

New Rules for the Digital Economy (and other Economies too...)



Mrs. Marie Bentley

Knowledge Director

marie.bentley@atoz.lu



Mr. Keith O'Donnell

Managing Partner

keith.odonnell@atoz.lu

The idea to tax the digital economy shifts slowly towards new taxation rights and new profit allocation rules that may affect more than just tech companies.

On 9 October 2019, the OECD published a proposal to tax Multinational Enterprises (“MNE”) wherever they have significant B2C relations (the “Unified Approach Proposal”). The Unified Approach Proposal is the result of ongoing discussion at the OECD level and aims notably to answer the question of how to allocate taxing rights on income generated from cross-border activities in the digital age among different jurisdictions.

Despite the first initiatives aimed at taxing big digital companies such as GAFA (Google, Amazon, Facebook and Apple), the scope of the Unified Approach Proposal goes even further. It now aims at amending the current international taxation principles more generally with a view to adapt them to the digitalisation of the economy and to introduce a new taxing right for market jurisdictions.

Why is the Unified Approach Proposal important?

The Unified Approach Proposal seeks to create a new model for allocating profit to different main jurisdictions.

- Impact for the global economy and relations between States

The model addresses clear unease at how profits are mixed in the digital economy. However, the proposals have morphed over time into a proposal to shift profit from producer States to consumer States. This will have consequences for the relations between States with economies that produce high value goods and services and States with large consumer populations.

- Impact for businesses

Most businesses are prepared to pay a fair level of tax but seek to pay tax on profits in one location in a manner that is clear and manageable from a compliance perspective.

The Unified Approach Proposal does acknowledge the risk of double taxation but is relatively silent on the potential compliance cost and overall complexity. Businesses should engage with the consultation process (see below) to ensure that the very practical issues the Unified Approach Proposal raises are understood and that any final proposals in the future do not create a disproportionate cost of compliance, which for even medium size businesses, could act as a barrier to cross-border trade and potentially increase the concentration of economic power in large companies.

Background of the Unified Approach Proposal

The tax challenges of the digitalisation of the economy were identified as one of the main areas of focus of the Base Erosion and Profit Shifting (“BEPS”) Action Plan, leading to the 2015 BEPS Action 1 Report. In March 2017, the G20 Finance Ministers mandated the Task Force on the Digital Economy (“TFDE”), through the Inclusive Framework on BEPS, to deliver an interim report on the implications of digitalisation on taxation by April 2018 and a final report in 2020.

The Tax Challenges Arising from Digitalisation – Interim Report dated March 2018 (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: scale without mass, heavy reliance on intangible assets, and the importance of data, user participation and their synergies with intangible assets.

Since then, continuing discussions and proposals were articulated around two pillars which could form the basis for consensus: Pillar One focuses on the allocation of taxing rights by suggesting modifications to the rules on profit allocation and nexus and; Pillar Two focuses more on unresolved BEPS issues.

On 13 February 2019, the OECD released a consultation document “Addressing the Tax Challenges of the Digitalisation of the Economy” setting out three proposals to revise existing profit allocation and nexus rules (Pillar One). These proposals were based on the concepts of “user participation,” “marketing intangibles” and “significant economic presence” (the “Three Proposals”). The consultation document also set out a fourth, global anti-base erosion proposal to allow countries to tax profits where income is otherwise subject to no or very low taxation in another country (Pillar Two).

However, the ongoing work of the OECD on Pillar One, including the public consultation process as well as input received from various stakeholders, has highlighted important questions that needed to be addressed and the broader challenges that the Three Proposals posed in relation to existing tax rules. It has also revealed some more fundamental issues of the existing

international tax framework, which have not been resolved with the BEPS package. In addition, as each of the Three Proposals was significantly different in scope, calculation method and justification, no consensus could be reached on either of the Three Proposals.

Commonalities of the Three Proposals were thus highlighted in order to facilitate a consensus solution on Pillar One. These proposals do indeed have the same primary objective: to recognise the value created by a business's activity or participation in user/market jurisdictions which is not recognised in the current framework for allocating profits.

As a result, the Unified Approach Proposal under Pillar One has been developed to respond to the main dissatisfaction relating to how the existing profit allocation and nexus rules take into account the increasing ability of businesses, in certain situations, to participate in the economic life of a jurisdiction without an associated or meaningful physical presence. With this Unified Approach Proposal, the OCDE also wants to prevent the risk that more jurisdictions, unhappy with the taxation outcomes produced by the current international tax system, will adopt uncoordinated unilateral tax measures that could provoke significantly increasing compliance burdens, double taxation and uncertainty.

Outline of the Unified Approach Proposal

The Unified Approach Proposal, drafted at a relatively general level, aims at designing a solution that will generate support from all stakeholders. The OECD recognises in this respect that certain aspects still require further work and that several implementation and administration questions still need to be addressed. Nevertheless, the Unified Approach Proposal is presented as a viable option.

1. Scope of the Unified Approach Proposal

The Unified Approach Proposal covers highly digital business models but also reaches further as it focuses on "consumer-facing businesses", broadly defined (e.g. businesses that generate revenue from supplying consumer products or providing digital services that have a consumer-facing element). This would include highly digitalised businesses which interact remotely with users, who may or may not be their primary customers, as well as other businesses that market their products to consumers and may use digital technology to develop a consumer base.

At this stage, further discussion should take place to articulate and clarify this scope and further considerations should also be given on whether some specific sectors (e.g. financial services) should be carved out, considering the tax policy rationale as well as other practicalities. Discussion on scope and carve-outs should also include consideration of size limitations, such as, for example, the €750 million revenue threshold used for country-by-country reporting requirements.

2. New Nexus Rule for the Taxpayers in the Scope of the Unified Approach Proposal

Currently, a non-resident company is taxable on its business profits only if it has a permanent establishment in a jurisdiction. It is, however, assumed that large businesses will conduct more and more consumer-facing and/or user-facing activities from a remote location, with no or minimal physical presence in the market. The new nexus rule aims thus at targeting all cases where a business has 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 primary indicator of sustained and significant involvement in that jurisdiction would be a revenue threshold in the market (the amount of which could be adapted to the size of the market) which would 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. Notably, a revenue threshold would not only create nexus for business models involving distance selling to consumers, but would also apply to groups that sell in a market through a distributor.

3. New Profit Allocation Rule going beyond the Arm's Length Principle.

Once it is determined that a country has a right to tax the profits of a non-resident enterprise, the next question is how much profit the Unified Approach Proposal allocates to that jurisdiction.

This question is currently answered by Article 7 (Business Profits) of both the OECD and United Nations Model Tax Conventions. However, given that the new taxing right would create a nexus for an MNE group even in the absence of a physical presence, the existing rules to allocate profit do not fit into this new nexus in cases where no functions are performed, no assets are used, and no risks are assumed in the market jurisdictions. Therefore, new profit allocation rules going beyond the arm's length principle and limitations on taxing rights determined by reference to a physical presence (two principles generally accepted as cornerstones of the current rules) are required.

Without giving any details on the new allocation criteria, the intention of the Unified Approach Proposal is to create a new profit allocation rule applicable to taxpayers within the scope, and irrespective of whether they have an in-country marketing or distribution presence (permanent establishment or separate subsidiary) or sell via unrelated distributors. The approach would keep the current transfer pricing rules based on the arm's length principle, but supplements them with formula-based solutions in areas where tensions in the current transfer pricing system are the highest.

The OECD only states in this respect that the new rules, taken together with existing transfer pricing rules, will need to deliver the agreed quantum of profit to market jurisdictions and do so in a way that is simple, avoids double taxation, and significantly improves tax certainty relative to the current position. The new rules should also be applicable to both profits and losses.

4. Increased Tax Certainty delivered via a Three-Tier Mechanism.

The Unified Approach Proposal proposes the following three-tier mechanism to share profits between jurisdictions:

- Amount A: a share of deemed residual profit allocated to market jurisdictions using a formula approach (i.e. the new taxing right).

In broad terms, the idea developed by the Unified Approach Proposal would be to reallocate a portion of the deemed residual profit of Company T, tax resident in State T based on current rules, between market jurisdictions (i.e. States M and N) in accordance with a new nexus unconstrained by physical presence requirements. The deemed residual profit would be the profit that remains after allocating what would be regarded as a deemed routine profit on activities to the countries where the activities are performed (i.e. State T). Similar to existing profit allocation rules, it would have effective application to both profits and losses, but specific rules may be considered for the treatment of losses (e.g. claw-back or “earn out” mechanism).

Amount A would be determined by simplifying conventions, and would require the determination of the level of the deemed routine profit (to be allocated to State T) and also a decision on the proportion of the deemed residual profit that should go to the market, which in turn would be allocated to particular markets (States M and N) meeting the new nexus rule through a formula based on sales. This method would replicate features of both the residual profit split (RPS) method (by introducing a threshold based on profitability to exclude the remuneration of routine activities) and the fractional apportionment method (by relying on formula-based calculations).

The starting point for the determination of Amount A would be the identification of the MNE group's profits based on the consolidated financial statements under the accounting standards of the headquarters jurisdiction prepared in accordance with the Generally Accepted Accounting Principles (GAAP) or the International Financial Reporting Standards (IFRS).

The next step in calculating Amount A would seek to approximate the remuneration of the routine activities based on an agreed level of profitability. The level of profitability deemed to represent such “routine” profits could be determined by using a variety of approaches, but according to the OECD, a simplified approach would be to agree on a fixed percentage(s), possibly with variances by industry. The profitability of an MNE group can vary substantially across business lines, regions or markets, which suggests that the relevant measure of profits may need to be determined on a business line and/or regional/market basis.

Remuneration of the routine activities are defined as profits which would be regarded as rewarding routine functions and therefore would be excluded from the calculation of the pool of profits from which the allocation to market jurisdictions would be made. The completion of this step would not be intended to disturb the actual allocation of the remuneration derived from actual routine activities under the current transfer pricing framework.

Assuming that the proportion of profits to revenues (i.e. profit margin), derived from the consolidated financial statements of Company T, is z%, a portion of that percentage may be regarded as representing routine profits.

If that portion is x%, then x% would be ignored for the purposes of the calculation of the non-routine profits reallocated to market jurisdictions.

If the profit margin is z% from which x% is deducted on the basis that it represents the deemed routine profits, then the balance, assumed to be y%, would be regarded as representing the group’s deemed non-routine or residual profits.

Once profits in excess of the stipulated level of profitability are deemed to be the group’s non-routine profits, it is then necessary to 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. A crucial aspect of the “Unified Approach” would be to determine and agree on the method through which the profit attributable to market jurisdiction is determined, and whether this percentage should vary by industry.

The amount of the non-routine profits – the y% – would then need to be allocated between the profits attributable to market jurisdictions (assumed here to be w%) and the profits attributable to other factors such as trade intangibles (assumed here to be v%). The final step of the proposed approach would then be to allocate the relevant portion of the deemed non-routine profit (w%) among the eligible market jurisdictions.

This final 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 subject to the new taxing right.

- Amount B: a fixed remuneration for baseline marketing and distribution functions that take place in the market jurisdiction;

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 of the OECD Model Tax Convention). For this purpose, Amount B 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. The quantum of the fixed return could be determined in a variety of ways (i.e. a single fixed percentage; a fixed percentage that varied by industry and/or region; or some other agreed method). The fixed return under Amount B would seek to reduce disputes in this area where tensions are high as a result of applying the transfer pricing rules.

Whilst the distinction between marketing and distribution activities and others performed by an MNE group will, in most cases, be clear, there will be some borderline issues. Therefore, a clear definition of the activities that qualify for the fixed return would be required.

- Amount C: binding and effective dispute prevention and resolution mechanisms relating to all elements of the proposal, including any additional profit where in-country functions exceed the baseline activity compensated under Amount B.

Taxpayers and tax administrations would retain the ability to argue that the marketing and distribution activities taking place in the market jurisdiction go beyond the baseline level of functionality and therefore warrant a profit in excess of the fixed return contemplated under Amount B, or that the MNE group or company perform other business activities in the jurisdiction unrelated to marketing and distribution.

Amount C would thus cover 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.

Next step?

The OECD now calls for public input on the Secretariat Proposal for a "Unified Approach" under Pillar One. Comments have to be provided by 12 November 2019. The public consultation meeting on the proposed "Unified Approach" to deal with Pillar One issues will be held on 21 and 22 November 2019 at the OECD Conference Centre in Paris, France.

If consensus is reached on the fact that the Unified Approach Proposal is the way to carry things forward on the road to a global and long-term solution to the Tax Challenges of the Digitalisation of the Economy, this Unified Approach Proposal could lead to a real and substantial modification of the international tax principles and deeply change the international tax landscape.

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