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OECD Programme of Work on the Tax Challenges Arising from the Digitalisation of the Economy

On 31 May 2019, as part of the ongoing work of the G20/OECD Inclusive Framework on Base Erosion and Profit Shifting, the OECD released a **Programme of Work to Develop a Consensus Solution to the Tax Challenges Arising from the Digitalisation of the Economy**.

The programme sets out the work to develop proposals under two 'pillars':

- Pillar One: Revising **nexus** and **profit allocation rules** to address how taxing rights should be **allocated among countries** and, in particular, to **market countries**
- Pillar Two: A **global anti-base erosion proposal to strengthen countries' ability to tax profits** where income is locally subject to **a low effective rate of tax**.

Deloitte Comments

The proposals and wide-reaching reforms under consideration are not limited to the technology sector or those businesses that might be considered to be highly digitalised. The fundamental nature of the reforms to the international tax framework will, if agreed, have a broad impact and all businesses will need to understand how this could affect them.

The OECD participating governments have agreed to work on detailed technical aspects of the proposals in order to help inform the political discussions, with a view to countries reaching political agreement by the end of 2019. Alongside the tax technical work the OECD will undertake economic studies to evaluate the impact of proposed measures.

The programme highlights the significance of the technical work that needs to be completed. Key areas will include when a country has the right to tax trading profits and the rules for allocation of trading profits to each country. A particular focus is on ensuring sufficient profit is awarded to the 'market' jurisdiction, whether the country of users or sales. Detailed design considerations will look at the use of a residual profit split approach (either on a global or business line/regional basis) alongside existing transfer pricing rules, or the use of formulae or 'fractional apportionment' by reference to metrics such as sales, employees, assets or users. A newly proposed approach considers a base level of return for distribution activities in market countries. Technical topics to be analysed include, for example, the implications for losses, cost-plus approaches, and existing withholding tax rules. The global income inclusion rule to allow countries to require a minimum effective level of tax will also be part of the programme of work.

Changes, when agreed, will have implications for and require significant amendments to existing double tax treaties, the OECD's Transfer Pricing Guidelines, rules for the attribution of profits to permanent establishments and also domestic legislation. As such, it is likely to take some time before any new rules can be effectively implemented.

For businesses, the key concern, expressed at the public consultation meeting in March 2019, will be to ensure that profits are taxed only once and that there is effective and timely resolution of disputes between countries. Clear rules and boundaries will help with this, but binding arbitration or other measures to give certainty will also be essential. The work programme makes clear that, given the potentially extensive and disruptive changes being considered, both governments and businesses want simplification where possible. This is particularly important given that the BEPS Inclusive Framework is made up of 129 countries, many of them developing, and the desire for a system and measures that can be administered and adopted on a global basis.

The work programme will require significant resources from governments participating in the OECD Inclusive Framework. The overarching objective though, for businesses and for international growth, is that there remains a consistent global framework that does not hinder cross-border trade.

Pillar One: Revised profit allocation and nexus rules

Three proposals are being explored to develop a consensus-based solution to expand the taxing rights of market/user countries where value is considered to be created in that country:

- **User participation** – social media platforms, search engines and online marketplaces;
- **Marketing intangibles** – applicable to all businesses
- **Significant economic presence** – applicable to all businesses

Although the proposals vary in objective and scope, there are important common policy features. All three contemplate: the existence of a nexus in the absence of physical presence; using the total profit of a business; simplifying conventions, including those that diverge from the arm's length principle, to reduce compliance costs and disputes; and rules which operate alongside current transfer pricing rules.

The programme of work sets out the technical work required to develop proposals:

- **New profit allocation rules** - approaches to determine the amount of profits (and losses) subject to any '**new taxing right**' and their allocation among jurisdictions;
- **A new nexus rule** - a concept of taxable business presence in a market jurisdiction outside of physical presence requirements;
- **Implementation and efficient administration** of any 'new taxing right', including the effective elimination of double taxation and resolution of tax disputes.

New profit allocation rules

Three alternative methods are identified as potential options to quantify the amount of profit to be reallocated to and between market jurisdictions under any 'new taxing rights':

Modified residual profit split method ('MRPS')
A portion of a group's non-routine profit would be allocated to market jurisdictions:

- **Determine total profit to be split** - consideration will be given to the suitability of using accounting rules, the relevant measure of profit to be used (e.g. pre-tax profit), and any appropriate adjustments needed. The relative merits of determining total profits on a group-wide basis or on an entity/aggregated entity basis will be evaluated.
- **Remove routine profit**, using either:
  - Current transfer pricing rules - determining routine and non-routine profit, and mechanisms required by tax authorities to confirm the amount of non-routine profit; or
  - Simplified approaches - including possible proxies to determine non-routine profit;
- **Determine the portion of the non-routine profit that is within the scope of any new taxing right**, using either current transfer pricing rules or simplified conventions.
  - Simplified conventions could include the use of proxies e.g. based on capitalised expenditure, projections of future income, or fixed percentages of total non-routine income (potentially with variations for different lines of business).
- **Allocate the non-routine profit subject to any new taxing rights among market jurisdictions** – including evaluation of possible allocation keys e.g. revenue.

Fractional apportionment method
The amount of profits subject to any new taxing right to be calculated as follows:

- **Determine the profit to be divided**
  - No distinction between routine and non-routine profit.
  - Options may include the profit of the selling entity as determined by current transfer pricing rules, or by applying a global profit margin to local sales.
- **Select allocation keys** – factors including employees, assets, sales, and users will be explored.
- **Apply this formula to allocate a fraction of the profit to market jurisdictions.**

Distribution-based approaches
Simplified methods will be considered including the potential development of rules to specify a **baseline of profit attributable to marketing, distribution, and user-related activities** which would allocate a proportion of routine and non-routine profits to market countries. The potential to adjust the baseline amount based on a group's overall profitability, industry or market differences will also be explored.

Other design considerations

- **Business line and regional segmentations:** whether the new rules should be applied to a group as a whole, or separately take into account different business lines and/or geographical regions.
- **Design potential scope limitations**, for example:
  - by reference to the nature of a business e.g. negative exclusions, safe harbours, thresholds based on revenue or other relevant factors.
  - focus the scope on businesses that are of a type to which the rules should apply.
  - the applicability of any new taxing right to commodities and financial instruments.
- **Treatment of losses:** options for the effective application of the new rules to both profits and losses.

New nexus rule
The development of new concepts to allow market jurisdictions to exercise taxing rights will be explored:

- remote taxable presence (i.e. without a traditional physical presence) and a new set of standards for identifying when such a remote taxable presence exists; and
- taxable income sourced in (i.e. derived from) a jurisdiction.

The development of a new nexus rule could be achieved through amendments to the definition of a permanent establishment in Article 5 of the OECD model tax treaty (i.e. a permanent establishment could be deemed to exist where a group has a remote yet sustained and significant involvement in the economy of a country); or through the development of a standalone rule establishing a new and separate nexus.

Indicators of a group's remote but sustained and significant involvement in the economy of a market country will be explored but could require: a sustained local revenue threshold (both monetary and temporal); and a range of additional indicators which demonstrate a link beyond that of merely selling into a country.

Implementation of the new taxing right

- **Elimination of double taxation and dispute resolution**
  - How source countries would exercise reallocated taxing rights, and how residence countries would provide relief from double taxation of the relevant income – including which members of a group should be considered to derive the relevant income for reallocation.
  - The effectiveness of existing treaty provisions and the need to develop new or enhanced treaty provisions for the effective elimination of double taxation.
  - The interaction between any new taxing right and existing taxing rights (such as withholding taxes on royalty payments or payments for services).
  - The need for multilateral (rather than bilateral) approaches to dispute avoidance and resolution.
  - Multilaterally coordinated risk assessment, informed by ongoing work by the Forum on Tax Administration e.g. the International Compliance Assurance Programme.
- **Administration**
  - Enforcement and collection arrangements will be considered, e.g. where the tax liability is assigned to an entity that is not a resident of the taxing jurisdiction.
  - Challenges in determining and reporting the location of sales will be considered, including: establishing the final destination of remote sales; sales through third

party intermediaries located in a third country; multi-sided business models where users/consumers are located in different jurisdictions; and the destination of services.
  - The use of simplified registration-based collection mechanisms together with enhanced exchange of information and cooperation mechanisms will be considered.
  - A withholding tax mechanism will also be explored as a complementary measure.
  - Any changes are expected to result in the need for new data, documentation and reporting obligations. Recommendations will be developed, including a system based on the existing framework and technology used for the exchange of country-by-country reports between countries.

- **Changing existing tax treaties**

The work will cover ways to coordinate and streamline the effective implementation of tax treaty changes e.g. through amending or supplementing the BEPS Multilateral Instrument or establishing a new multilateral convention.

Pillar Two: Global anti-base erosion proposal

A global anti-base erosion proposal ('**GloBE**') would enable countries to tax profits which are taxed at an effective rate below a '**minimum rate**' in the country which has the primary taxing right. This proposal consists of two interrelated elements:

Income inclusion rule

An income inclusion rule would tax the profits of a foreign controlled entity or branch if that profit was subject to a low effective tax rate:

- A shareholder with an ownership interest in a controlled company would be required to bring into account a proportionate share of the profit of that company. The rule would supplement existing controlled foreign company ('CFC') rules.
- A switch-over rule would turn off the benefit of exemption in the case of profits attributable to exempt foreign branches, or income derived from foreign immovable property.

The work programme will examine the use of a **fixed percentage tax rate** for the minimum rate. It is contemplated that the rule would operate as a **top up to the minimum rate of tax**, although low taxed profits benefiting from a harmful preferential regime could be taxed at the higher of the minimum rate or the full domestic rate.

The tax base would be determined by reference to the tax rules applicable in the shareholder jurisdiction. However, simplifications will be considered to address concerns around significant compliance costs and situations where technical or structural differences lead to an otherwise highly-taxed subsidiary being treated as having a low effective tax rate (e.g. the treatment of carry forward losses and timing differences). The use of financial accounting rules, with appropriate adjustments, will be considered as a basis for determining 'net income'.

Additional areas identified for further exploration include:

- Possible uses of carve-outs for: regimes compliant with the OECD BEPS standard on harmful tax practices (or other substance-based criteria); based on a return on tangible assets; or for controlled companies with related transactions below a threshold.
- Consideration of the effects of blending – i.e. the mixing of high-tax and low-tax profits to arrive at a blended rate that is above the minimum rate.
- Co-ordination with other international tax rules, including withholding taxes, transfer pricing, and CFC rules.
- Co-ordination between countries where, for example due to a tiered ownership structure, several countries may need to apply the income inclusion rule.
- Rules for ownership thresholds, the attribution of profits to shareholders, the calculation of tax paid on profits, and the calculation of the investor's tax liability.

Tax on base-eroding payments

The second proposed element sets out a tax on base-eroding payments:

- An **undertaxed payments rule** which would deny a deduction for a payment made to a related party unless those payments were subject to tax at a minimum effective rate of tax. The possible use of carve-outs such as those under consideration for the income inclusion rule will be considered, along with measures to address conduit and indirect payments; and
- A complementary **subject to tax rule** to be incorporated into double tax treaties. The rule would deny treaty reliefs otherwise available to undertaxed payments e.g. under the interest and royalty articles. Consideration will be given to the benefits of a withholding tax over a denial of deduction approach and extending the rule to payments between unrelated parties where risks are identified.

Other issues

The programme of work sets out the need to coordinate the various elements of the minimum tax proposals to minimise the risk of double taxation and consider simplification measures to reduce compliance costs.

Possible options for additional thresholds or carve-outs will be explored, including based on turnover or size; *de minimis* thresholds to exclude transactions or entities with small amounts of profits or related-party transactions; and for specific sectors or industries.

The compatibility of the rules with international obligations, in particular the European Union fundamental freedoms, will also be explored.

Next steps

The programme of work will be presented for approval by G20 Finance Ministers during their meeting of 8 and 9 June 2019 in Fukuoka, Japan. OECD Working Parties will meet throughout the remainder of 2019 to consider the relevant technical issues and a report on the progress of work is expected in December 2019. Consideration will be given to the holding of further public consultations to gather business feedback as the various proposals are refined.

A recommendation for a unified approach on nexus and profit allocation and the key design elements of the global minimum tax will be submitted to the BEPS Inclusive Framework for agreement at the beginning of 2020. Work will continue on agreeing the policy and technical details with a final report due by the end of 2020.

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