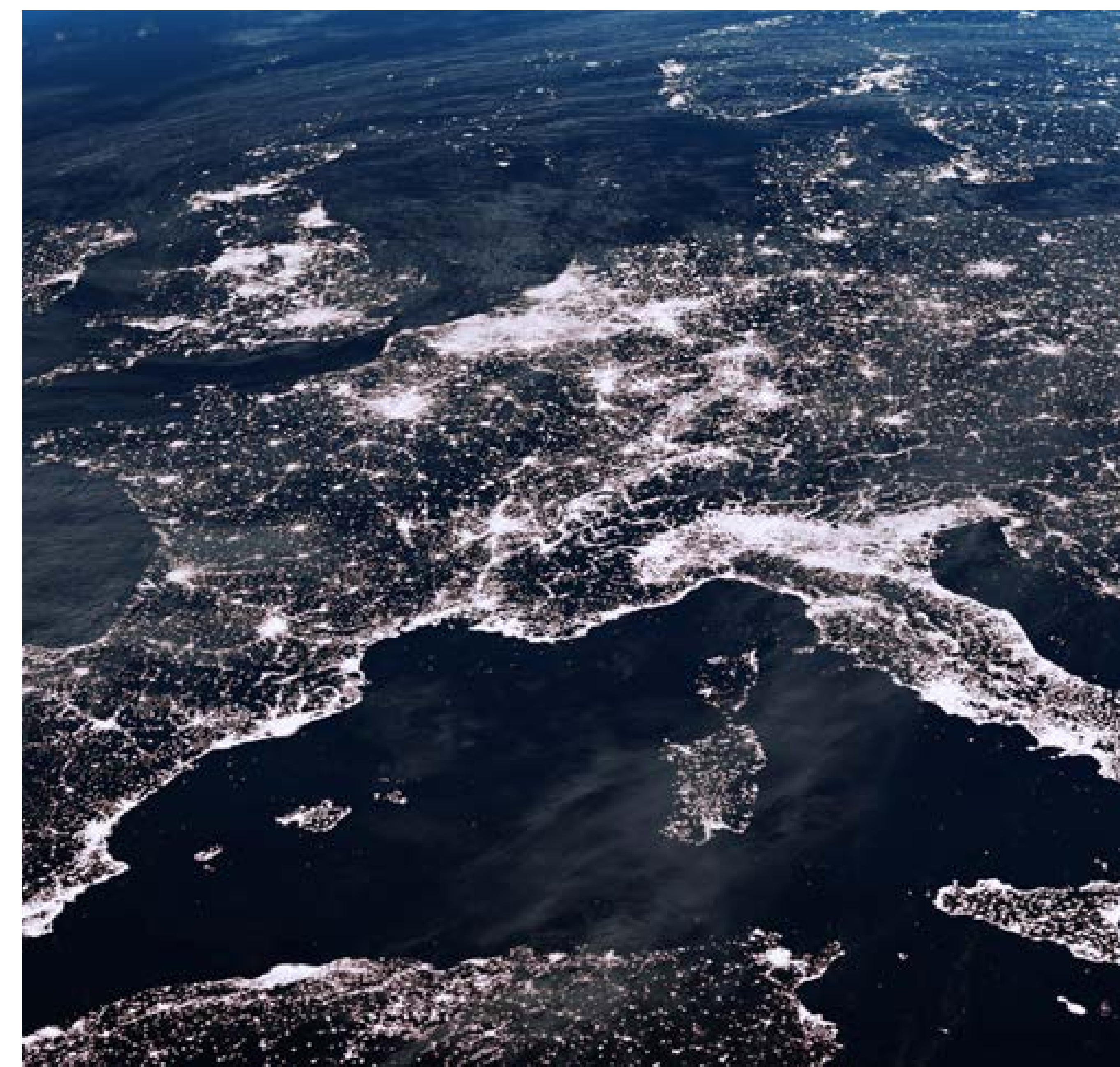
Several versions of an EU digital services tax (DST) have now been considered, with the current draft being the compromise text put forward by the Austrian presidency on 29 November 2018. Under this iteration of DST, a 3 per cent tax would be levied on revenues attributable to: (a) targeted advertising on digital interfaces; (b) making available multisided digital interfaces; or (c) selling user data, providing in all cases that the group in question had worldwide revenues of at least €750m and EU taxable revenues of at least €50m. DST would apply from 1 January 2022 (unless the directive was repealed or postponed before 1 January 2021 in light of OECD progress), and would cease to have effect once OECD changes to corporate tax standards were introduced or a (currently undefined) long stop date was passed.

It seems doubtful that there is sufficient support for this proposal to see it passed at the next ECOFIN meeting. Moreover, it remains to be seen whether the joint declaration by the French and German delegations – that DST should be introduced as soon as possible, covering only revenues attributable to targeted advertising on digital interfaces – will lead to the publication of a significantly revised draft.

As such, although the possibility that DST in some form will be introduced cannot be discounted, it does not appear to be coming in the near future.

Pascal Saint-Amans, Head of Tax, OECD, quoted in the FT article, 'OECD pushes ideas for global corporate tax overhaul'[1]:

**It may be a challenge for European countries to explain (that) their approach would result in taxing only Google.**



# OECD action

**It is against that backdrop that the OECD's Policy Note was published. It set out the four proposals that the Inclusive Framework members have agreed to consider, and it is these proposals that the consultation document seeks feedback on from stakeholders.**

In the Policy Note, the OECD divided these proposals into two 'pillars' (nexus and profit allocation, and the remaining BEPS issues): an approach designed to recognise that 'the digitalisation of the economy is pervasive, raises broader issues, and is most evident in, *but not limited to*, highly digitalised businesses' (emphasis added). In doing so, the OECD explicitly recognised that the proposals, if implemented, could extend beyond the taxation of 'digital giants' and introduce fundamental and far-reaching amendments to corporate tax norms. The implications of this approach cannot be overstated – a significant rewrite of the international tax architecture is possible.

Interestingly, it also suggests that the US – a long-term opponent of revenue-based taxes aimed at large, highly digitalised companies – is beginning to bring other Inclusive Framework members round to its way of thinking. Recent remarks by the US Treasury have made it clear that the US continues to see targeted taxes such as DST as overtly political measures lacking in conceptual justification, and it is of no surprise that the US has been lobbying for any OECD-led changes to be of more general application.

## Nexus and profit allocation

The first three of the OECD's proposals fall under what the Policy Note refers to as 'pillar 1', and consider changes to international norms regarding nexus (ie what the threshold is for becoming subject to tax) and profit allocation (ie once prima facie subject to tax, how much tax is actually chargeable).

Broadly speaking, each of these three proposals has the same objective: to recognise value created by businesses' activities and participation in jurisdictions that are beyond the reach of tax under the current framework.

As such, each of them has the potential to alter radically or to supplement the traditional permanent establishment concept that currently underpins international corporate taxation norms.

# OECD action (pillar 1)

## In summary, the nexus and profit allocation proposals are:

(i) **the revision of existing rules by reference to 'active user contribution',** recognising that, in highly digitalised businesses in particular, users can be a significant generator of value. This approach acknowledges the limits of transfer pricing and the arm's length principle in addressing this issue (indeed the proposal 'dismisses the idea that value created by user activities can somehow be determined through the application of the arm's length principle') and depends to an extent on a type of formulary apportionment. However, it is limited to specific types of digital business (social media platforms, search engines and online marketplaces in particular) and the consultation itself notes that this approach may not be sustainable as digitalisation increases its impact on more traditional businesses and business models evolve. There are also difficult issues here around how the value of users is calculated;

(ii) **the revision of existing rules by reference to marketing intangibles** (eg brand and trade names, customer data), recognising that, in many types of business, these can contribute as much to value in the market jurisdiction as activities performed in the jurisdiction of residence.This would be achieved by modifying existing transfer pricing and treaty rules to allocate non-routine profit attributable to marketing intangibles to the market jurisdiction; again, a kind of formulary apportionment is contemplated. This approach is not tied to specific types of digital business, perhaps making it palatable to the US. Moreover, by attributing value to the market jurisdiction, it appears to bear some resonance with the approach adopted by India, China and Mexico in recent years in the field of transfer pricing. Nonetheless, the consultation document questions whether the supposed 'intrinsic link' between marketing intangibles and the market jurisdiction (the justification underpinning this proposal) exists in all circumstances; and

(iii) **finally, the revision of existing rules based on the idea of 'significant economic presence',** recognising that, in a digitalised economy, it should be possible for companies to have a nexus with countries even if they have no (significant) physical presence there. There is less detail in the consultation document on this approach, although it does set out various factors that 'evidence a purposeful and sustained interaction with the jurisdiction via digital technology and other automated means'; the list is extensive, including, among other things, the existence of a user base, volume of digital content derived from a jurisdiction and a website in the local language. The proposal couples a fractional apportionment (involving identifying a tax base and allocating it by a method yet to be determined) with a gross-basis withholding tax as a collection mechanism and enforcement tool.

# OECD action (pillar 1)

## Conclusion

It remains to be seen which of these proposals, all of which 'apply a global approach to determination of profit', will gain the most support in the coming months. On the basis of the current landscape, however, the first of these three options may be politically challenging, and the US may be unenthusiastic about a measure targeted at highly digitalised businesses alone. Perhaps a reallocation of taxing rights on the basis of marketing intangibles is the most promising. The OECD, in the consultation document, seeks to find common ground between the first two proposals in the hope of bringing the competing camps together. Finding a united response to this question will not be straightforward.

**The pillar one proposals re-writing the nexus and profit allocation rules all, to an extent, entail a departure from the arm's length principle. There are strong hints of formulary apportionment pushing through each of the proposals, which is quite a radical change from the OECD's traditional stance as the guardians of transfer pricing and the arm's length principle.**

Murray Clayson, Tax Partner

1. The Financial Times, 'OECD pushes ideas for global corporate tax overhaul', January 2019, https://www.ft.com/content/0d9624ea-23a8-11e9-8ce6-5db4543da632

# Remaining BEPS issues (pillar 2)

**The fourth OECD proposal ('pillar 2' in the Policy Note) relates to steps that can be taken to address remaining BEPS concerns arising from the increasing digitalisation of the economy.**

There are two prongs to this: an income rule and an anti-base eroding rule to address concerns about profit shifting (apparently drawing some inspiration from the US GILTI and BEAT provisions, respectively). The first limb of this proposal would tax the income of foreign branches or CFCs if that income was subject to a low effective rate of tax in its primary jurisdiction, with the aim of reducing the incentives for multinational companies to allocate returns for tax reasons to low-taxed entities.

The second limb of this proposal would deny deductions for payments to related parties that are not subject to tax at a minimum rate and deny certain treaty benefits where income has not been sufficiently taxed in the other state, allowing source jurisdictions to protect themselves from the risk of base eroding payments. Desire for such reforms is difficult to quantify, although the French and German delegations have recently expressed support for minimum taxes, and the US has suggested it would not oppose such measures.

**Trying to achieve a consensus-based long-term global solution to this by 2020 will be no mean feat. But, the number of jurisdictions taking (or seriously considering taking) unilateral action is steadily increasing, and with this comes the potential for multiple layers of double taxation and increasing levels of complexity for taxpayers. The need to achieve consensus has never been greater.**

Brin Rajathurai, Knowledge Lawyer, Tax

## Next steps

The consultation document – which sought feedback by a revised deadline of 6 March – was followed by a public consultation on 13 and 14 March. There is agreement among the Inclusive Framework members to consider each of the proposals in the Policy Note (albeit on a without prejudice basis), and the comments collected from stakeholders will be used to further these discussions ahead of the next Inclusive Framework meeting in May. It is expected that the OECD will report back to the G20 finance ministers in June 2019, with the aim of providing a 'consensus-based long-term solution' for its final report to the G20 in 2020, presumably involving a co-ordinated programme of treaty changes (MLI2?). Against a backdrop of slow EU progress and an ever-increasing array of unilateral measures, it appears that any hope for co-ordinated, multilateral action rests firmly on the shoulders of the OECD Inclusive Framework.

# Authors

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