Addressing the Tax Challenges of the Digitalization of the Economy – OECD Publishes Consultation Document

The OECD's Inclusive Framework on BEPS (IF) issued a Public Consultation Document (ConDoc) February 13 describing several proposals for long-term solutions to tax challenges arising from the digitalization of the global economy and multinational businesses. Those challenges have led to a reexamination of fundamental principles that underpin the current system of international tax, including, in particular, how taxing rights on cross-border activities should be allocated between countries in the digital age and how to combat BEPS activities facilitated by digitalized business structures.

Much of the ground covered by the ConDoc was foreshadowed in a short Policy Note released after the January 23-24 meetings of the IF and the OECD's Committee on Fiscal Affairs. However, as was to be expected, the ConDoc describes the proposals sketched by the Policy Note in somewhat more detail and raises several questions for commentators to consider and address.

Written submissions from those wishing to respond to the ConDoc must be sent, by email, to the OECD Centre for Tax Policy and Administration by March 1, 2019. Given the complexity, scope, interconnectedness and potential impact of the proposals, that deadline provides very little time to reflect and provide thoughtful comments.

The ConDoc

As under the Policy Note, the ConDoc groups the proposals into two categories or "pillars." The proposals under each pillar are described as being made "without prejudice," which means that none of the member countries of the IF are committed, at this stage, to anything beyond mere exploration of the proposals.

Pillar 1: The Broader Tax Challenges – Proposals to Revise Nexus and Profit Allocation Rules

The first pillar focuses on the allocation of taxing rights between the jurisdictions in which a multinational business operates or has customers. This involves looking at, and potentially making fundamental changes to, the tax rules on both taxable presence, or nexus, and the allocation of profits to a taxable branch or subsidiary.

Each of the proposals under this pillar is based on the same premise: that the current framework for allocating profits does not properly recognize the value created by a business's activity in jurisdictions where a multinational enterprise has customers and/or users of its services or products, i.e., the user or market jurisdiction. As a result, each proposed solution aims to allocate more taxing rights to the market jurisdiction. The ConDoc outlines three proposals under the first pillar.

The "User Participation" Proposal

The "user participation" proposal would deal only with certain highly digitalized businesses that develop an active and engaged user base and solicit data and content contributions from users. Specifically, social media platforms, search engines and online marketplaces would be caught by this proposal.

The proposal would revise the profit allocation rules by allocating a certain portion (possibly according to a simple percentage) of the business's residual profits (after allocating a routine return to the functions and tangible assets of the business, where possible) to the value created by users in the market jurisdiction. In addition, the nexus rules would be changed so that the market jurisdiction would be given the right to tax the profits allocated to the user participation, regardless of whether the business otherwise has a taxable presence in that jurisdiction.

The "Marketing Intangibles" Proposal

The "marketing intangibles" proposal would also change both profit allocation and nexus rules, but, in contrast, it would have a much wider scope and apply to businesses in all industries (not just highly digitalized businesses). This proposal seeks to address situations where multinational businesses are able to develop a customer base and other marketing intangibles remotely.

Marketing intangibles (as distinct from a trade intangible) are intangible assets that relate to marketing activities, aid in the commercial exploitation of a product or that have important promotional value. Broadly speaking, marketing intangibles will include trademarks, customer lists and customer data.

Again, a residual profit split methodology would require allocation of some of the marketing intangibles and risks associated with such intangibles to the market jurisdiction regardless of the location in which the relevant marketing intangibles are legally owned or controlled. As a result, a portion of the business's profits would be allocated to the market jurisdiction. This allocation could be fact dependent or based on more simplistic, formulaic approximations.

Also, as under the user participation proposal, market jurisdictions would be given a right to tax businesses even in the absence of a traditional taxable presence, but here businesses that are not considered to be highly digitalized (e.g., consumer product retailers) would be caught if they are operating in the market jurisdiction remotely.

The "Significant Economic Presence" Proposal

The third, "significant economic presence," focuses more broadly on the ability of businesses to be involved in the economic fabric of a jurisdiction without having a significant physical presence there.

The basic tenet of this third proposal is that a taxable presence should arise when certain factors suggest a business has a "purposeful and sustained interaction with the jurisdiction." These new rules would provide a taxing right to a jurisdiction in which a nonresident business has sales revenue above a certain threshold if other conditions are also satisfied. This approach is analogous to the US Supreme Court's *Wayfair* decision last year, which addressed US states' powers to tax aspects of the digital economy. The ConDoc does not state the other conditions definitively but merely lists possible factors, such as a local user base, volume of digital content derived from the jurisdiction, local billing and payment, a website in the local language, local delivery of goods and after-sales services, and sustained marketing and sales promotion activities, either online or otherwise.

Interestingly, the allocation method for this proposal is described as a "fractional apportionment method" that might use a formula based on appropriately weighted factors, such as sales, assets, employees and (where relevant) users in the jurisdiction. Alternative simplified methods will also be considered.

A low-rate, non-final withholding tax on gross payments might be proposed as a collection mechanism, with the nonresident business then having the chance to file a return and claim a refund of excess tax paid through withholding.

Pillar 2: Remaining BEPS Concerns – Global Anti-base Erosion Proposal

The second pillar focuses on the continued risk of BEPS activity, exacerbated by digitalization, that allows multinational businesses to shift profits to jurisdictions with no (or low) taxation. The proposal to combat this risk, set out in the ConDoc, is a so-called global minimum tax regime, aimed at preventing base erosion and profit shifting to low-tax locations.

The recommendations advanced under this pillar relate to the taxation of all types of businesses, not just highly digitalized businesses. The proposal would operate through the combination of two interrelated rules:

- **Income inclusion rules** – i.e., rules that impose home-country tax at the shareholder level on income of low-taxed foreign subsidiaries and branches
- **Anti-base erosion rules** – i.e., rules that deny deductions or treaty relief for payments to low-taxed foreign affiliates

The basic principle is that all countries would have the right to "tax back" profits where other, low-tax, countries have not exercised their primary taxing rights sufficiently. The goal of this second pillar is to provide for such additional taxes within a multilateral, coordinated framework that would ensure "sufficient" taxation but avoid economic double taxation.

Both rules would necessitate changes to both domestic law and treaty rules. To the extent that overlap between the income inclusion rules and the anti-base erosion rules created double taxation risks, it may be necessary to have an ordering rule that would switch off the application of one set of rules when the other applies to the same transaction.

Income Inclusion Rule

The income inclusion regime would operate as a form of minimum tax that would require a shareholder in a corporation to recognize a ratable share of the income of that corporation if it was not subject to tax at a minimum rate. The new rules would use a 25% ownership threshold and would determine the foreign effective tax rate (and foreign tax credits) on a jurisdiction-by-jurisdiction basis. Drawing on aspects of the GILTI reforms on the US, the new income inclusion rules would supplement, not replace, a country's existing Controlled Foreign Corporation (CFC) regime.

The ConDoc lists numerous issues (including, for example, the mechanism for determining whether the income has been subject to tax at the minimum rate) that will need to be considered in designing the regime.

Tax on Base Eroding Payments

The anti-base erosion regime is intended to ensure the source jurisdiction can protect itself from the risk of inappropriate base eroding payments. The tax on base eroding payments would cover both:

- **An undertaxed payments rule** – i.e., a rule that denies a deduction for a payment to a related party if that payment was not subject to tax at a minimum rate
- **A subject to tax rule** – i.e., a new provision in tax treaties that would deny treaty benefits unless the income is taxed at a minimum rate in the other state

These new rules would have a broad scope and would catch, for example, conduit-based arrangements that effectively import tax benefits from offshore transactions into a jurisdiction.

Again, various design issues to be considered are listed in the ConDoc (including, for example, whether the undertaxed payments rule should deny deductibility in full or on a graduated basis reflecting the level of taxation in the jurisdiction of the recipient).

Questions Raised in the ConDoc

The ConDoc asks commentators to give their general views of the various proposals from a policy perspective, comment on design issues, and suggest how to reduce complexity, provide certainty of application of new rules and avoid or resolve disputes between jurisdictions.

Next Steps

As noted earlier, the deadline for submitting written comments on the ConDoc is March 1, 2019.

A public consultation meeting on the ConDoc will take place in Paris on March 13-14 as part of a meeting of the IF's Task Force on the Digitalizing Economy. Only those who have submitted timely written comments on the ConDoc will be able to attend the public consultation.

The IF has promised to deliver an interim report on its progress, containing a detailed program of work, to the June 2019 meeting of the G20 Finance Ministers in Fukuoka, Japan.

Assuming that the interim report is approved, the IF will proceed with the program of work, with the assistance of the OECD's working parties on tax treaties, transfer pricing and aggressive tax planning, with the goal of producing a final report for the G20 (with, it hopes, consensus-based recommendations) by the end of 2020.

We Can Help

We have a dedicated team of leading tax experts to help you with issues arising in the taxation of the digital economy. Our digital tax team is led by Jeff VanderWolk who has extensive experience in private practice and government and agency work. Most recently, Jeff was head of the Tax Treaty, Transfer Pricing and Financial Transactions Division at the Centre for Tax Policy at the OECD. He has also served as International Tax Counsel to the US Senate Committee on Finance and as a Special Counsel in the Office of the Chief Counsel at the Internal Revenue Service.

We can strategize and support your engagement with the OECD's Inclusive Framework on BEPS. We can help you understand the possible business and technical tax impacts of the proposals set out in the ConDoc and assist with formulating considered responses. We are also ready to assist with the implementation of strategies to ensure you are positioned to respond efficiently and effectively when change comes.

As a full-service global law firm, we are connected both locally and globally on the tax challenges arising from digitalization. We can provide unique insight at the point where law, business and government meet. We place our clients at the core of everything we do, giving them a voice, supporting their ambitions and achieving successful outcomes.

We look forward to engaging with you as your trusted adviser, as national and international tax law continues to evolve and respond to the digitalization of the economy.

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