

Report on recent US international tax developments - 15 February 2019

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The Organisation for Economic Co-operation and Development (OECD) on 13 February [issued a public consultation document](#) expanding on the proposed two-pillar approach to the tax challenges of the digital economy that was first discussed in the [Policy Note](#) by the Inclusive Framework on Base Erosion and Profit Shifting (BEPS IF), released on 29 January 2019. The first pillar addresses profit allocation and nexus, with the second pillar including a global anti-base erosion proposal consisting of an income inclusion rule or minimum tax, and a fallback proposal aimed at certain related-party, base-eroding payments.

While the OECD characterized its efforts as addressing the tax challenges of the digital economy, the proposed options covered by the consultation document could apply broadly to many industries and companies that do not view themselves as "digital companies." The proposals in the second pillar would have broad application to most multinational businesses.

The discussion on revising the profit allocation and nexus rules focuses primarily on two proposals: user participation and marketing intangibles. The user participation proposal addresses digital business and the value created by digitalized businesses through "developing an active and engaged user base, and soliciting data and content contributions from them." That value is most significant in business models such as social media, search engines, and online marketplaces. The proposal seeks to revise profit allocation rules to accommodate such value-creating activities, and to revise nexus rules so that user jurisdictions would have the right to tax the additional profit allocable to them.

A marketing intangibles approach would change the profit allocation and nexus rules for a broader set of businesses (beyond digital) that enter a jurisdiction to develop a user/customer base and other marketing intangibles. The document acknowledges “an intrinsic functional link between marketing intangibles and the market jurisdiction.”

Current transfer pricing and tax treaty rules would have to be modified under the proposal, to require marketing intangibles and risks associated with such intangibles to be allocated to the market jurisdiction, which would be entitled to tax some or all of the associated income. A “significant economic presence” proposal is also discussed.

The consultation paper’s second pillar addresses the remaining BEPS challenges of risk and profit shifting to entities that are subject to no or very low taxation, through a global anti-base erosion proposal: this includes two interlocking rules -- an income inclusion or minimum tax, and a tax on base-eroding payments. The income inclusion rule would operate as a minimum tax by requiring a shareholder in a foreign branch or controlled entity to bring into account a proportionate share of income if that income was subject to a low effective tax rate in the jurisdiction, applied on a per jurisdiction basis.

The proposal for a tax on base-eroding payments would include both an “undertaxed payments rule” that would deny a deduction for a payment to a related party if the payment was not subject to a tax at a minimum rate, and a “subject to tax rule” to deny treaty benefits if the item of income is insufficiently taxed in the other jurisdiction.

Comments are requested by 1 March and a public consultation on the consultation document will be held on 13-14 March at the OECD in Paris. Following the consultation, an update is expected to be presented to the G20 finance ministers meeting in Japan in June, and the OECD is aiming for “a consensus-based, long-term solution” to be reached in 2020.¹

A senior United States (US) Treasury official responded to the OECD release, saying that he expected there would be a “relatively modest” reallocation of taxing rights emanating from the OECD digital taxation project. He was quoted as predicting that, to the extent there is consensus, it will fall under the broader “umbrella concept of marketing intangibles.” He further suggested that the reallocation of taxing rights in this regard would likely follow a formulaic approach because most countries are unable to undertake a full transfer pricing analysis of the value of marketing intangibles.

The official added that the pillar’s user participation proposal and significant economic presence approach would generally only apply to the subset of cross-border digital companies, effectively providing a ring-fenced approach applicable only to those companies. The US has adamantly opposed such a targeted approach and the Treasury official said that ring-fencing applicable only to cross-border digital companies is losing support among OECD BEPS IF countries.

The US Government is suggesting that it may not be able to finalize all the proposed international tax regulations by June 2019 as it had originally planned, according to several officials this week. A Treasury official was quoted as saying he expected the final global intangible low-taxed income (GILTI) regulations would be released before 22 June, perhaps as early as spring but possibly early summer. The remainder of the proposed international tax regulations would likely be finalized in the order they were released, he said. The official implied that the magnitude of the work needed to finalize those regulations may push some of the final regulations to be released past the June deadline.

Another senior Treasury official this week was quoted as saying that finalizing the proposed Internal Revenue Code Section 163(j) regulations and the various international tax regulations are the Government’s top priority, but said it was not clear if the Section 163(j) project would be completed before 22 June.

Endnote

1. See EY Global Tax Alert, *OECD opens public consultation on addressing tax challenges arising from digitalization of the economy: time-sensitive issue impacting all multinational enterprises*, dated 14 February 2019.

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