Tax Insights

Tax challenges of digitalisation: OECD paper released

Snapshot

On 13 February 2019, as part of the ongoing work of the OECD/G20 Inclusive Framework for the global implementation of the BEPS project, the OECD released a consultation document "Addressing the Tax Challenges of the Digitalisation of the Economy."

The consultation document sets out proposals under consideration by the members of the Inclusive Framework as they work towards reaching a new consensus-based long-term solution in 2020. Options under consideration are:

- **Revised profit allocation and nexus rules:** Three proposals to revise existing rules based on the concepts of (i) "user participation," (ii) "marketing intangibles" and (iii) "significant economic presence;" and

- **Global anti-base erosion proposal:** comprising an income inclusion mechanism, and a tax on base eroding payments, including both a denial of deduction rule and a denial of treaty benefits rule. Together, these proposals permit countries to tax profits where income is otherwise subject to no or very low taxation in another country.
The consultation document makes clear that countries have agreed to look at a range of proposals on a “without prejudice” basis to allow for necessary further work without commitment at this stage to a particular course of action.

**Revised profit allocation and nexus rules**

Three proposals are being explored that share the same objective of expanding the taxing rights of market/user countries in situations where value is considered to be created in that market/country of the user. The proposals are being looked at on their individual merits, but the Inclusive Framework is also considering some common design issues and how some of the proposals could be framed in a more aligned manner. Any of the proposals will require changes to the allocation between countries of the right to tax corporate profits (“nexus”) and the methods or mechanisms that allocate profits to business activities in different countries (“profit allocation”).

1 “User participation” proposal – social media platforms, search engines and online marketplaces

The proposal focuses on highly digitalised businesses where user participation is seen to represent a significant contribution to value creation. The activities and participation of users contributes to the creation of the brand, the generation of valuable data and the development of a critical mass of users that helps to establish market power. The proposal considers that this source of value is most significant, on an absolute basis and relative to traditional drivers of business value, for social media platforms, search engines and online marketplaces, such that this proposal may perhaps be limited to these business models. The proposals could restrict businesses in scope by reference to their size to reduce administrative and compliance burdens.

An amount of profit will be allocated to the market/user country where their active and participatory user bases are located, irrespective of whether the business has a local physical presence.

The profit allocated to a user country in respect of user participation would be calculated through a non-routine or residual profit split approach (not through the application of the traditional arm’s length principle). A proportion of the residual non-routine profits of the business or business line would be attributed to the value created by the activities of users, and allocated between the countries in which users are based using an agreed allocation metric. Under this approach, allocation of profit to routine activities carried out by a business would be unchanged.

The consultation document acknowledges that significant challenges exist in calculating non-routine profit, particularly at the level of an individual business line. A pragmatic approach, such as the use of formulae to approximate value, could be considered to help avoid disputes between countries. This could be combined with strong dispute resolution mechanisms.

2 “Marketing intangibles” proposal – applicable to all businesses

This proposal would apply to all types of businesses, whether or not highly digitalised.

The term “marketing intangibles” is defined in the OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations and includes trademarks, trade names, customer lists, customer relationships and proprietary market and customer data that is used or aids in marketing and selling goods or services to customers.

The digitalisation of the economy and other wider changes to business models are considered to have increased the opportunity for multinational businesses to “reach into” a jurisdiction, either remotely with no physical presence, or through a limited local presence (such as a distributor with limited risk and functionality) to develop a user/customer base and other marketing intangibles. There is considered to be an intrinsic link between marketing intangibles and the market jurisdiction, and therefore the proposal would extend taxing rights to market jurisdictions.
Three key fact patterns are identified under which non-routine profit attributable to the use of marketing intangibles related to that market jurisdiction would be allocated and taxed in the market jurisdiction:

- A highly digitalised business deriving revenues from sales and marketing activities targeting a market jurisdiction in which it does not have a taxable presence;
- A highly digitalised business with a local presence that operates as a limited risk distributor; and
- A consumer product business that is not highly digitalised, but operates either remotely with no physical presence or through a limited risk distributor.

Under the first two fact patterns, the consultation document expects the user participation proposal and the marketing intangible proposal to reach a broadly similar tax outcome.

The proposal would modify current profit allocation and nexus rules to attribute all (or a portion) of the non-routine or residual profit of a multinational group that is attributable to marketing intangibles and their attendant risks, and allocate it to the market jurisdiction. This special allocation of non-routine returns from marketing intangibles would apply regardless of: legal title; performance or control of development, enhancement, maintenance, protection and exploitation (DEMPE) functions related to the intangibles; or how risks related to the marketing intangibles would be allocated under existing transfer pricing rules. The allocation of profits attributable to technology-related intangibles generated by research and development, or attributable to routine functions would be unchanged.

The amount of non-routine or residual profits generated by marketing intangibles could be determined through: (i) normal transactional transfer pricing principles dependent on the economic contribution to profits provided by the marketing intangibles; or (ii) a revised profit split analysis, potentially using mechanical approaches.

The profit attributable to marketing intangibles would then be allocated across market jurisdictions based on an agreed metric, such as sales or revenues. Marketing intangible profits generated from advertising would be allocated based on the location of the customers targeted by the advert rather than the payer. Under the proposal, businesses may be offered the possibility of “early certainty” and a strong dispute resolution component will be considered.

### 3 “Significant economic presence” proposal

Under this proposal, a taxable presence would arise where there is a purposeful and sustained interaction with the country through digital technology and other automated means that constitutes a significant economic presence.

In order to trigger a taxable presence, the requirement for revenues to be generated on a sustained basis would need to be combined with other factors that could include: the existence of a user base and associated data; the volume of digital content derived from the jurisdiction; billing and collection in local currency or with a local form of payment; the maintenance of a website in a local language; responsibility for the final delivery of goods to customers or other support services (e.g. after-sales service, repairs and maintenance); or sustained marketing and sales promotion activities (whether online or not) to attract customers. The revenue-generating activity of a nonresident enterprise would need to be linked to its significant economic presence.

Different options will be considered as to how profit should be allocated to the significant economic presence. This could include a fractional apportionment method under which the tax base could be determined by applying the global profit rate of the group to the revenues generated in a jurisdiction and then apportioning the tax base using an agreed weighting of allocation keys such as sales, assets and employees. Consideration will be given to the use of a withholding tax as a collection mechanism and enforcement tool.
Design considerations

Given some of the structural commonalities between the marketing intangibles and user participation proposals, consideration is being given to some common design issues and how some of the proposals could be framed in a more aligned manner:

- Scope and potential limitations – e.g. materiality thresholds and exclusions;
- Business line segmentation may be appropriate but could increase complexity and uncertainty, and increase administration issues;
- Profit (or loss) determination – a new type of residual profit split method could rely on simplified conventions for determining profit (or losses);
- Profit allocation on an agreed allocation metric (informed by the method used to determine the level of non-routine or residual profit) and reconciled with existing profit allocation rules to prevent double taxation;
- Elimination of double taxation including changes to treaty provisions and incorporation of strong dispute prevention and resolution components;
- Nexus and treaty considerations that could include amending the definition of permanent establishment or a new standalone rule in treaties and domestic rules; and
- Administration including strong dispute prevention and resolution components, e.g. improved multilateral risk assessment procedures, multilateral advance pricing agreements, etc. The use of principle-based administrative simplifications and collection mechanisms could include new or existing withholding taxes, provided double taxation is eliminated effectively.

It is acknowledged that there are important policy trade-offs between precision and the need for certainty and predictability. Design considerations will take account of the need for solutions that can be administered by tax authorities irrespective of different levels of development and capacity, and the need to ensure a ‘level playing field’ between small and large countries.

The above proposals relating to nexus and allocation are all directed at increased market country taxing rights, whether the sales are made into that country by a non-resident principal or an in country buy/sell entity. The BEPS process so far has already sought to address these issues through Action 7 (permanent establishment status), supplemented by Action 15 (Multilateral Instrument) as well as Actions 8-10 (transfer pricing). This further work implies that the BEPS outcomes so far are not sufficient to address concerns of stakeholders.

The proposals are directionally similar to the Multinational Anti Avoidance Law (MAAL) in Australia which targets multinational groups that “avoid a taxable presence by undertaking significant work in Australia in direct connection to Australian sales but booking their revenue offshore”. The MAAL seeks to expand Australia’s taxing rights in the case where Australia is the market country.

On the other hand, these same rules could see Australian based groups exposed to increased foreign tax where they are selling into foreign markets.

1 Explanatory Memorandum, Tax Laws Amendment (Combating Multinational Tax Avoidance) Bill 2015
Global anti-base erosion proposal

Some countries consider that measures set out in the 2015 BEPS reforms do not yet provide a comprehensive solution to the risks of profits being shifted to entities subject to no or very low taxation. A global anti-base erosion proposal is being examined that would respect the right of countries to set their own tax rates, but enable other higher-tax countries to tax profits where others have not “sufficiently” exercised their primary taxing rights. The scope of this proposal addresses perceived BEPS challenges more broadly, is not limited to highly digitalised businesses and consists of two interrelated elements.

Income inclusion rule

The first element is an income inclusion rule that would tax the income of a foreign controlled entity or branch if that income was subject to a low effective tax rate:

- A shareholder with a significant (e.g. 25%) ownership interest in a corporation would be required to bring into account a proportionate share of the income of that corporation, if that income was not subject to tax above a minimum rate. The rule would be applied on a country-by-country basis, with credit available on the same basis for any underlying tax paid. The consultation states that the rule is intended to supplement, rather than replace, countries’ CFC rules.

- In the case of exempt foreign branches, the rule would operate by way of a switch-over rule that would turn off the benefit of an exemption for branches subject to low levels of local taxation.

Areas identified for further work include: the determination of the minimum rate; the ability of a minority shareholder to access the information needed to calculate its liability; the design of the effective tax rate test; the design of any thresholds or safe harbors; rules for attributing income to shareholders; detailed mechanisms for avoiding double taxation; and compatibility with international obligations including EU law.

Tax on base-eroding payments

The second element proposed is a tax on base-eroding payments comprising:

- An undertaxed payments rule that would deny a deduction for certain defined categories of payment made to a related party unless those payments were subject to a minimum effective rate of tax. A related party could be based on a 25% common ownership test. A broad scope is proposed that would cover “conduit” or “imported” arrangements; and

- A complementary subject to tax rule to be incorporated into double tax treaties. The rule would deny treaty relief otherwise available to undertaxed payments under certain treaty articles (e.g. interest and royalty articles). The rule could be limited to related party payments. To simplify administration, consideration could be given to thresholds and safe harbors. Mechanisms for resolving disputes and limiting risks of double taxation also could be examined.

Design issues recognized as requiring consideration include: determining the minimum rate; the relevance, if any, of any substance in the entity receiving the payment; the scope of payments covered by the rule; the threshold for related party status; the information parties are likely to need to be able to comply with the rules; the mechanics of an effective tax rate test, and whether this should be applied on an entity-by-entity or transaction-by-transaction basis; compatibility with international and EU law; whether the rule should deny a deduction in full – or on a graduated basis to reflect the level of taxation in the recipient jurisdiction; and the impact of the rules on certain categories of taxpayers (e.g. individuals, pension funds and charities).
Coordination

Given the potential for overlap between the various elements of this proposal, the need for an ordering/coordination rule is recognized. One option is that this would apply on a payment-by-payment basis, or alternatively a more systematic approach that would switch off one of the rules if the group is based in a country that had introduced the other rule.

Whilst the global anti-base erosion proposals are novel as compared to existing international tax architecture, the options are building on some models that have recently developed around the world.

The consultation document acknowledges that the income inclusion rule will “draw on aspects of the US regime for taxing Global Intangible Low-Taxed Income (GILTI).”

The concept of an undertaxed payments rule has similarities to the US Base Erosion and Anti-abuse Tax (BEAT) and will already be familiar to Australian taxpayers. The proposal bears many similarities to the targeted integrity rule. The targeted integrity rule “will prevent the effect of the hybrid mismatch rules to neutralise double non-taxation outcomes from being compromised by multinational groups using interposed conduit type entities that pay effectively no tax to invest into Australia, as an alternative to investing into Australia using hybrid instruments or entities. These structures can be used to effectively replicate a deduction/non-inclusion outcome” 2

The Australian diverted profits tax (DPT) also has features that are consistent with the global anti-base erosion proposals. The DPT can act as an income inclusion rule or as an undertaxed payments rule.

Layered over this potential reform is the principal purpose test (PPT) being rolled out via the Multilateral Instrument. As the ratification of the Multilateral Instrument becomes more widespread, and through this current round of OECD work, the international tax architecture could be dramatically different by as early as next year.

Next steps

Comments on the consultation document are invited by 6 March 2019 (extended from 1 March 2019). A public consultation meeting will be held on 13 and 14 March 2019 at the OECD in Paris.

The Inclusive Framework will meet in May 2019 to agree a detailed programme of work with a view to reporting progress to G20 Finance Ministers. A consensus-based, long-term solution will be delivered in 2020.

Comments

The consultation draft sets out the latest proposals as countries participating in the OECD’s Inclusive Framework look for a consensus-based solution to the tax challenges of the digitalisation of the economy. A number of the proposals would extend to the taxation of all multinational businesses, and not just those that are highly digitalised.

To address modernisation of business practices and models as a result of digitalisation, the three proposals for allocating taxing rights and profits between countries go beyond fundamental concepts within the current international tax framework, such as requiring a physical presence to be taxed in a

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2 Explanatory Memorandum, Treasury Laws Amendment (Tax Integrity and Other Measures No. 2) Bill 2018
country and allocation of profits according to the arm’s length principle. These will require double tax treaty changes to be adopted.

The global anti-base erosion proposal sets out points that require consideration, including examples of the situations that this measure is seeking to address. Among the areas to be explored will be how to deal with the challenges of countries’ differing tax bases (e.g. in relation to research and development costs) as well as differing tax rates.

Businesses should be pleased to see that in some proposals the consultation document includes references to strong dispute prevention and resolution components, but this will remain of key importance as the OECD’s work progresses. Businesses also will want comfort that deductions for costs incurred will be available, clarity over allocation of losses as well as profits and, where possible, certainty, to minimise the number of disputes. The consultation draft acknowledges the benefits of simplicity from both a business compliance and a tax authority administration perspective.

The consultation document includes a number of questions for businesses to consider, which will be important despite the challenging timetable for comments. The worst outcome would be a failure for consensus to be reached at the OECD/global level and for there to be a break-out of uncoordinated unilateral measures by countries leading to double or multiple taxation.
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