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G20/OECD: Tax challenges of the digitalization of the economy update

The Dbriefs International Tax series

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16 April 2019

Agenda

- Background
- Asia Pacific round up
- 2019 OECD public consultation document
- Revised profit allocation and nexus rules
  - Proposal 1: user participation
  - Proposal 2: marketing intangibles
  - Proposal 3: significant economic presence
- Global anti-base erosion proposal
  - Income inclusion rule
  - Tax on base eroding payments
- What might the future look like?
- Questions and answers

Background

Background
2015-2018

BEPS Action 1: 2015 final report

- "Addressing the tax challenges of the digital economy"
  - Final BEPS report issued in **October 2015**
  - Few specific direct tax recommendations: VAT/GST recommendations

G20 finance ministers and leaders

- In **2017**, renewed mandate for the OECD, through the inclusive framework, to examine implications of digitalization of taxation
- Timetable set for an interim report in 2018, and a final report in 2020

2018 OECD interim report

- "Tax challenges arising from digitalization"
  - Released on **March 2018**
  - Further work on "nexus" and "profit allocation"
  - OECD don't recommend specific interim measures but set design principles

Background

OECD interim report – March 2018

- **Three characteristics** are frequently observed in highly digitalized businesses

1
Scale without mass

2
Reliance on intangible assets

3
Data and user participation, including network effects

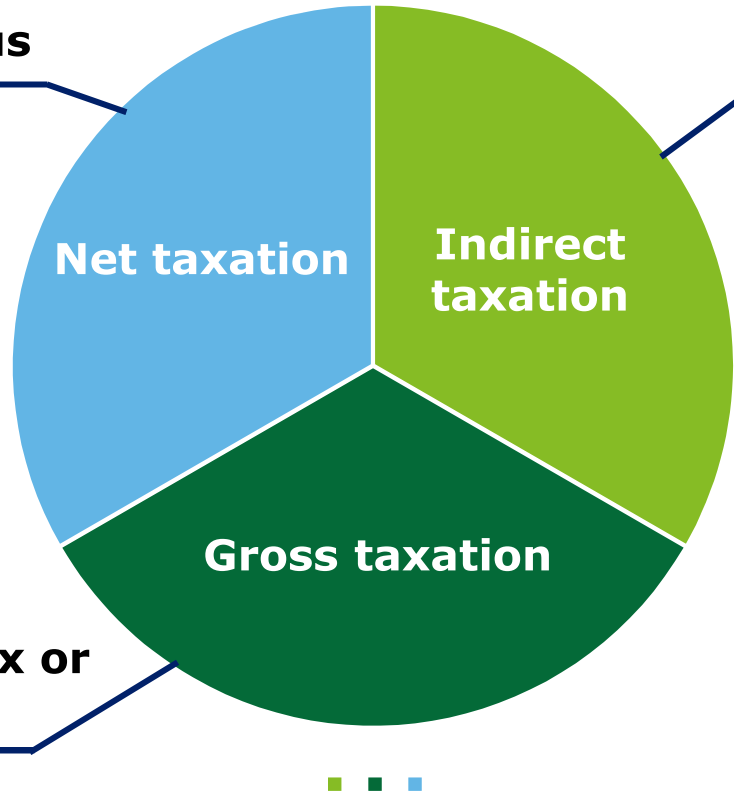
- **Long term adaptation of system**
  - Realign income with **value creation**
  - Common interest in maintaining a single set of relevant and coherent international tax rules
  - How taxing rights are allocated between jurisdictions – **"nexus"**
  - How profits (and losses) are allocated to different activities carried out by multinational enterprises – **"profit allocation"**

Asia Pacific round up

Three areas of activity

Expansion of nexus

- Australia: MAAL
- New Zealand
- India: SEP
- Indonesia: PE
- Taiwan: source
- South Korea?



Indirect tax

- Action 1, 2015
- Most countries: either in place or will commence
- VAT, GST, Services tax, consumption tax: rules are not consistent
- System and compliance challenges

Digital services tax or similar

- Australia: no
- New Zealand: to be confirmed
- India: equalization levy

Indian response

- **India – nexus**: Significant Economic Presence (SEP) test introduced into domestic law (i.e., subject to tax treaties). SEP means
  - Any transaction regarding goods, services or property carried out by a non-resident in India (including provision of download of data or software in India) if the aggregate payments from these transactions exceeds a prescribed amount; or
  - Systematic and continuous soliciting of business activities or engaging in interaction through digital means with a prescribed number of users
  - Rules to operationalize the provisions yet to be notified
  - Will be the base for negotiating treaties
  - “Economic” versus “digital”
  - User/activity based norms expected
  - Rationalization with other measures

Indian response (Cont'd)

- **India – equalization levy**: 6% charge to be withheld from gross consideration payable to a non-resident service provider, with no PE in India. The levy is not a tax on income under Indian legislation so it cannot be encompassed under India's tax treaties
- Currently only applies to B2B online advertisement services. However, the legislation delegates to the government, the ability to extend this to other digital services in future
- Burden of tax can be shifted
- Tax chargeable on the non-resident but to be collected by payer
  - No compliance requirement for non-resident payee
- Estimates of collection
  - US$52M (2016-17)
  - US$90M (2017-18)

A fork in the road

Unilateral responses (gross taxation)

- Tax imposed on gross income: digital service tax
- Uncoordinated
- Risk of multiple tax without relief

OECD multilateral approach (net taxation)

- Consensus based solution
- Novel but familiar

2019 OECD public consultation document

Public consultation document
Overview

- On 13 February 2019, the OECD released a public consultation document **addressing the tax challenges of the digitalization of the economy**
- The document sets out **two types of proposals**

Revision of the existing profit allocation and nexus rules	A global anti-base erosion proposal

The work on these proposals is being conducted on a "**without prejudice"** basis to allow for necessary further work without commitment to a particular course of action

A number of the proposals would extend to the taxation of **all multinational businesses** - not just those that are highly digitalized

Public consultation document
Overview

Proposals would lead to solutions that go **beyond the arm's length** principle

Proposals may reach into fundamental aspects of the current **international tax architecture**

Beyond the limitations on taxing rights determined by reference to a **physical presence**

Revised profit allocation and nexus rules

Three proposals

Revised profit allocation and nexus rules

Overview

- **Three alternative proposals** to expand the taxing rights of user/market jurisdictions by revising existing **profit allocation** and **nexus** rules

1

User participation

2

Marketing intangibles

3

Significant economic presence

The "user participation" proposal

Targeted at highly digitalized businesses

Focuses on digitalized businesses where a significant source of **value** is **derived** from **user participation and engagement**

Users contribute to

- Creation of the **brand**
- Generation of valuable **data**
- **Market power** through development of a critical mass

Social media platforms

Search engines

Online marketplaces

The "user participation" proposal

Mechanics

Profits allocated to the jurisdiction where **active and participatory user bases are located**, irrespective of physical presence

Non-routine or residual profit split approach proposed

1. Calculate the **residual** or **non-routine** profits of a business
2. Attribute a proportion of those profits to the value created by activities of users
3. Allocate those profits between jurisdictions, using an agreed metric
4. Give jurisdictions the right to tax that profit irrespective of current taxable presence

- How to calculate the non routine profit?
- Pragmatic approach
- Combined with a strong dispute resolution component

The "marketing intangibles" proposal

Potentially applies to all businesses

The digitalization of the economy is considered to have increased the opportunity for multinational businesses to "reach into" a jurisdiction with a **limited local presence** to **develop a user/customer base** and other marketing intangibles

- This proposal would apply to **all businesses equally** whether digitalized or not, e.g.,

(a)

Digitalized Businesses with **no taxable presence**

(b)

Digitalized businesses which operate as a **limited risk distributor**

(c)

Consumer product businesses which operate **remotely** or as **limited risk distributor**

- There is considered to be an intrinsic link between **marketing intangibles** and the **market jurisdiction**
  - OECD Transfer Pricing guidelines: "depending on the context, marketing intangibles may include, for example, 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 “marketing intangibles” proposal
Mechanics

Modify current profit allocation and nexus rules to attribute all (or a portion) of the non-routine or residual profit which is **attributable to marketing intangibles** and **allocate it to the market jurisdiction**

- The special allocation to a market jurisdiction would apply regardless of existing transfer pricing rules e.g., location of development, enhancement, maintenance, protection, and exploitation functions, control, and management of risks or legal title

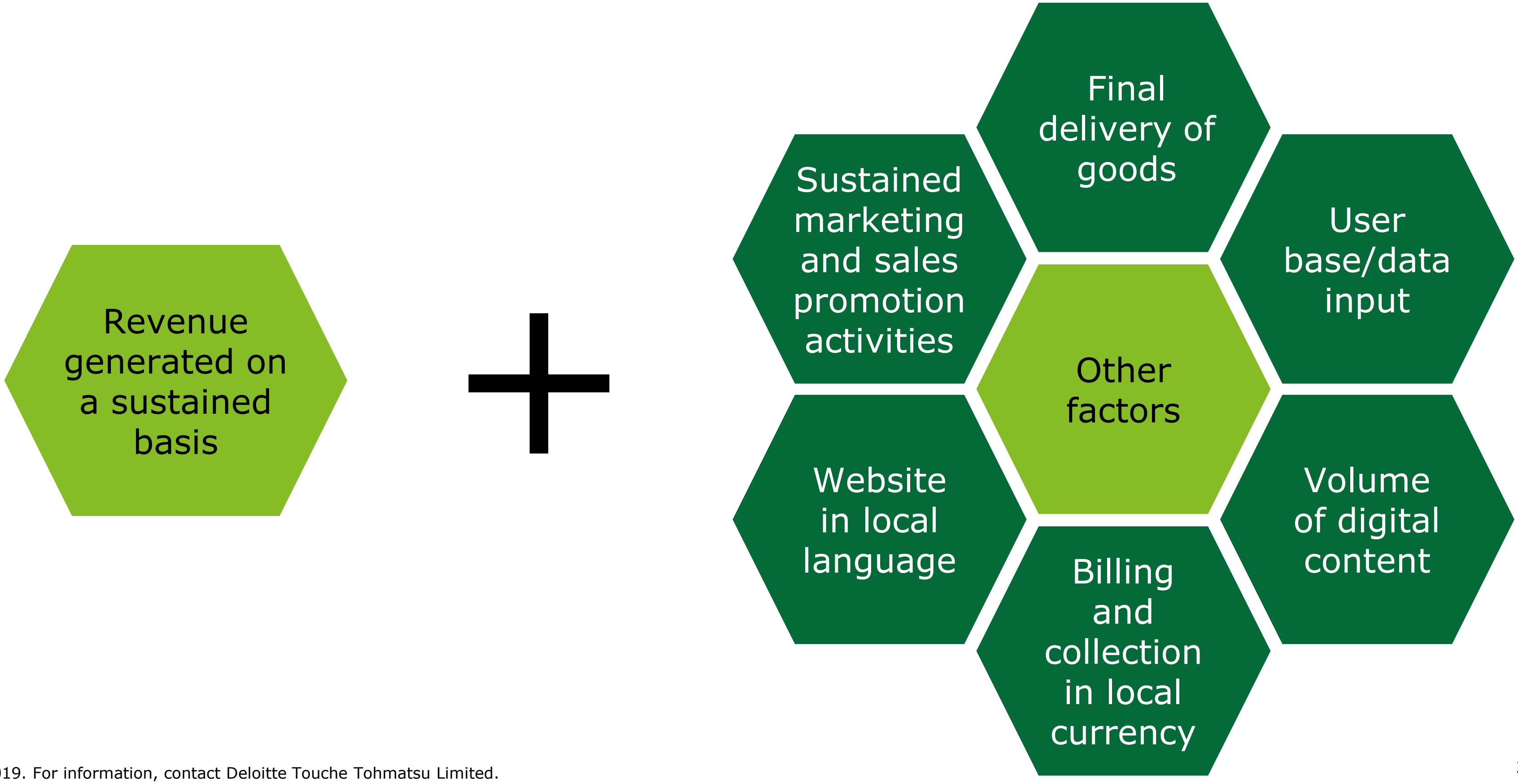
Steps

1. Calculate the non-routine or residual profits generated from marketing intangibles through
   - Transactional transfer pricing principles
   - A revised profit split analysis, potentially using mechanical approaches
2. Allocate attributable profit across market jurisdictions, based on an agreed metric (such as sales or revenue)
   - For advertising, based on customers **targeted**

The "significant economic presence" proposal

Potentially applies to all businesses

Significant economic presence would arise where there is a **purposeful and sustained interaction** with the country through **digital technology**



The "significant economic presence" proposal
Mechanics

- Allocation could be based on a **fractional apportionment method**

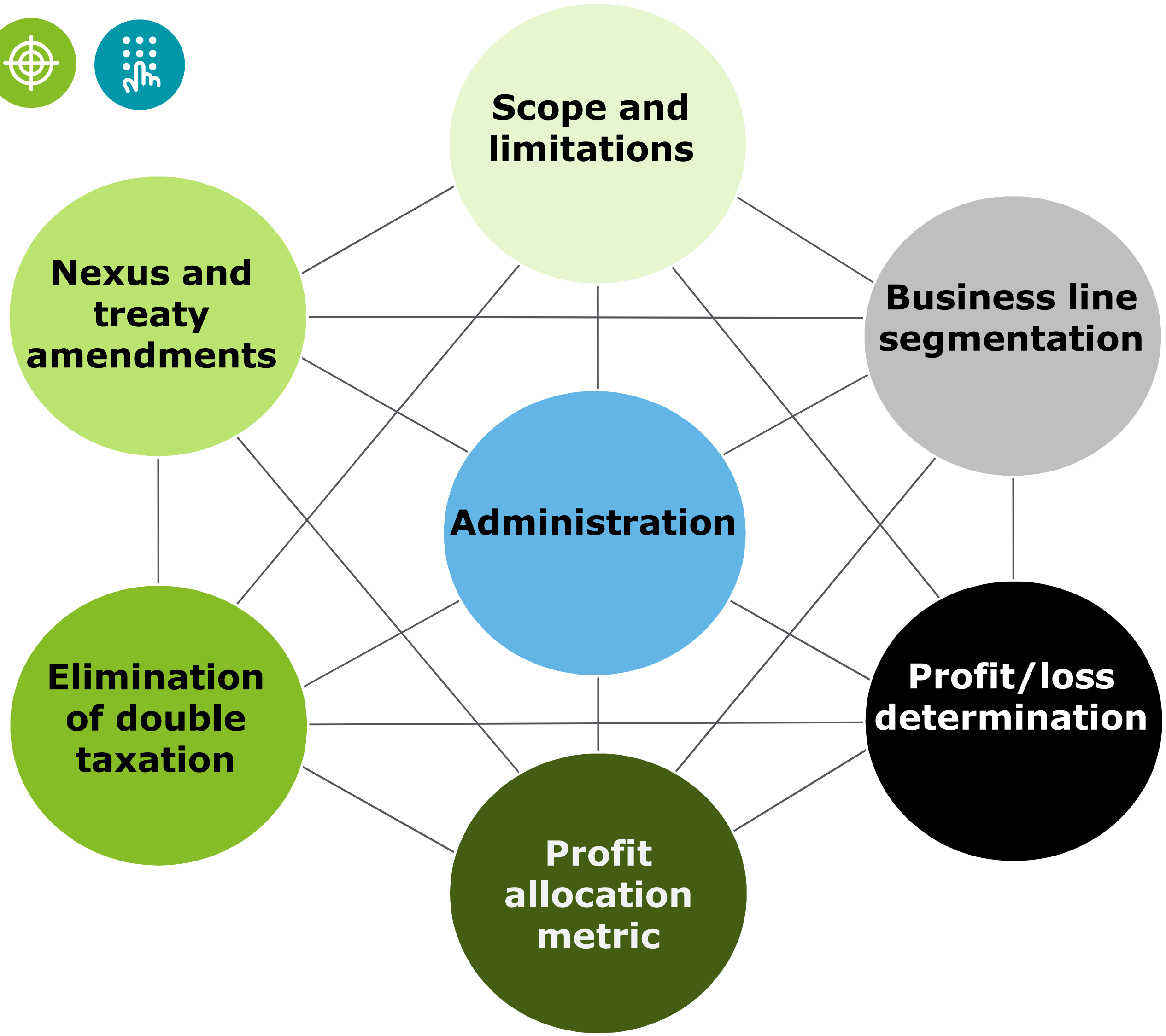
Steps

1) Define the tax base
2) Determine the allocation keys to divide that tax base
3) Weight the allocation keys

- Potential keys include **sales**, **assets**, and **employees**
- Consideration given to the use of a **withholding tax** as a collection mechanism

Revised profit allocation and nexus rules

Potential design considerations



- Policy trade off between precision and certainty
- Consideration of different levels of development and capacities of tax administrations
- Level playing field between large and small jurisdictions
- Effect on revenue and taxpayer behaviours

Revised profit allocation and nexus rules
Summary

- **Three alternative proposals** to expand the taxing rights of user/market jurisdictions by revising existing **profit allocation** and **nexus** rules

1

User participation

2

Marketing intangibles

3

Significant economic presence

Global anti-base erosion proposal

Global anti-base erosion proposal
Global minimum tax

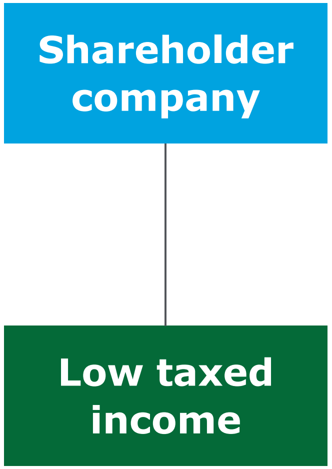
- Rules to permit countries to tax profits where income is subject to **no or very low taxation**
- This is **not** limited to highly digitalized businesses
- The proposal has **two inter-related elements**

Income inclusion rule

Tax on base-eroding payments

Global anti-base erosion proposal
Income inclusion rule

- Requires a **shareholder** to bring income into account if not subject to tax at **a minimum rate**
- This rule would **supplement** rather than replace **CFC rules**
- Significant direct or indirect ownership interest (25% suggested)
- **Switch-over rule** for exempt branches
- Tax and tax credits calculated on **jurisdiction-by-jurisdiction** basis



Future work

- Determine minimum tax rate
- Accessibility of information for minority shareholder
- Effective tax rate test
- Thresholds and safeguards
- Mechanisms to avoid double taxation
- Compatibility with international obligations, e.g., EU law

Global anti-base erosion proposal
Tax on base eroding payments

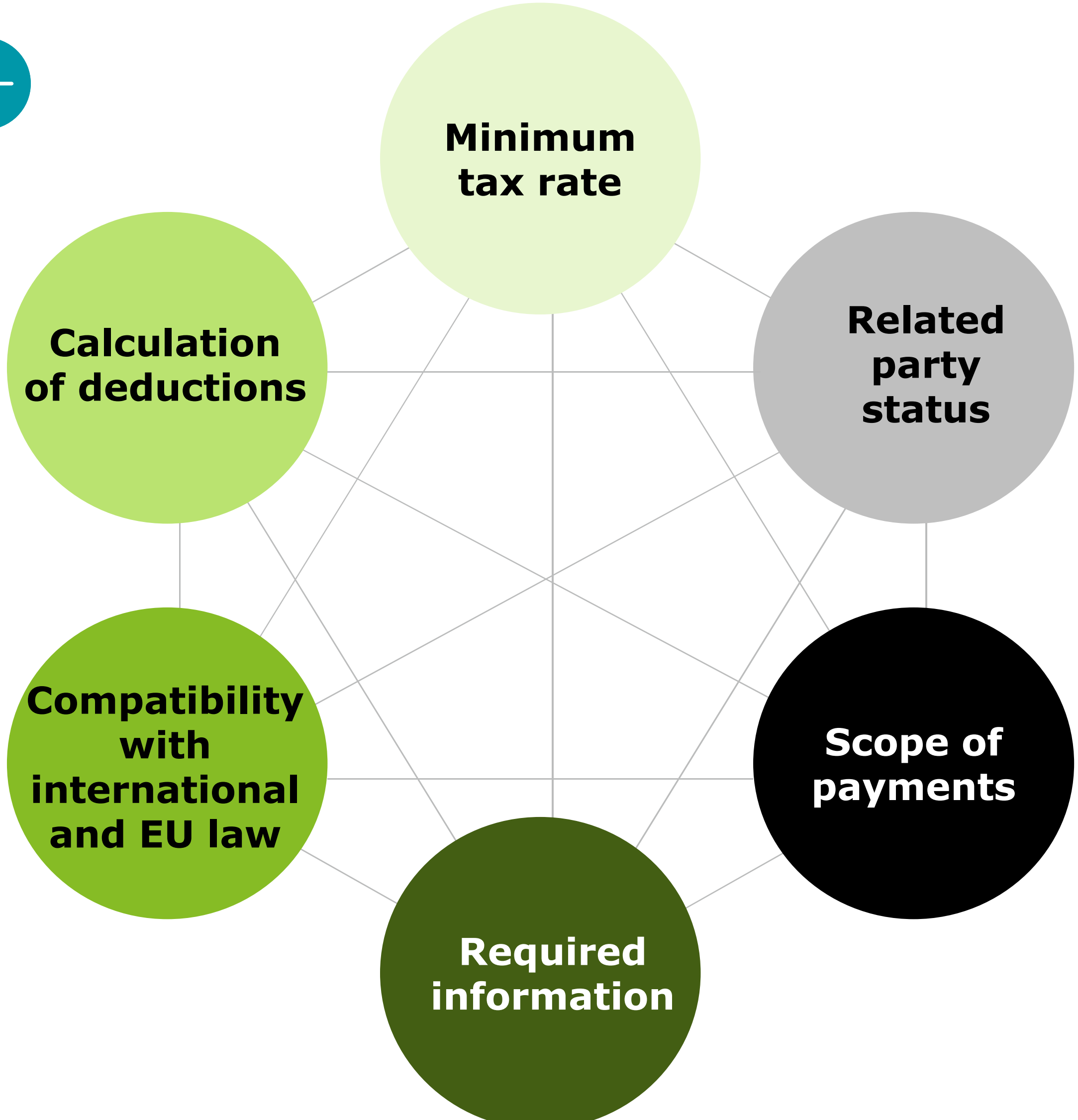
Undertaxed payments rule

- Denies a deduction for payments to a related party, that are not subject to a minimum tax rate
- 25% related party test proposed
- Broad scope proposed, including “conduit” and “imported” arrangements

Subject to tax rule

- Denies **treaty reliefs** to undertaxed payments (e.g., interest and royalty articles)
- Could be limited to related party payments, or broader scope for payments of interest, royalties, and for capital gains

Global anti-base erosion proposal
Potential design considerations



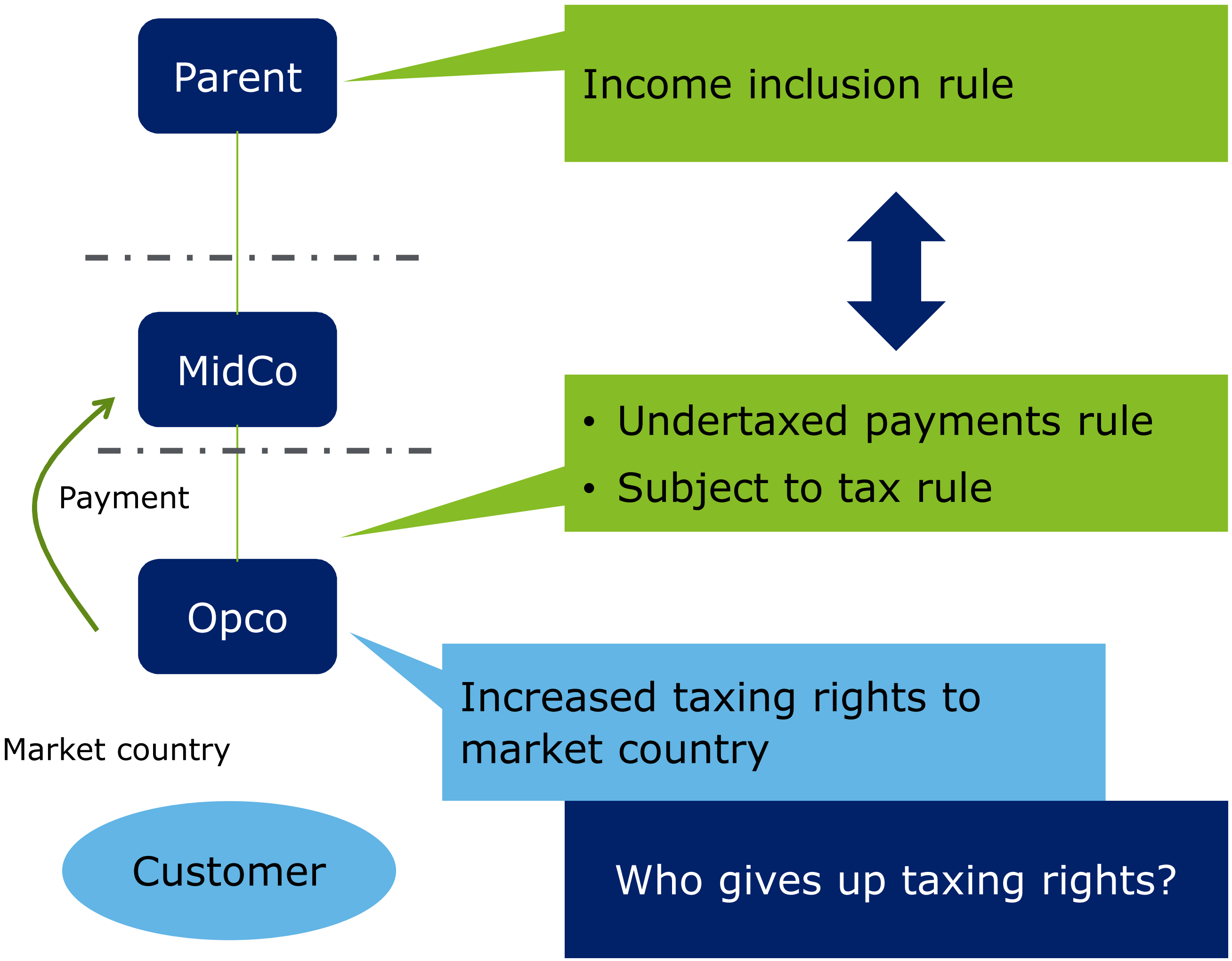
Co-ordination rule

The role of substance

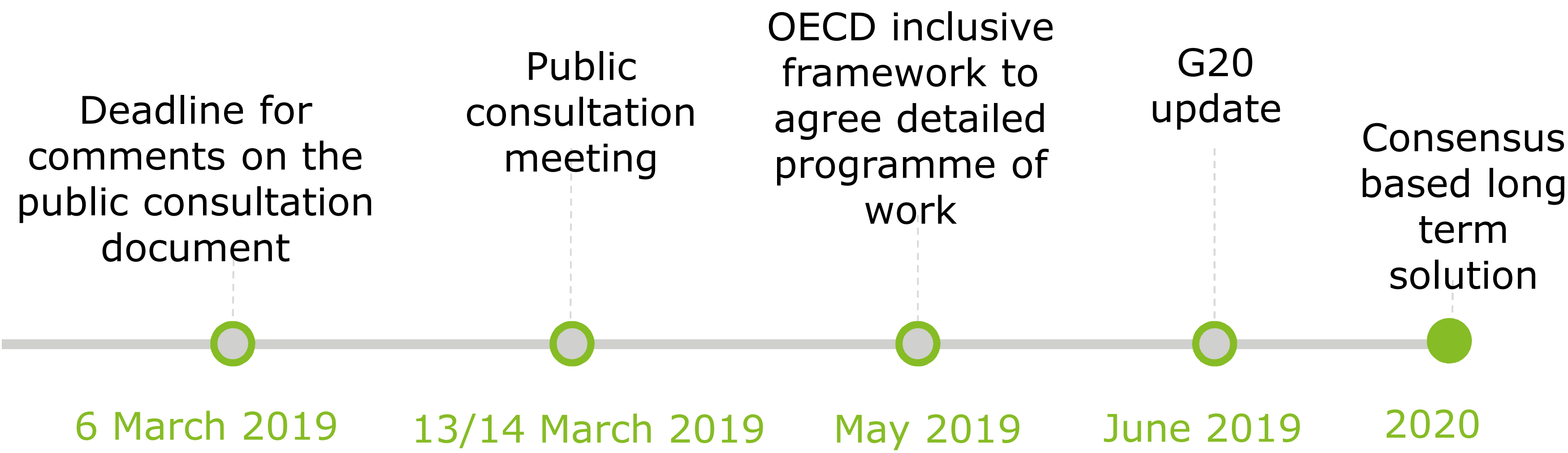
What might the future look like?

Key dates

The end result?



Timeline and next steps



- Changes to double tax treaties
- Changes to the OECD Transfer Pricing guidelines
- Changes to OECD guidance on the attribution of profits to a permanent establishment
- Changes to domestic law

Questions and answers

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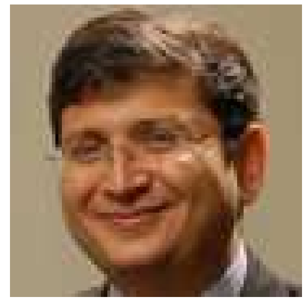

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