Taxing the Digital Economy: OECD Proposed Pillar One Unified Approach

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February 21, 2020

Agenda

- The journey so far and forces driving change
- Overview of the proposed Pillar One approach
- Challenges
- Q&A

The journey so far and forces driving change

Digital Tax- Dominating the headlines

Facebook's Zuckerberg wants 'new framework' for digital tax

The digital tax has emerged as a key bone of contention between the US and France in particular, after Paris imposed its own tax on US digital giants such as Facebook, Google, Amazon and Apple last year.

AFP | February 14, 2020, 15:15 IST

Talks over global digital tax are back on track, says OECD

Tariffs dispute between US and France is 'pushing countries to compromise'

137 countries on board for OECD digital tax plan: Angela Gurria

OECD chief Angela Gurria on Thursday said the international body's plan to help solve digital tax problems has got support of 137 countries and new rules must be put in place to stop evasion worth hundreds of billions of dollars.

PTI | Last Updated: Jan 23, 2020, 07.56 PM IST

Digital Tax- Dominating the headlines

EU tech regulator backs UK plans for digital tax, despite Trump threats

Margrethe Vestager says EU will also tax tech firms who 'create value but do not pay taxes'

Thu 23 Jan 2020 19.09 GMT

FINANCIAL TIMES

UK to push on with digital tax in face of US anger

Trump officials threaten tariffs if London does not back down

JANUARY 21 2020

Spain looks to adopt 'Google tax' that has angered the U.S.

By ASSOCIATED PRESS

Published: Feb 18, 2020 2:31 p.m. ET

OECD director: Agreement on digital services tax underway

Date published
February 18, 2020

Three key trends in global tax reform policy

Adoption of BEPS 1.0	— Coordinated action on international standards – County-by-country reporting, multilateral instrument, transfer pricing guidelines — Domestic law adoption of BEPS recommendations – U.S. tax reform/EU Anti-Tax Avoidance Directive (ATAD)/other domestic reforms
Proliferation of unilateral measures	— U.K. and Australia diverted profits tax — U.S. tax reform (BEAT/FDII) — Digital services taxes (DSTs) and other unilateral measures to address taxation of the digital economy
OECD effort to reestablish consensus **BEPS 2.0**	— Reconsider balance between source- and residence-country taxation — Address concerns spurred by consideration of challenges of taxation of digital economy without ring-fencing — Strengthen and extend BEPS recommendations

Unilateral Developments

Summary of unilateral country measures

Alternative PE thresholds

- Significant economic presence test (e.g., Israel, India)
- Virtual service PE (e.g., Saudi Arabia)

Withholding taxes

- Broader royalty definitions
- Technical service fees
- Online advertising

Turnover taxes

- Targeted sectors such as digital ads (e.g., Hungary)
- Levy on digital transactions (Italy)
- Equalization levy (e.g., India)

Specific regimes for large MNEs

- Diverted profits tax (e.g., U.K and Australia)
- BEAT (U.S.)

Concerns driving “BEPS 2.0”

Scale without mass

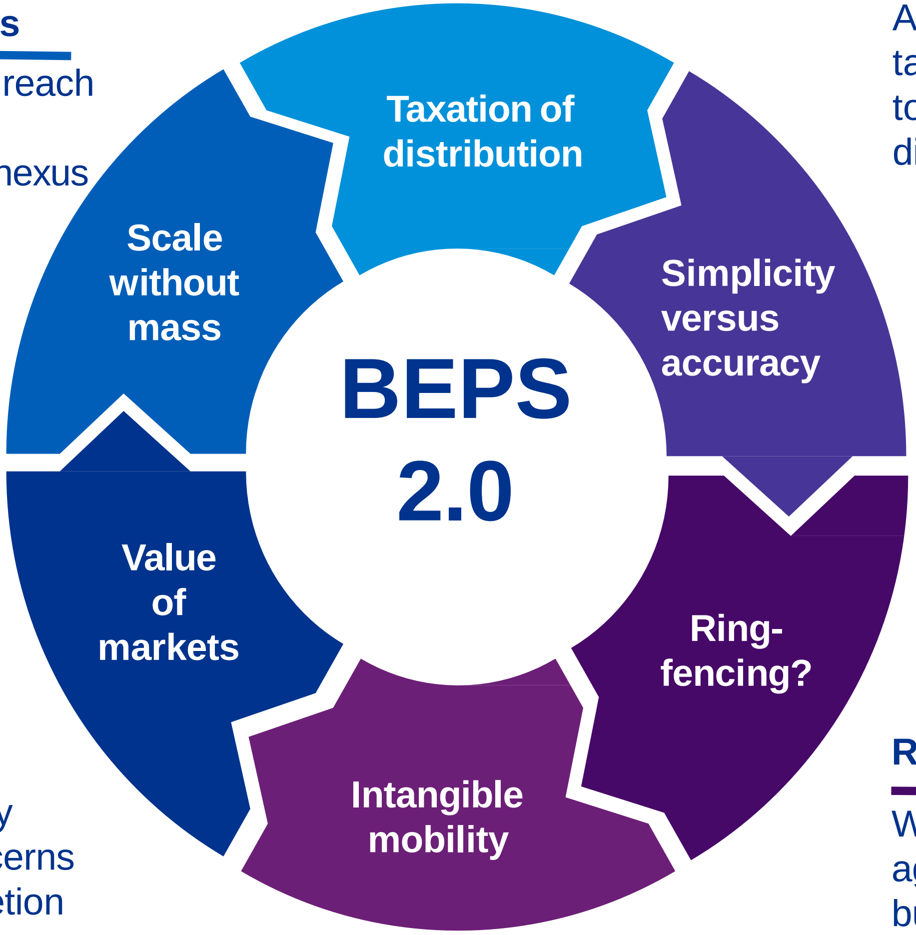
Increasing ability to reach markets without traditional physical nexus

Value of markets

Some countries believe that the current rules insufficiently remunerate market jurisdictions

Intangible mobility

BEPS 1.0 did not fully address country concerns about taxpayer discretion to concentrate profits at location of intangibles



Attribution of profit to marketing and distribution

A number of countries have taken aggressive approaches to taxation of limited risk distributors

Simplicity versus accuracy

Current rules are complex and difficult to administer, and jurisdictions with limited resources believe they are at a disadvantage

Ring-fencing?

Will new rules discriminate against highly digitized businesses relative to other business models?

Overview of the proposed Pillar One approach

Pillar One - User participation

Users create value that is currently not subject to tax in the user's jurisdiction

- Sees sustained engagement and active user participation as critical components for some highly digitalised businesses
- Deviation from arm's length principle in respect of allocation of non-routine profits from business models reliant upon active user participation
- Business models consistent with UK DST consultation paper
- A 'ring-fenced' solution that partially accepts formulary apportionment principles

Pillar One - Market Intangibles

Allocate a portion of marketing profit to market countries regardless of ownership of marketing IP

Sees marketing-based intangibles as critical components in modern business models

Major change from existing transfer pricing principles is linking marketing intangibles with market jurisdictions

Primarily targeted at resolving the issue of economic scale with limited local mass, a long-standing issue with both traditional and modern distribution models

Unlike User Participation proposal, not ‘ring-fenced’ to digital business models

Pillar One - Substantial Economic Presence

Economic nexus with simplified profit attribution

Taxable presence arises where non-resident enterprise has a ‘significant economic presence’ in a jurisdiction

Key factors can include:
- existence of a user base and associated data input
- volume of digital content derived from the jurisdiction
- maintenance of a website in a local language

Unified Approach – Background and scope

- May 28 Programme of Work presented three alternatives for new profit allocation rules:
  - Modified residual profit split method
  - Fractional apportionment method
  - Distribution-based approach
- Unified Approach based on commonalities among these methods
  - Formulaic residual profit split with expanded nexus
  - Fixed baseline distribution return
  - Continued role for existing transfer pricing rules
  - Recognizes importance of measures to prevent and resolve disputes and double taxation
- Scope – focused on consumer-facing businesses
  - Excludes extractive industries
  - Other potential carve-outs, including financial services, to be studied
  - Potential size limitations, e.g. €750 million threshold

Estimated global net revenue gain up to 4% of global CIT revenues or USD 100 billion annually, depending on reform design

Unified Approach – Market jurisdiction taxable profit

Taxable profit to market jurisdictions based on three amounts:

Amount A* – *Amount allocated to market jurisdictions under new taxing right

- Determine total profit of group or business line
- Subtract formulaic "deemed routine profit" to determine "deemed residual profit"
- Apply fixed percentage to deemed residual profit to determine Amount A
- Allocate Amount A to market jurisdictions using sales-based formula
  - Expanded nexus approach not dependent on physical presence
  - Look through third-party distributors in determining sales
- "Going beyond arm's-length principle"

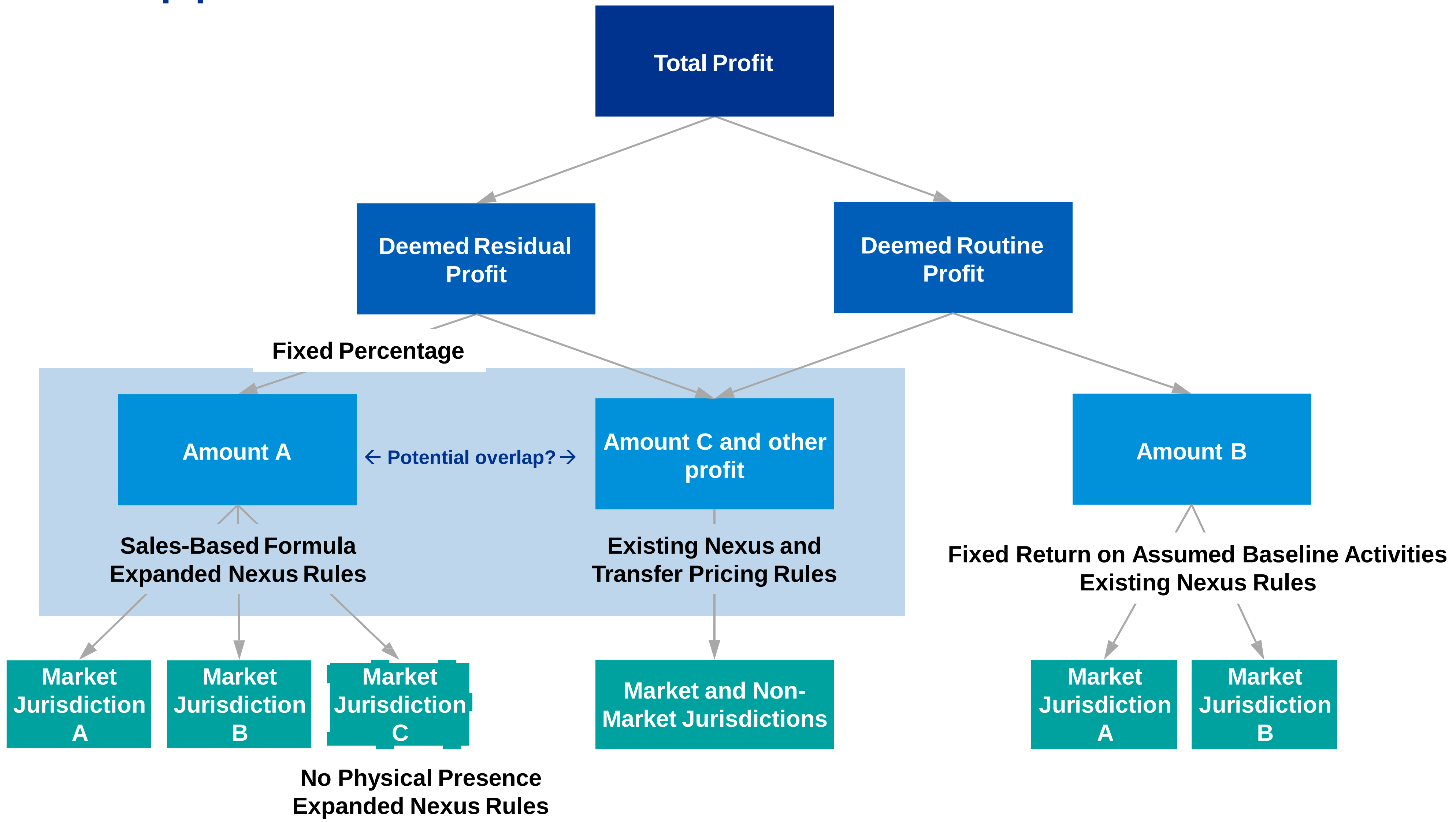
Amount B* – *Fixed remuneration for baseline marketing and distribution activity

- Intended to represent arm's-length compensation under existing principles

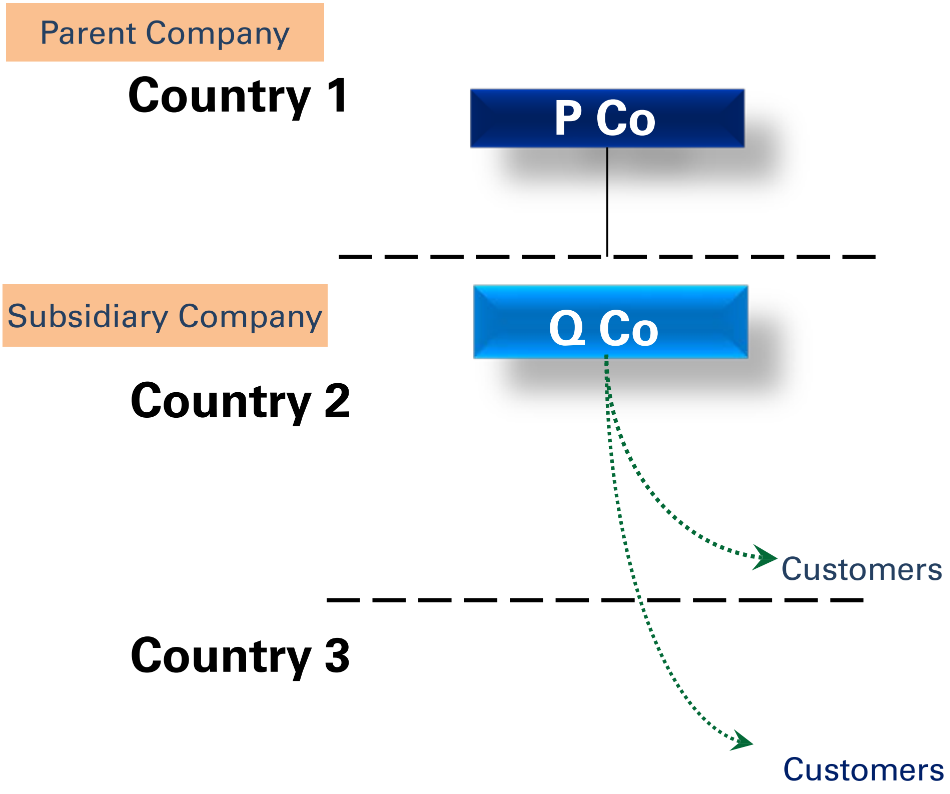
Amount C* – *Compensation for additional market jurisdiction functions beyond baseline

- Determined under existing transfer pricing rules
- Subject to enhanced dispute prevention and resolution mechanisms

Unified Approach illustrated



OECD Illustration- Facts



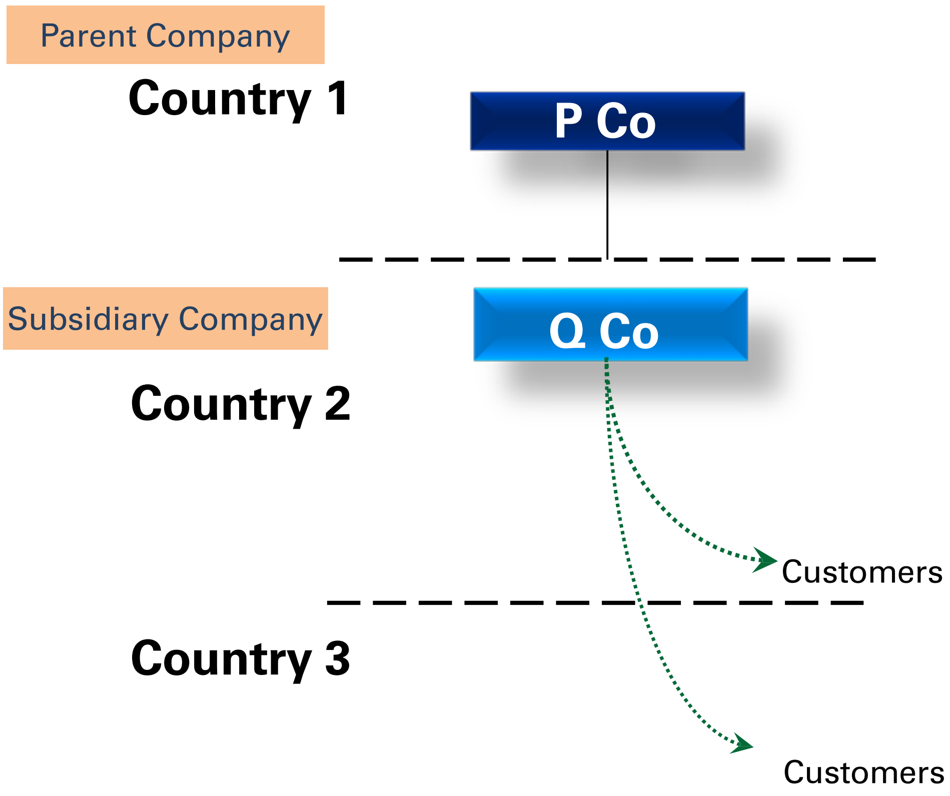
P Co:

- Parent Company of Group X
- Owns all intangible assets
- Currently entitled to all non-routine profits earned by the group

Q Co:

- Responsible for marketing and distribution activities of the Group
- Sells streaming services to Country 2 customers
- Also sells streaming services remotely to customers in Country 3
- No taxable (physical) presence in Country 3

OECD Illustration- Application of Unified Approach



Group has taxable presence in market jurisdiction (County 2)

- Group X already has a taxable presence in the form of Q Co. in Country 2.
- Country 2 may tax that income directly from P Co. - Entity owning the deemed non-routine profit (**Amount A**)
- Q Co would be the taxpayer for the only applicable fixed return for baseline marketing and distribution activities **(Amount B)**
- Q Co to have additional profits if the activities go beyond the baseline activity assumed in Amount B **(Amount C)**

Group does not has taxable presence in market jurisdiction (Country 3)

- Group X does not have a taxable presence under existing rules. However, Q Co is making remote sales in the country 3.
- New Taxing right (**Amount A**) - Determine whether Group X has a non-physical nexus in that jurisdiction.
- Country 3 may tax that income directly from P Co. - Entity owning the deemed non-routine profit (**Amount A)**

Proposed Pillar One challenges

Unified Approach – Scope

The OECD indicates that scope will be focused on two categories of business large "automated digital services" and "consumer-facing businesses."

- What is "consumer-facing"?
  - Supply through intermediaries, supply of component products, use of franchise arrangements – where in the value chain is the B2B vs. B2C distinction drawn?
  - Exclusions for specific industries? How to avoid complexity and subjectivity?
    - Extractive industries excluded, financial services to be studied
- What is automated digital services?
  - Merely using digital means to deliver services involving a high degree of human intervention and judgment is not intended to be covered
- Balancing competing objectives
  - Keeping focus on intended business models (ring-fencing?)
  - Potential for disputes around definitional issues
  - Neutrality among business models

Unified Approach – Scope

The OECD recognizes that the Unified Approach raises various issues with respect to elimination of double taxation.

- Overall Revenue Threshold
  - **Gross Revenue Threshold** – Applicable to MNE exceeding revenue Euro 750 million
  - **In-scope revenue threshold** – Carve-out being considered for MNE groups with in-scope revenue below certain threshold
  - **De minimis carve-out-** A carve-out could also be considered where profit to be allocated under the new taxing right would be minimal.
- **Nexus**
  - Automated digital services – In-scope in market jurisdiction beyond a threshold
  - Consumer facing business – Besides in-scope revenue additional evidence of "sustained interaction". "Revenue plus" factors to be identified
- **Exclusion**
  - Financial Services
  - Shipping, air transport and other transportation activities

Unified Approach – Elimination of double taxation

The OECD recognizes that the Unified Approach raises various issues with respect to elimination of double taxation.

- No underlying principle for reaching agreement on quantum of amount A
- Identifying surrender jurisdiction for Amount A
  - Potential complexity especially for business models with more than a small number of risk-bearing entities
- Avoiding double-counting or duplication among Amounts A, B, and C
  - Amount C may draw on same residual profit pool as Amount A
  - Treatment of losses
  - Reconciling deemed routine profit and actual routine profit per existing rules
- Dispute prevention and resolution mechanisms
  - Will Amount B approach really reduce disputes?
  - Prevalence of multijurisdictional issues under Unified Approach
  - Expanded need for mandatory binding arbitration / representative panel
  - Need for clearly articulated principles as basis for dispute resolution

Unified Approach – Other issues

- Determining deemed residual profit and Amount A
  - Differential rules for deemed routine profit and Amount A by industry or other factors?
- Defining and applying new nexus rule for Amount A
  - "Look-through" of intermediaries
  - Addressing concerns of developing countries while ensuring administrability
- Issues around Amounts B and C
  - Need for clear definition of baseline marketing and distribution
  - Variation of Amount B return by industry?
  - How much leeway for variation from baseline amount before Amount C kicks in?
  - Can Amount C be negative? Role of taxpayers and counterparty jurisdictions (competent authority) in asserting Amount C

Unified Approach – Other issues (continued)

- Use of segmentation
  - Worldwide profit from financial statements versus segmentation by line of business or region?
  - If segmentation: financial statement segments or custom tax definition?
- Impact of reduced focus on actual intercompany transactions
  - Resolution of double tax associated with Amount B (determination of counter-party jurisdiction)
  - Reconciliation with customs
- Relationship to permanent establishment concerns

US Government perspective

…serious concerns regarding potential mandatory departures from arm's-length transfer pricing and taxable nexus standards…. Nevertheless, we believe that taxpayer concerns could be addressed and the goals of Pillar 1 could be substantially achieved by making Pillar 1 a safe-harbor regime. The United States also fully supports a GILTI-like Pillar 2 solution.

We urge all countries to suspend digital services tax initiatives, in order to allow the OECD to successfully reach a multilateral agreement

- ***Treasury Secretary, Steven Mnuchin***

French Government perspective

"The French digital tax would be dropped as soon as an agreement is found at the OECD to overhaul decades-old international tax rules. If the U.S. do the same, then it's the end of the issue"

"A US proposal for international digital taxes to be made "optional" is "not acceptable"

- ***French Finance Minister Bruno Le Maire***

India perspective

Indian IRS Officer Mr. Akhilesh Ranjan rues "missed opportunity" to sidestep arm's length principle, questions efficacy of OECD's digital taxation proposals

"*The current approach of the Inclusive Framework in not letting go of the traditional arm's length principle is "faint hearted" or "timid"*

*"In an attempt to stick to traditional concepts, I think we **lost an opportunity to transform the global taxation system.** The road does not end here, and a huge amount of work needs to be done on this"*

- Akhilesh Ranjan, CBDT Member"

Next steps

OECD timeline

January 2019	Policy Note introduces “Pillar One” and “Pillar Two”
May 2019	Programme of Work describes Pillar One and Pillar Two, options to be considered
June 2019	Progress report to G20 finance ministers
October 2019	Public Consultation Document on Pillar One
November 2019	Public Consultation on Pillar One; Public Consultation Document on Pillar Two
December 2019	Public Consultation on Pillar Two
January 2020	Outlines of architecture agreed, including “reduced number of options under Pillar One”
End of 2020	Final report

Thank You