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Dbriefs

G20/OECD: Tax challenges of the digitalized economy - an update

Dbriefs Special Edition – International Tax

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Agenda

- Work to date
- OECD secretariat's unified approach proposal (pillar 1)
  - Scope
  - New nexus
  - New profit allocation rules and the three tier mechanism
  - Examples
- Impact assessment
- Next steps
- Questions and answers

Work to date

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2015-2019

- **BEPS action 1: 2015 final report** – October 2015
- **2018 OECD interim report** – March 2018
- **OECD policy note** – January 2019
  – Sets out the two pillar approach
- **Public consultation document** – February 2019
  – Comments sought on policy issues and technical aspects
  – Followed by **public consultation meeting** – March 2019
- **Programme of work** – May 2019
  – Roadmap towards agreeing consensus solution by the end of 2020
- **OECD secretariat proposal** – 9 October 2019
  – Unified approach: nexus and profit allocation rules
- **OECD secretary general report to G20**

New nexus and profit allocation rules

Unified approach proposal

New nexus and profit allocation rules

OECD secretary-general report to G20 Finance Ministers – October 2019

"…the current rules do not fit the **growing challenges** of the **digitalization of the economy**…"

"…it is essential to move forward now to construct **the architecture of a global long-term solution** through the G20/OECD Inclusive Framework"

"…providing more **certainty and stability** in the international tax system for all countries and jurisdictions in the world"

"…a proposal aimed at **facilitating consensus on common rules** on nexus and profit allocation…"

New nexus and profit allocation rules

- The unified approach proposal draws on the commonalities identified in the May programme of work

Reallocating taxing rights in favour of the **user/market country**

Envisaging a **new nexus** rule **not dependent on physical presence** in the user/market country

Going **beyond the arm's length principle** and **departing from the separate entity principle**

Searching for **simplicity**, **stabilisation** of the tax system, and **increased tax certainty** in implementation

The proposal does not, at this stage, have consensus political support from the G20/OECD inclusive framework on BEPS.

New nexus and profit allocation rules

Key features of OECD secretariat's proposed unified approach

- **Scope of new taxing right**
  - Large consumer-facing businesses
- **New nexus rules**
  - Not dependent on physical presence
- **New profit allocation rules**
  - Calculated using a three-tier mechanism
- **Robust dispute prevention and resolution**
  - Including binding arbitration

Scope and new nexus

New taxing right

New nexus and profit allocation rules

Scope

Approach covers highly digital business models but goes **wider**...

...broadly focussing on **consumer-facing businesses**

"Businesses that generate revenue from supplying consumer products or providing digital services that have a consumer-facing element."

Possible revenue threshold?

€750 million revenue

Possible exclusions

Extractives commodities financial services

New nexus and profit allocation rules

New nexus in a market country

1. Applicable where a business has **sustained and significant involvement in the economy** of a market country...

2. ...irrespective of level of **physical presence** in the country

3. Largely based on **sales**

4. Possible **country-specific sales thresholds** for smaller economies

5. Captures **all forms of remote involvement** in the economy of a market country e.g., remote selling, and groups that sell in a market through a distributor

6. **Self-standing treaty provision** in addition to existing permanent establishment and business profit articles

New profit allocation rules

Three tier mechanism

Three tier mechanism

Profit allocation – beyond the arm's length principle

New taxing right

Amount A

- **New taxing right**
  - Allocates a **portion of deemed residual profit** to market jurisdictions using a **formulaic** approach

Modification of existing allocation

Amount B

- **Fixed "baseline" return** for marketing and distribution functions

Amount C

- **Additional return** based on transfer pricing analysis and subject to binding arbitration

Three tier mechanism – Amount A

New taxing right

1. **Determine the total profit of the group**
   - Possible use of consolidated financial statements
   - Consideration is being given to the use of business line and/or regional segmentation

2. **Determine residual profit** by excluding deemed routine profit
   - Fixed percentages
   - Possible variation by industry

3. **Allocate a proportion of deemed residual profit attributable to market countries**
   - Fixed percentages
   - Possible variation by industry

4. **Allocate profits between market countries** using allocation keys

Three tier mechanism – Amount B

Fixed return for baseline marketing and distribution functions

Establish a fixed return for "baseline" or routine marketing and distribution activities

- Intention of OECD secretariat to

Reduce disputes

Increase certainty

Three tier mechanism – Amount C

Additional return based on arm's length transfer pricing

Provides businesses and tax authorities with the ability to **recognise profit in excess** of the return calculated under Amount B

where

the marketing and distribution activities taking place in the market country go **beyond the baseline level of functionality**

or

the group or company perform **other business activities** in the country unrelated to marketing and distribution

Any additional profit must be supported by the arm's length principle

Ensure profits are not duplicated in market country

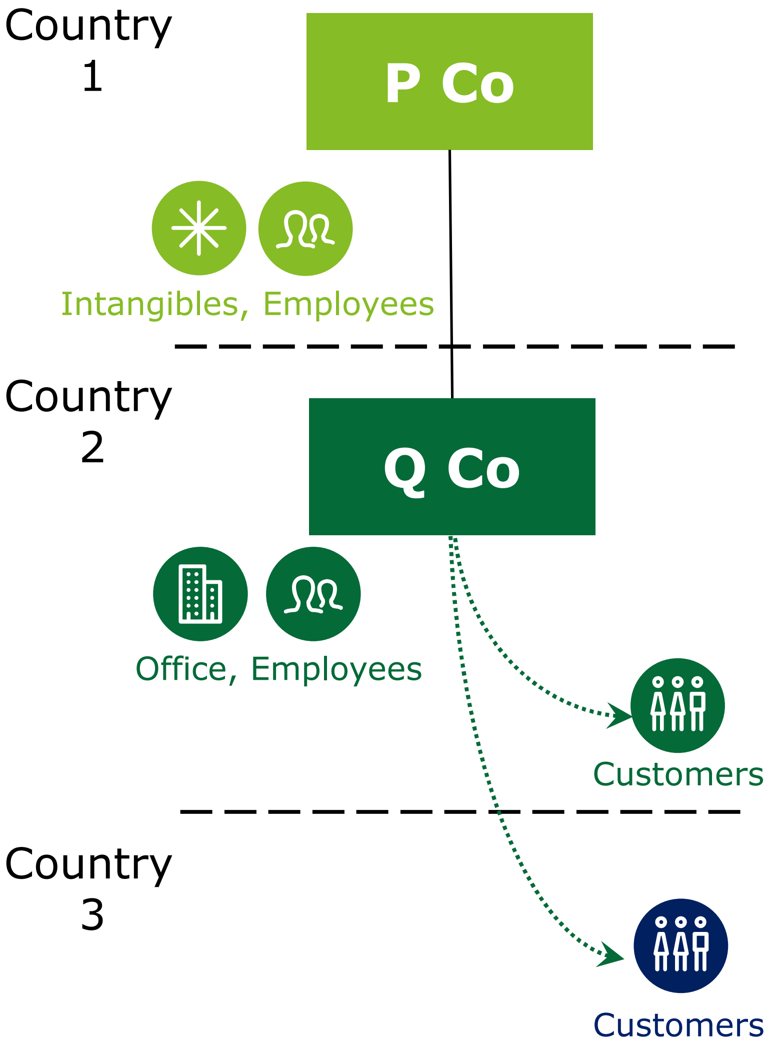
Prevent double taxation

Robust measures to resolve disputes, including binding arbitration

Examples

OECD example

Group provides a streaming service



- **P Co**
  - Owns all intangibles
  - Currently entitled to all non-routine profit

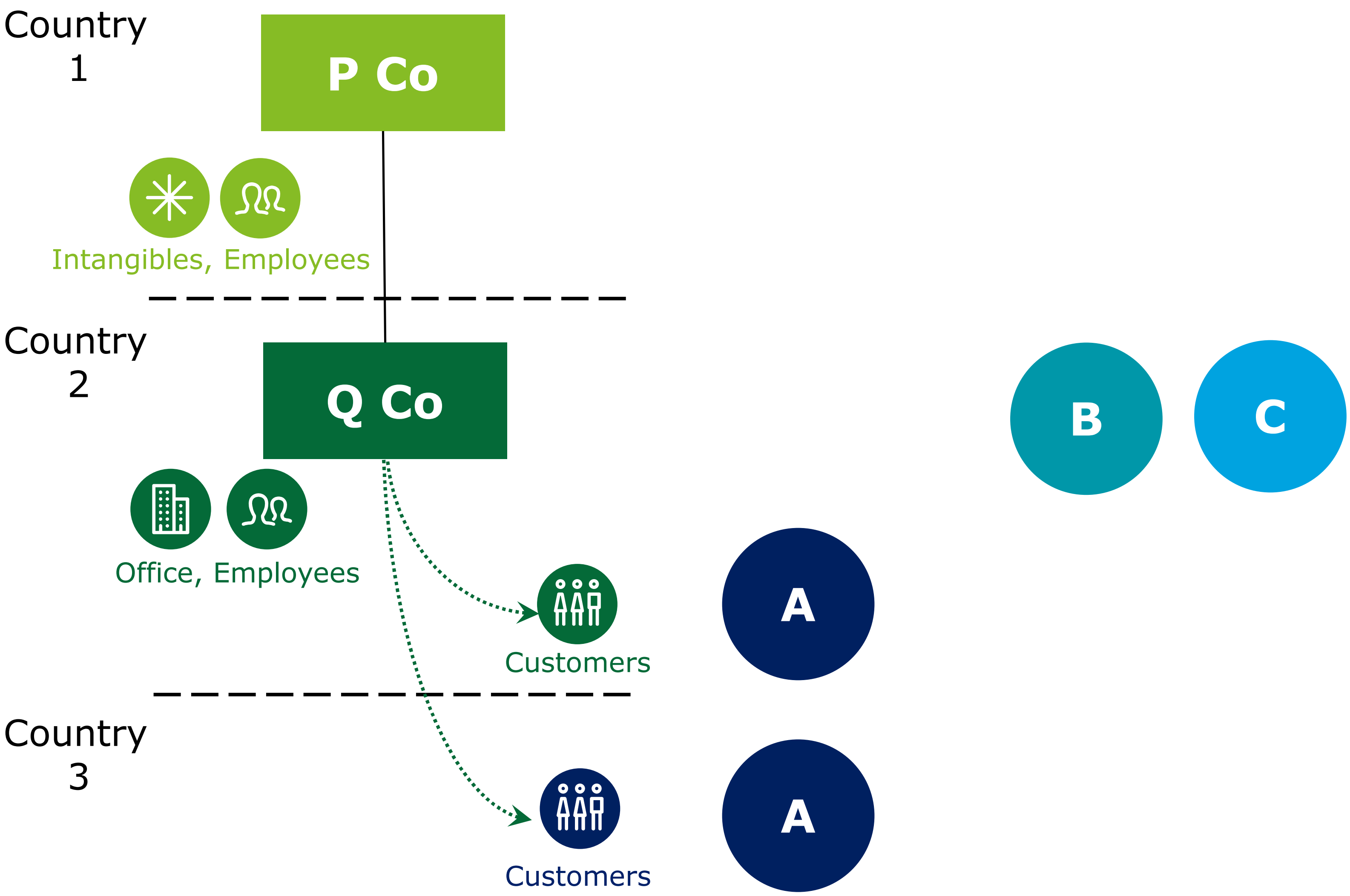
- **Q Co**
  - Performs marketing and distribution activities
  - Sells streaming services to country 2 customers

- **Q Co**
  - Also sells streaming services to country 3 customers
  - No physical presence in country 3

Source: OECD Public Consultation Document

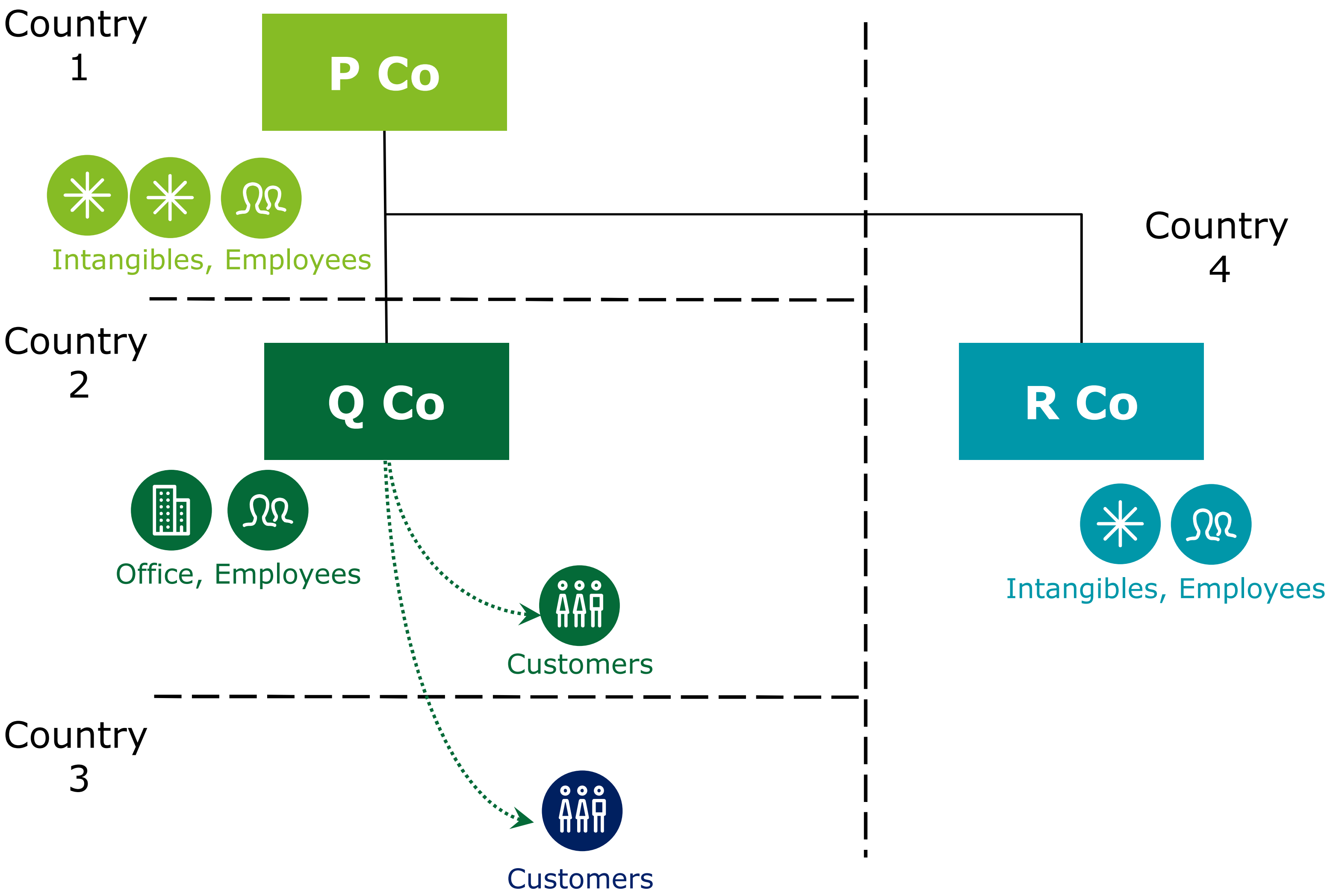
OECD example

Group provides a streaming service (Cont'd)



Source: OECD Public Consultation Document

Example 2
Intangibles located in multiple locations



Impact assessment

Pillar 1 and pillar 2

Impact assessments – preliminary findings

OECD secretary-general's report to G20 finance ministers

Final outcomes "will depend on the **reform design** and the **behavioural responses** of countries and multinational enterprises"

"Pillar 1 involves a significant change to the way taxing rights are **allocated** among jurisdictions but it would also lead to a **modest increase** in tax revenues"

"**Low and middle-income** economies would gain from pillar 1"

"**Investment hubs,** where the analysis suggests that levels of residual profit are high**,** would experience **significant losses in tax base**"

"**Larger market jurisdictions** will benefit more in absolute"

Next steps

Global anti-base erosion proposal
Minimum tax (pillar 2)

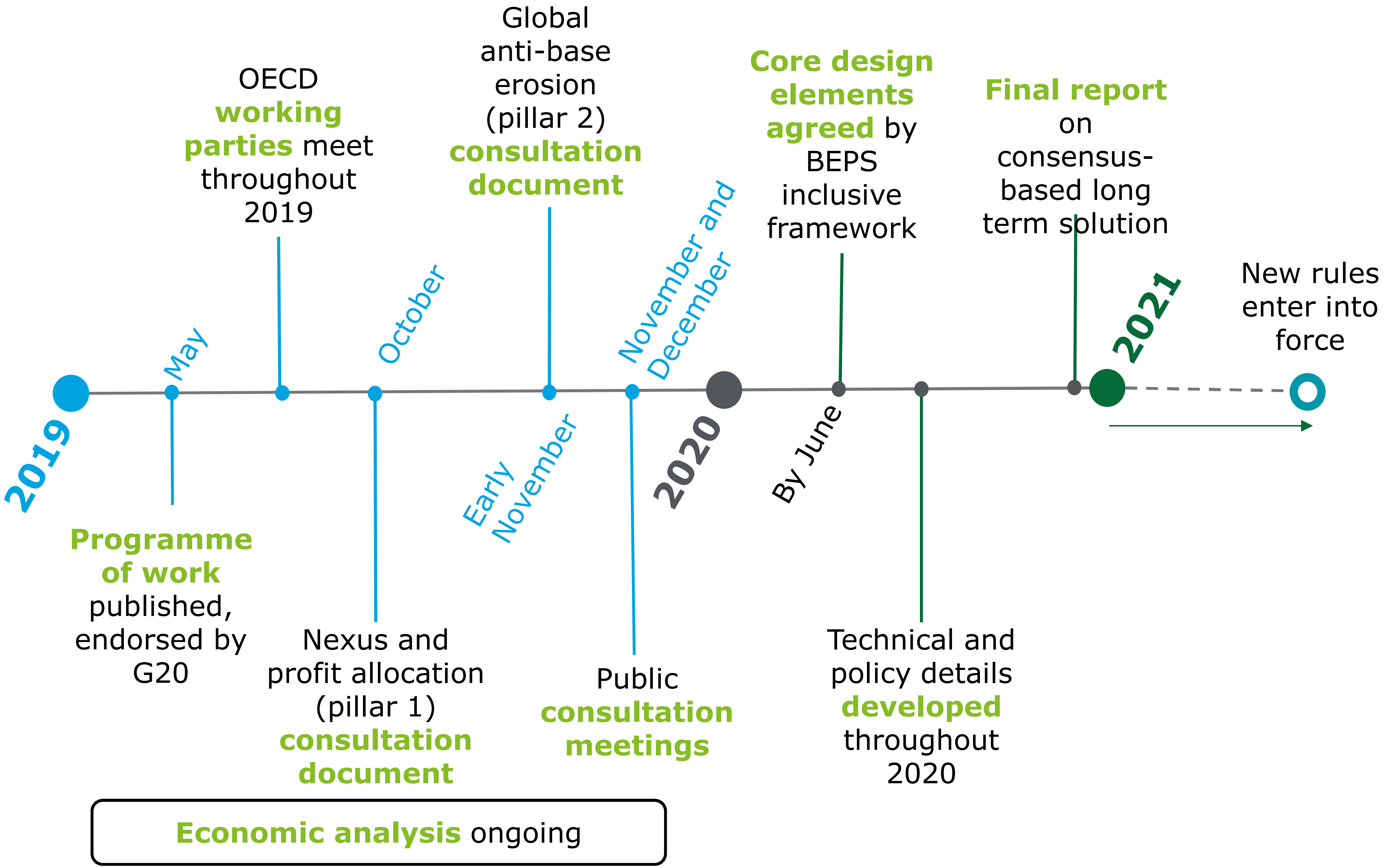
- Rules to permit countries to tax profits where income is subject to **no or very low taxation**
- **Two inter-related elements**

Income inclusion rule

Tax on base-eroding payments

- Public consultation document expected early November
- Public consultation meeting to follow

Timeline


2019
May
Programme of work published, endorsed by G20
OECD working parties meet throughout 2019
October
Nexus and profit allocation (pillar 1) consultation document
Global anti-base erosion (pillar 2) consultation document
Early November
November and December
Public consultation meetings
2020
Core design elements agreed by BEPS inclusive framework
By June
Technical and policy details developed throughout 2020
Final report on consensus-based long term solution
2021
New rules enter into force
Economic analysis ongoing

Questions and answers

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