



OECD releases public consultation document on digital economy

Global Transfer Pricing Alert 2019-004

The Organisation for Economic Co-operation and Development (OECD) (now working as the expanded Inclusive Framework of 127 countries on Base Erosion and Profit Shifting (BEPS)) on 13 February 2019 released a public consultation document on the proposals around changing the international tax architecture that could potentially affect all cross-border businesses, not just those typically thought of as “digital businesses.”

Comments on the [public consultation document](#) are due 6 March 2019, and a public consultation will be held in Paris on March 13 and 14.

The public consultation document describes in more detail the same two-pillar approach that was foreshadowed with the release of a “policy note” by the Inclusive Framework on 29 January 2019.¹ In that policy note, and now in the public consultation document, Inclusive Framework members have agreed to examine proposals involving two “pillars” that could form the basis for consensus.

Pillar One: Nexus and Profit Allocation Issues

The first pillar addresses nexus and profit allocation issues focused on giving market jurisdictions greater rights to assert tax nexus and to be allocated a share of a multinational entity’s taxable income. The concepts to be discussed under the first pillar are:

- A user participation proposal;

¹ For a discussion of the policy note, see “OECD policy note has broad implications for US multinationals,” in *The Arm’s Length Standard*, Feb. 2019.

- A marketing intangibles proposal; and
- A significant economic presence proposal.

User Participation Proposal

The user participation proposal focuses on significant digital presence and income allocation based on users. Underlying it is the idea that value is created by certain highly digitalized businesses through developing an active user base and soliciting data and content contributions from those users.

The public consultation document describes the rationale behind this proposal as follows:

[The user participation] 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 digitalised businesses. The activities and participation of these users contribute to the creation of the brand, the generation of valuable data, and the development of a critical mass of users which helps to establish market power.²

This proposal contemplates that the source of value is most significant for social media platforms, search engines, and online marketplaces. The potential change in the rules under this proposal would be limited to business models that benefit from this type of user base. For businesses that have more traditional relationships with customers, however, the nexus and profit allocation rules would not change.

The mechanics of the user participation proposal would allocate profits regardless of whether a business had an actual physical presence in the user jurisdiction. Specifically, the public consultation document states:

The proposal would 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.³

The proposal dismisses the idea that the value created by user activities can be determined through the application of the arm's length principle. Instead, this proposal contemplates that the profit allocated to the user jurisdiction be calculated through a non-routine or residual profit split approach. Under such an approach, the profit attributed to the routine activities of the multinational group would continue to be determined in accordance with current rules. The only effect of the proposal would be to reallocate a portion of the non-routine profit of the business to the jurisdictions in which the users are located.

Marketing Intangibles Proposal

² "Addressing the Tax Challenges of the Digitalisation of the Economy" (Public Consultation Document), 13 February – 1 March 2019, ¶ 18.

³ *Id.* at ¶ 22.

The marketing intangibles proposal identifies valuable marketing intangibles (for all taxpayers) and assigns some or all of the return on those intangibles to the market jurisdictions. The public consultation document indicates that this proposal would apply to all businesses and not just digital businesses, saying:

Like the user participation proposal, [this proposal] would change the profit allocation and nexus rules. But unlike the user participation proposal, it would not be intended to apply only to a subset of highly digitalised businesses. Instead, it would have a wider scope in an effort to respond to the broader impact of the digitalisation on the economy.⁴

This proposal would modify current transfer pricing and treaty rules to require that marketing intangibles and risks associated with such intangibles be allocated to the market jurisdiction.

Under the proposal, the market jurisdiction would be entitled to tax some or all of the non-routine income associated with such intangibles and their attendant risks. All other income, however, would be allocated among members of the group based on existing transfer pricing principles.

The public consultation document describes the mechanics of this proposal as follows:

The proposal would modify current profit allocation and nexus rules to require that the non-routine or residual income of the MNE group attributable to marketing intangibles and their attendant risks be allocated to the market jurisdiction. All other income, such as income attributable to technology-related intangibles generated by research and development and income attributable to routine functions, including routine marketing and distribution functions, would continue to be allocated based on existing profit allocation principles.⁵

The proposal leaves open the possibility of allocating the non-routine income between marketing intangibles and other income-producing factors through different methods, one of which might be to apply normal transactional transfer pricing principles. Alternatively, the allocation could be done under a revised residual profit split analysis.

Significant Economic Presence Proposal

This proposal, which was discussed in the policy note, focuses on a permanent establishment in the case of a “significant economic presence.” This proposal has been further developed in the February 13 public consultation document to resemble a formulary apportionment approach.

⁴ *Id.* at ¶ 29.

⁵ Public consultation document at ¶ 43.

The rationale behind this proposal is described as follows:

This proposal is motivated by the view that the digitalisation of the economy and other technological advances have enabled business enterprises to be heavily involved in the economic life of a jurisdiction without a significant physical presence. According to this view, these technological advances have rendered the existing nexus and profit allocation rules ineffective.⁶

Under this proposal, taxable presence would arise on the basis of factors, and the allocation of profit to a "significant economic presence" could be based on a fractional apportionment method.

That approach is described in the public consultation document as follows:

The proposal contemplates that the allocation of profit to a significant economic presence could be based on a fractional apportionment method A fractional apportionment method would require the performance of three successive steps:

1. the definition of the tax base to be divided,
2. the determination of the allocation keys to divide that tax base, and
3. the weighting of these allocation keys.⁷

According to the public consultation document, the tax base could be determined by applying the global profit rate of the multinational group to the revenue (sales) generated in a particular jurisdiction. The document then states that the tax base would be apportioned by taking into account factors such as "sales, assets and employees."⁸

Finally, the significant economic presence proposal contemplates that, for businesses for which users contribute meaningfully to the value creation process, users would also be taken into account in apportioning income.

Administration Issues, Including Elimination of Double Taxation

The document recognizes the impact these proposals would have on the existing international tax architecture. It therefore emphasizes the need to incorporate strong dispute prevention and resolution mechanisms to eliminate double taxation.

In particular, the document states:

Because the new profit allocation proposals envisage a reallocation of the [multinational] group residual profits to user or market jurisdictions, some changes to existing treaty provisions to address the elimination of double

⁶ *Id.* at ¶ 50.

⁷ *Id.* at ¶ 52.

⁸ *Id.* at ¶ 53.

taxation seem necessary. Adjustments to the amount of profits allocated to MNE group members under the proposals should be designed so as to prevent double taxation among associated enterprises.⁹

The document states that dispute prevention and resolution mechanisms could range from assessment procedures drawing on the International Compliance Assurance Programme (ICAP) pilot, multilateral advance pricing agreements, and joint audit programs.

The public consultation document also proposes various data points that could be used in the administration of these proposals and discusses simplified collection mechanisms such as withholding taxes. In particular, the document states that primary data points could be derived from tax accounting or financial accounting data, but that additional data needs could potentially be added to “an already agreed filing and exchange of information mechanism such as that in place under BEPS Action 13 (country-by-country reporting).”¹⁰

Comparison of Public Consultation Document with Policy Note

Importantly, the policy note had indicated that “[i]n all cases, 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.”¹¹ This is confirmed in the public consultation document.

Questions for Public Comments

The public consultation document lists the questions for which comments are requested with respect to the first pillar:

1. What is your general view on those proposals? In answering this question, please consider the objectives, policy rationale, and economic and behavioral implications.
2. To what extent do you think that businesses are able, as a result of the digitalization of the economy, to have an active presence or participation in that jurisdiction that is not recognized by the current profit allocation and nexus rules? In answering this question, please consider:
 - i. To what types of businesses do you think this is applicable, and how might that assessment change over time?
 - ii. What are the merits of using a residual profit split method, a fractional apportionment method, or other method to allocate income in respect of such activities?
3. What would be the most important design considerations in developing new profit allocation and nexus rules consistent with the proposals

⁹ *Id.* at ¶ 80.

¹⁰ Public consultation document at ¶ 85.

¹¹ “Addressing the Tax Challenges of the Digitalisation of the Economy – Policy Note,” p. 2 (Jan. 23, 2019).

described above, including with respect to scope, thresholds, the treatment of losses, and the factors to be used in connection with profit allocation methods?

4. What could be the best approaches to reduce complexity, ensure early tax certainty, and to avoid or resolve multijurisdictional disputes?

Pillar Two: Income Inclusion Rule and Tax on Base-eroding Payments

The second pillar addresses the continued risk of profit shifting to entities subject to no or very low taxation through the development of two interrelated rules -- an income inclusion rule (similar to the US GILTI regime under IRC §951A, although done on a country-by-country basis) and a tax on base-eroding payments in the event the country to which the payments are made does not enact its own income inclusion rule.

Income Inclusion Rule

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 if that income was not subject to tax at a minimum rate. The rule would apply to any shareholder with a significant (for example, 25 percent) 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 (CFC) rules. Exempt foreign branches would be subject to this regime as well.

Tax on base-eroding payments

This proposal is designed to complement the income inclusion rule by allowing a source jurisdiction to tax what it considers to be base-eroding payments. This element of the proposal would involve:

- 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 grant certain treaty benefits only if the item of income is sufficiently taxed in the other state.

Questions for Public Comment

The public discussion document lists the following questions for which comments are requested with respect to the second pillar:

1. What is your general view of this proposal? In answering this question, please consider the objectives, policy rationales, and economic and behavioral implications of the proposal.
2. What would be the most important design considerations in developing an inclusion rule and a tax on base-eroding payments? In your response, please comment separately on the undertaxed payments and subject-to-tax proposals and also cover practical, administrative, and compliance issues.
3. What, if any, scope limitations should be considered in connection with the proposal set out above?
4. How would you suggest that the rules should best be coordinated?
5. What could be the best approaches to reduce complexity, ensure early tax certainty and to avoid or resolve multijurisdictional disputes?

Conclusion

The work of the Inclusive Framework regarding the digitalization of the economy will likely affect all businesses with cross-border operations, will require a great degree of technical attention, and is moving very quickly. As a result, companies may wish not only to follow the technical work closely but also to consider providing comments by March 1, 2019, or engaging with broader business groups that are doing so.

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