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Global Tax Alert

OECD's new insights describe growing support on comprehensive changes to international tax policy, beyond digital

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Executive summary

On 29 January 2019, the Organisation for Economic Co-operation and Development (OECD) issued a press release (the Press Release) and a Policy Note (the Policy Note) in relation to its work on *Addressing the Tax Challenges of the Digitalisation of the Economy*. The long-foreshadowed documents were issued shortly before the OECD's latest *Tax Talks Webcast*,[1] which also covered the same issue, in addition to other topics.

The Press Release set outs how the OECD believes that the international community has made important progress in this area and has agreed to continue working multilaterally towards achievement of a new consensus-based, long-term solution in 2020.

Renewed international discussions, it says, will focus on two central pillars identified in the Policy Note which was released after the Inclusive Framework's on Base Erosion and Profit Shifting (BEPS IF) 23-24 January meeting, which brought together 264 delegates from 95 member jurisdictions[2] and 12 observer organizations.

Importantly, the Policy Note describes that the BEPS IF recognizes that what is being proposed may go far beyond the taxation of highly digitalized business models, also affecting *a much wider group of enterprises with cross-border* *business operations, for instance those with marketing intangible profits but limited risk distribution structures in market jurisdictions.* Additionally, the Policy Note describes that *these proposals would lead to solutions that go beyond the arm's-length principle*.

Detailed discussion

Background

The Policy Note outlines how, following a mandate by G20 Finance Ministers in March 2017, the BEPS IF, working through the OECD's Task Force on the Digital Economy[3] (TFDE), delivered an Interim Report[4] on 16 March 2018, titled *Tax Challenges Arising from Digitalisation – Interim Report 2018*. This interim report was issued just a few days before the European Commission issued two proposals for new Directives that will deliver new ways to tax digitalized forms of business activity.[5]

The OECD's Interim Report provided an in-depth analysis of value creation across new and changing business models in the context of digitalization and the tax challenges they presented. These challenges included risks remaining after the G20/OECD BEPS project in relation to highly mobile income producing factors which still can be shifted into low-tax environments. While members of the BEPS IF did not converge on the conclusions to be drawn from this analysis, they committed to continue working together towards a final report in 2020 aimed at providing a consensus-based long-term solution, with an update in 2019.

Moreover, the Press Release noted that the TFDE has further intensified its work since the delivery of the Interim Report. Drawing on the analysis included in the Action 1 Report (*Addressing the Tax Challenges of the Digital Economy*) as well as the Interim Report, and informed by recent discussions at the July and December 2018 meetings of the TFDE, a number of proposals have been made. This includes one from the G24 group of emerging markets, a fact not mentioned in the Policy Note or Press Release, but covered within the Tax Talks Webcast. These proposals, together with the recent discussions and comments from members of the BEPS IF, provide a base from which this group can build an agreement on a way forward.

Given the significance of the new proposals for the international tax system, the BEPS IF will issue a consultation document in February that describes the two pillars in more detail, and a public consultation will be held on 13 and 14 March 2019 in Paris as part of the meeting of the TFDE. Further details on the consultation process, including how stakeholders can provide input and most effectively participate, along with the consultation document, will be published in the coming weeks.

About the OECD's proposed way forward

The OECD says that there is now agreement among the BEPS IF to examine proposals involving two pillars which could form the basis for consensus. The first pillar addresses the broader challenges of the digitalized economy and focuses on the allocation of taxing rights, including nexus issues.

The second pillar would address remaining BEPS issues. The OECD believes that a two pillar approach would be effective in recognizing that the digitalization of the economy is pervasive, raises broader issues, and is most evident in, but not limited to, highly digitalized businesses – in essence remaining aligned to the BEPS Action 1 statement that *special rules designed exclusively for the digital economy would prove unworkable, broadly stating that the digital economy cannot be ring-fenced because it is increasingly becoming the economy itself*.

The two-pillar approach, says the Policy Note, raises questions regarding where tax should be paid and if so, in what amount in a world *where enterprises can effectively be heavily involved in the economic life of different jurisdictions without any significant physical presence and where new and often intangible value drivers more and more come to the fore*.

The Policy Note also states that the features of the digitalizing economy exacerbate BEPS risks, and enable structures that shift profits to entities that escape taxation or are taxed at only very low rates. A solution would therefore require comprehensive work that covers the overall allocation of taxing rights through revised profit allocation rules and revised nexus rules, as well as anti-BEPS rules.

The first pillar: allocation of taxing rights and revisions to the nexus concept

The first pillar of the OECD's ongoing work will focus on the existing rules that allocate the right to tax the income of multinational enterprises among jurisdictions. This will require a re-examination of the so-called "nexus" rules – namely how to determine the connection a business has with a given jurisdiction – and the rules that govern how much profit should be allocated to the business conducted there.

The BEPS IF will look at proposals based on the concepts of marketing intangibles, user contribution and significant economic presence and how they can be used to modernize the international tax system to address the tax challenges of digitalization. A second pillar aims to resolve remaining BEPS issues and will explore two sets of interlocking rules designed to give jurisdictions a remedy in cases where income is subject to no or only very low taxation.

The Policy Note describes how several different proposals have been made that would allocate more taxing rights to market or user jurisdictions in situations where value is created by a business activity through participation in the user or market jurisdiction that is not currently recognized in the framework for allocating profits. The Policy Note sets out that some of the proposals being studied would require reconsidering the current transfer pricing rules as they relate to non-routine returns, and other proposals would entail modifications potentially going beyond non-routine returns.

In all cases, says the OECD, these proposals would lead to solutions that go beyond the arm's-length principle. They also go beyond the limitations on taxing rights determined by reference to a physical presence generally accepted as another corner stone of the current rules. The BEPS IF agreed that issues of profit attribution and nexus would need to be developed contemporaneously, with each playing a key role in any solution ultimately adopted, noting that they may require changes to tax treaties. On nexus, the BEPS IF agreed to explore different concepts, including changes to the permanent establishment threshold, such as the concept of "significant economic presence" which was discussed in the Action 1 Report or the concept of "significant digital presence," as well as special treaty rules. No further details were included in the Policy Note.

The second pillar: an income inclusion rule and a tax on base-eroding payments

In addition to changes to profit attribution and nexus, the BEPS IF has also agreed to study further measures that it believes would strengthen the ability of jurisdictions to tax profits where a second jurisdiction with taxing rights applies a low effective rate of tax to those profits. These proposals, says the Policy Note, recognize not only ongoing BEPS challenges, but also more recent developments such as US tax reform.

The proposal under this pillar would focus on two inter-related rules. The first would be an income inclusion rule and the second, a tax on base-eroding payments. These rules would include a coordination rule to mitigate the risk of double taxation.

The policy notes outlines that such measures would not preclude countries or jurisdictions from setting their own corporate income tax rates or to not have a corporate income tax system at all. Instead, the proposal considers the OECD view that, in the absence of multilateral action, there is a risk of uncoordinated, unilateral action, both to attract more tax base and to protect the existing tax base, with adverse consequences for all countries, large and small, developed and developing.

Members of the BEPS IF also agreed that any new rules to be developed should not result in taxation when there is no economic profit nor should they result in double taxation. They stressed the importance of tax certainty and the need for effective dispute prevention and dispute resolution tools. The members were mindful of the need to ensure a level playing field between all jurisdictions; large or small, developed or developing.

Neither the Policy Note nor the Press Release provides any further detail on the scope or operation or either measure, nor did they set out whether such measures will be issued as recommendations, leading practices or minimum standards.

Guiding principles

Mindful of compliance and administrative burdens, the Policy Note states that members will strive to make any rules as simple as the tax policy context permits, including through the exploration of simplification measures. Furthermore, given the interlinked nature of the issues to be discussed, the challenging timeframe, and the fundamental nature of the changes proposed, the BEPS IF decided to mandate the BEPS IF Steering Group to elaborate a detailed work program. It also mandated detailed instructions to subsidiary bodies to which the BEPS IF could agree at its May meeting, with a view to reporting progress to the G20 Finance Ministers in June 2019 and to deliver final recommendations in 2020.

The Policy Note sets out that the work of BEPS IF will be driven by the desire to find the right balance between accuracy and simplicity. This, says the OECD, means that any solution needs to be administrable by tax administrations and taxpayers alike and take account of the different levels of development and capacity of members. The BEPS IF, says the Policy Note, is open to exploring solutions, administrative simplifications and collection mechanisms, which should all be principle-based and could include withholding taxes where they do not result in double taxation.

Further technical work on the design considerations of the proposals would be required, taking into consideration potential scope limitations, business line segmentation, profit determination and allocation, as well as nexus and treaty considerations. While not mentioned in either document issued by the OECD, it is assumed that the OECD will continue to follow the Ottawa principles of neutrality, efficiency, certainty, fairness and flexibility.

Timeline

During the OECD Tax Talks webcast, Pascal Saint-Amans, Director of the OECD's Centre for Tax Policy & Administration outlined that there would be a call for public input during the month of February. This input would be further studied by the TFDE at its March meeting. Some elements of the March 2019 TFDE meeting may be made open to the public.

Work would then continue in the OECD's working parties during the months of April and May, before the delivery of an interim report to the G20 Finance Minister's meeting in June 2019. This potential timeline is illustrated in Image 1 below:

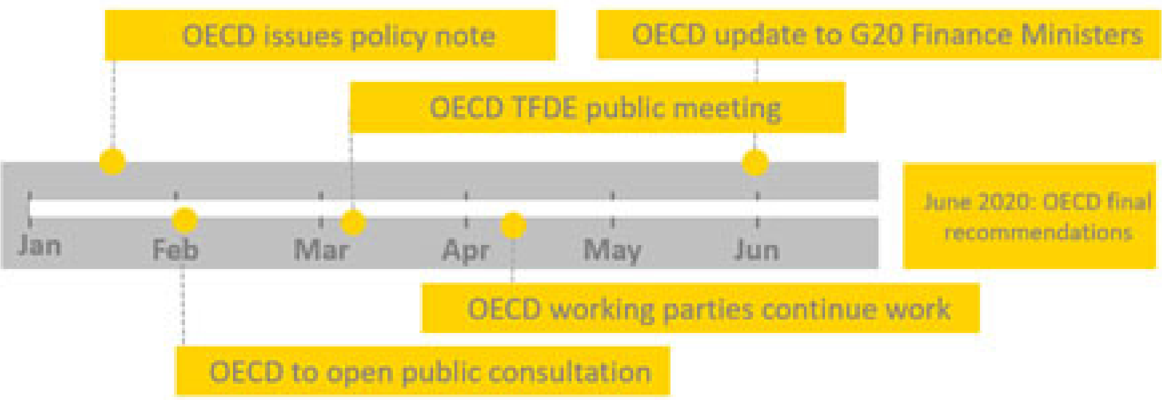

Image 1: An overview of the OECD's potential timeline

Implications

Collectively, the potential new measures and approaches set out in the OECD's Press Release and Policy Note represent fundamental and significant changes to the current system of cross-border taxation, and take this debate far beyond digital.

They include changes to the allocation of taxing rights, nexus, some form of global minimum tax and, importantly, potential changes to the internationally-accepted transfer pricing framework. These changes are complicated and interlinked, and in many cases are likely to require amendments to income tax treaties.

Little is known of the details of any of the potential measures at this point, and there will be much work ahead for the OECD and BEPS IF to try and build any form of consensus. The fact that the OECD is trying to build consensus among the 127-jurisdiction strong BEPS IF demonstrates that the OECD wishes this process to be fully inclusive.

The lack of detail provided by the OECD illustrates that the proposed changes are at the early stages of development, and their composition and final form is far from certain. However, with the involvement of the United States, as well as France, Germany and the United Kingdom, companies are encouraged to follow and remain involved in the discussion as the practical likelihood of this moving forward has increased. Taxpayers are therefore recommended to take the opportunity to provide their input to the OECD and its subsidiary bodies, whether by written input or by attending the TFDE's public session. Additionally, taxpayers should also consider whether providing input to national policymakers may also be appropriate.

Other related factors, including the ongoing European Commission work on Digital Services Tax and the International Monetary Fund's expected paper on formulary apportionment and the Arm's-Length Principle, may also impact the ongoing discussions at OECD level.

The pace and number of unilateral Digital Service Taxes also continues to accelerate into 2019. This requires companies to prepare for compliance in this area on specific business models. But on the basis of the scope of the changes discussed by the OECD, all global, intangible-aligned companies should actively prepare for this new, redefined taxation framework.

Endnotes

1. https://www.oecd.org/tax/tax-talks-webcasts.htm.
2. The BEPS IF now numbers 127 jurisdictions in total.
3. Currently co-chaired by France and the United States.
4. See EY Global Tax Alert, *OECD releases interim report on the tax challenges arising from digitalization*, dated 16 March 2018.
5. See EY Global Tax Alert, *European Commission issues proposals for taxation of digitalized activity*, dated 21 March 2018.

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