

## OECD opens public consultation on addressing tax challenges arising from digitalization of the economy: time-sensitive issue impacting all multinational enterprises

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### Executive summary

On 13 February 2019, the Organisation for Economic Co-operation and Development (OECD) issued a public consultation document (consultation document) seeking public comments on possible solutions identified to address the tax challenges arising from the digitalization of the economy.

The publication of the consultation document was discussed in the 29 January 2019 [Policy Note](#)<sup>1</sup> published by the Inclusive Framework on Base Erosion and Profit Shifting (BEPS IF), following the agreement of the now 128-strong members of the BEPS IF to examine proposals involving two pillars. One pillar would focus on the allocation of taxing rights and a second pillar would address BEPS issues. Importantly, the consultation document sets out more detail on the proposals within both pillars than was previously known. The consultation document also notes that the impact of these proposals is not limited to digital business models only, and would impact any business models utilizing intangible assets.

The OECD notes that the proposals included in the consultation do not represent the consensus views of the BEPS IF, the OECD's Committee on Fiscal Affairs (CFA) or their subsidiary bodies. It is important in this regard to note that the current proposals may continue to be revised or added to. In that regard, they represent a current snapshot of what is being discussed by OECD member countries.

The [consultation document](#) describes the proposals discussed by the BEPS IF at a high level, and seeks comments from the public on a number of policy issues and technical aspects. The specific questions posed by the OECD on each proposal are listed in full in the consultation document. The comments provided will assist the BEPS IF in preparing a solution for its final report to the G20 leaders in 2020. That final report will be preceded by an update to that group in 2019.

Given the intention for the consultation to inform policy makers, the consultation is open for three weeks and interested parties are invited to send their comments to the OECD no later than 1 March 2019.

## Detailed discussion

The 32-page consultation document is divided into three key sections:

- ▶ **Section 1: Introduction:** provides detailed background, reviewing the OECD's work in this area to date
- ▶ **Section 2: Revised profit allocation and nexus rules:** provides detailed examination of three key proposals under debate
- ▶ **Section 3: Global anti-base erosion proposal:** sets out proposals to address the continued risk of profit shifting to entities subject to no or very low taxation

### Section 1: Introduction

Section 1 discusses how, in March 2017, the G20 Finance Ministers mandated the BEPS IF working through the Task Force on the Digital Economy (TFDE), to deliver an interim report on the implications of digitalization for taxation by April 2018 and a final report in 2020. The interim report, *Tax Challenges Arising from Digitalisation – Interim Report 2018*<sup>2</sup> was delivered to the G20 in March 2018. Building on the BEPS Action 1 Report, the Interim Report reflected, among other things, the progress made since 2015 in considering the two previously identified direct tax issues, namely the exacerbated BEPS issues and the broader tax challenges.

The TFDE has continued evaluating various proposals and the result of this effort is presented in the consultation document, which sets out a number of proposals for consideration as part of a longer-term solution. The proposals are not legislative instruments or specific recommendations, and are at the policy design phase only, and therefore only high-level descriptions are provided. Importantly, and as noted throughout the consultation document, the proposed design elements of some of the proposals would mean that the

impact of any changes adopted may not be limited to highly digitalized business models alone, and as such, may impact any multinational enterprise (MNE) utilizing intangible assets, including “marketing intangibles” (as defined in the OECD’s Transfer Pricing Guidelines).

### Section 2: Revised profit allocation and nexus rules

The consultation document describes the current proposals related to the “broader tax challenges” to the existing profit allocation and nexus rules. Sections 2 and 3 broadly describe policy proposals made by some members of the BEPS IF that would modify those rules based on the concepts of (i) user participation, (ii) marketing intangibles, and (iii) significant economic presence, each of which is described in more detail below.

The consultation document notes that the Interim Report identified three key characteristics – scale without mass, a heavy reliance on intangible assets, and the role of data and user participation – which sometimes work together to enable highly digitalized businesses to create value by activities closely linked with a jurisdiction without needing to establish a physical presence. The consultation document notes that any solution that seeks to address nexus must also address the closely-related issue of profit allocation.

The consultation document highlights developments already taking place in response to the recommendations from the BEPS project, including BEPS Action 7 (relating to permanent establishments). By way of example, the consultation document notes that some MNE groups with highly-digitalized business models have been able to establish local affiliates in market jurisdictions, whereby the local affiliates are commonly structured to have no ownership interest in intangible assets, perform no DEMPE (development, enhancement, maintenance, protection, and exploitation) functions, and do not assume any risks. Accordingly, only a modest return may be allocated to these “limited risk distributors,” (LRDs). Thus, without effective changes to profit allocation rules, the document notes that an MNE group may seek to sidestep the nexus issue by establishing local affiliates that are not entitled to an appropriate share of the group’s profit.

Importantly, the consultation document asks whether the issues raised with respect to highly digitalized MNEs also are relevant to a broader set of businesses – for example, businesses that, due to digitalization and changes in the global economy, can build their brand, develop an engaged

customer base and create value in the absence of local activities or in the absence of local activities that attract a significant share of taxable profits.

Section 2 describes the (i) user participation proposal, and (ii) marketing intangibles proposal that focus on value creation in the user/market jurisdiction that is not recognized in the current framework for allocating taxing rights and taxable profits.

The consultation document notes that three proposals for revising the profit allocation and nexus rules are currently being debated. It should be noted that these proposals are in no way final and continue to be debated among jurisdictions.

### The “user participation” proposal

This proposal focuses on the value created by certain highly-digitalized businesses through developing an active and engaged user base, and soliciting data and content contributions from them. The proposal is premised on the idea that soliciting the sustained engagement and active participation of users is a critical component of value creation for certain highly-digitalized businesses. These include:

- ▶ Social media platforms
- ▶ Search engines
- ▶ Online marketplaces

In summary, the proposal suggests revising profit allocation rules to accommodate the value creating activities of an active and engaged user base. In addition, nexus rules would also be revised, so that the user (i.e., market) jurisdictions would have the right to tax the additional profit allocable to them. However, the consultation document notes, this proposal would be limited in applicability to business models which benefit from this type of user base; thus for businesses that have more traditional relationships with customers, no change in the profit allocation or nexus rules would be proposed.

The consultation document notes that the mechanics of this proposal would act to modify current profit allocation rules to require that, for certain businesses, an amount of profit be allocated to jurisdictions in which those businesses' active and participatory user bases are located, irrespective of whether those businesses have a local physical presence. It further notes that there would be significant difficulties in using traditional transfer pricing methods for determining the amount of profit that should be allocated to a user jurisdiction. As an example, it dismisses the idea that the value created by user activities can somehow be determined

through the application of the arm's-length principle. Instead, it proposes that the profit allocated to a user jurisdiction, in respect of the activities/participation of users, be calculated through a non-routine or residual profit split approach.

### The “marketing intangibles” proposal

This proposal is based on the concept of “marketing intangibles” as defined in the OECD Transfer Pricing Guidelines. Like the “user participation” proposal, it would change the profit allocation and nexus rules, but would also be broader in scope in an effort to respond to the impact of the digitalization on the economy.

The “marketing intangibles” proposal addresses a situation where an MNE group can essentially (in the OECD's words) “reach into” a jurisdiction, either remotely or through a limited local presence (such as an LRD), to develop a user/customer base and other marketing intangibles. It sees an intrinsic functional link between marketing intangibles and the market jurisdiction. Taking this link into account, the proposal would modify current transfer pricing and treaty rules to require marketing intangibles and risks associated with such intangibles to be allocated to the market jurisdiction. The proposal considers that the market jurisdiction would be entitled to tax some or all of the non-routine income properly associated with such intangibles and their attendant risks, while all other income would be allocated among members of the group based on existing transfer pricing principles. The proposal does not look at trade intangibles which, according to the consultation document, are seen as not similarly possessing an intrinsic functional link with market jurisdictions.

The special allocation of some or all non-routine returns from marketing intangibles, and the related expansion of the market country's taxation rights, would apply regardless of which entity in the MNE group owns legal title to the marketing intangibles, regardless of which entities in the group factually perform or control DEMPE functions related to those intangibles, regardless of how risks related to the marketing intangibles would be allocated under existing transfer pricing rules, and regardless of how those rules would ordinarily allocate income related to the marketing intangibles and their associated risks.

### The “significant economic presence” proposal

This proposal is based on the concept of “significant economic presence” as originally described in Section 7.6 of the BEPS [Action 1 Report](#).

Under this proposal, a taxable presence in a jurisdiction would arise when a nonresident enterprise has a significant economic presence on the basis of factors that evidence a purposeful and sustained interaction with the jurisdiction via digital technology and other automated means. Revenue generated on a sustained basis is the basic factor, but such revenue would not be sufficient in isolation to establish nexus. Only when combined with other factors (such as existence of a user base, the volume of digital content derived from the jurisdiction and sustained marketing and sales promotion activities) would revenue potentially be used to establish nexus in the form of a significant economic presence in the country concerned.

The proposal contemplates that the allocation of profit to a significant economic presence could be based on a fractional apportionment method, as discussed in Section 7.6.2.2 of the Action 1 Report. Other simplified methods for allocating profit will also be considered, such as the modified deemed profits methods described in section 7.6.2.3 of the Action 1 Report. The proposal also contemplates the possible imposition of a withholding tax as a collection mechanism and enforcement tool. In this context, consideration could be given to a gross-basis withholding tax at a low rate on payments to an enterprise with a significant economic presence, with the enterprise having the right to file an income tax return and seek a refund if the withheld amount exceeded the enterprise's income tax liability.

### Section 3: Global anti-base erosion proposal

Section 3 describes proposals related to the perceived risk of profit shifting and explores two sets of rules designed to give jurisdictions a remedy in cases where income is subject to no or only very low taxation: (i) an income inclusion rule, and (ii) a tax on base eroding payments. Importantly, the scope of the anti-base erosion proposal is not limited to highly digitalized businesses. Instead it focuses on the remaining BEPS challenges and looks to propose a systematic solution designed to ensure that all internationally operating businesses pay a minimum level of tax.

The income inclusion rule would operate as a minimum tax by requiring a shareholder in a corporation to bring into account a proportionate share of the income of that corporation if that income was not subject to tax at a minimum rate. The rule would apply to any shareholder with a significant (e.g., 25%) direct or indirect ownership interest in that company and would be applied on a per jurisdiction basis. The amount of income to be included would be calculated under domestic law

rules and shareholders would be entitled to claim a credit for any underlying tax paid on the attributed income, with such credits also being calculated on a jurisdiction-by-jurisdiction basis. This rule would supplement rather than replace a jurisdiction's Controlled Foreign Corporation rules.

The consultation document explains that the income inclusion rule would build on the BEPS Action 3 recommendations and draw on aspects of the United States (US) regime for taxing Global Intangible Low-Taxed Income (GILTI). The rule would be designed in such a way that Member States of the European Union (EU) could apply it to both domestic and foreign subsidiaries and it could be adopted via an EU directive.

The second key element of the proposal is a tax on base eroding payments that complements the income inclusion rule by allowing a source jurisdiction to protect itself from the risk of base eroding payments. More specifically, this element of the proposal would include:

- ▶ An undertaxed payments rule that would deny a deduction for a payment to a related party if that payment was not subject to tax at a minimum rate; and
- ▶ A subject-to-tax rule in tax treaties that would only grant certain treaty benefits if the item of income is sufficiently taxed in the other state.

The consultation document highlights that because the various elements of the anti-base erosion proposal are intended to tackle the same structures, there is the possibility that these rules will overlap to a certain extent. Given the potential for overlap, an ordering rule would be necessary and there are at least two design options for such an ordering rule: a rule that could be applied on a payment by payment basis or a more systemic approach that would switch off the application of one rule if an MNE was based in a jurisdiction that had introduced the other rule. Further technical work would need to explore these overall approaches and then also establish the order in which they would be applied.

### Public meeting in Paris

A public consultation meeting will be held at the OECD Conference Centre in Paris on 13 March and the morning of 14 March 2019. Further information regarding the [public consultation](#) is available on the OECD's website. Those wishing to attend are invited to register by no later than 1 March 2019. Speakers and other participants will be selected from among those providing timely written comments on the consultation document.

Persons wishing to request to attend the public consultation event are invited to [submit their application for registration](#) by 1 March 2019. The public consultation event will be live streamed by the OECD. A full agenda for the public consultation will be published by the OECD in due course.

## Implications

The consultation document contains proposals which, if implemented, would represent a significant departure from current international tax systems. For example, some of the proposals go beyond current internationally-accepted transfer pricing norms. As is acknowledged in the consultation document, some of the proposals would have implications for a very wide range of businesses whether digitalized or more traditional.

The consultation period which ends 1 March 2019 is relatively short for an issue of such magnitude. MNE groups should evaluate the proposals outlined in the consultation document at their earliest opportunity to gauge impacts on existing or future business models. As noted, attendance at the OECD's public consultation in March is conditional on having provided comments on the consultation document.

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## Endnotes

1. See EY Global Tax Alert, [OECD's new insights describe growing support on comprehensive changes to international tax policy, beyond digital](#), dated 29 January 2019.
2. See EY Global Tax Alert, [OECD releases interim report on the tax challenges arising from digitalization](#), dated 16 March 2018.

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EYG no. 000464-19Gbl

1508-1600216 NY  
ED None

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