Base Erosion and Profit Shifting (BEPS): CIOT responds to recent OECD work

International Tax

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The CIOT has submitted comments to the OECD in response to its recent Discussion Draft on BEPS Action 7 – Additional Guidance on Attribution of Profits to Permanent Establishments (PEs) and Request for Input on Work regarding the Tax Challenges of the Digitalised Economy.

BEPS Action 7 – Attribution of Profits to PEs

The OECD's Discussion Draft on Additional Guidance on Attribution of Profits to PEs largely adopts the approach of setting the high-level general principles in relation to the attribution of profits to PEs resulting from changes to the model double tax treaty article 5. There are some helpful points made in the Discussion Draft (including, for example, the acknowledgement that double taxation should be avoided).

However, in our response we said that more detailed guidance than that currently drafted would better assist taxpayers and tax authorities. In particular taxpayers brought within the rules as a result of the changes, which lower the PE threshold, may potentially have many more PEs than previously, and may have little previous experience in applying profit attribution principles in practice. Therefore, we encouraged the OECD to develop this guidance further. By their very nature high-level principles can often be interpreted in a number of different ways and we suggested that further, more detailed guidance may be necessary to ensure a more certain and consistent approach to profit attribution.
We also said that we would like to see the OECD explicitly support adoption of the Authorised OECD Approach to attribution of profits. We think that doing so would

result in more certainty and consistency. The aim should be for a consistent approach by as many tax authorities as possible and, in our view, this would be better achieved if there is support for a single approach.

We reiterated that the threshold issues associated with the OECD's final report on BEPS Action 7 remain a concern of businesses as a result of the potential compliance burden and the risk of double taxation. In additional where a company has multiple PEs in different countries resolution of disputes will be complex. We suggested that the OECD should monitor the position as this develops.

The OECD has recognised (in its final report on BEPS Action 7) the administrative burden that may arise even in circumstances where no profits are attributable to a PE. The Discussion Draft (at paragraph 19) also recognises that the 'profits attributable to the PE may be either positive, nil or negative (that is a loss)'. Thus, in recognition of the considerable administrative burden (with potentially no added benefit to tax authorities or taxpayers) we suggested that the OECD goes further in encouraging countries to introduce domestic legislation that would reduce the administrative burden; for example, by the OECD developing a best practice in this area.

Our full response can be found on the CIOT website.

BEPS Action 1 – Tax Challenges of the Digitalised Economy

In our response to the OECD's Request for Input on Work regarding the Tax Challenges of the Digitalised Economy we agreed with the OECD's conclusion in the 2015 report, reiterated in the Request for Input, that it would be very difficult, if not impossible, to ring fence the digital economy and identify digital businesses to which any new rules should apply because of the pervasive nature of digitalisation within the majority of businesses.

We noted that digitalisation does not produce unique BEPS issues and that many BEPS Actions (particularly Actions 3, 6, 7 and 8–10) are likely to substantially address the BEPS issues exacerbated by digitalisation.

We said that is important to define why further work on the challenges of the digitalised economy is required. The BEPS project as a whole was driven by a

concern that substantial profits made by multinational enterprises (MNEs) were not taxed in any jurisdiction, or were taxed at artificially low rates. The various BEPS recommendations made in the final reports in 2015 were intended to resolve such issues.

Is further work considered necessary because the BEPS proposals are thought to be inadequate? Or is it the case that the BEPS proposals are expected to lead to MNE profits being taxed, but the complexity and, indeed, novelty in some cases, of the value chains of digital businesses, mean that further work is required to ensure that the allocation of taxation between jurisdictions is fair and reasonable?

We said that defining which of these is the primary aim of further work is critical to arriving at the right solutions. In particular, we said that BEPS Actions, such as Actions 3, 6, 7 and 8-10, need to be given time to take effect, so that a clearer picture emerges of any remaining issues that need to be addressed.

We can only see merit in further work on the digitalised economy which considers how profits are allocated between jurisdictions. The application of the existing arms-length principle to a digitalised economy and whether this is appropriate is worth further consideration, as is whether existing principles properly measure the value chains of digitalised business. But the CIOT would like to see a long term global solution to these questions and the challenges should not be underestimated. Time should be taken to investigate and consider the difficult and complex decisions that may have to be taken in this area.

In our view two of the proposals in the Request for Input – withholding taxes and an equalisation levy – are short term fixes that would lead to a complexity and double taxation, and are likely have a negative influence on further innovation. The third, (Tax nexus concept of '*significant economic presence*') whilst having greater theoretical merit, has significant practical challenges around the attribution of profits. We said that progress towards a longer term solution is likely to be slower than some may like. But it is important to recognise that a proper consideration of options, even if the conclusion from doing so is that other options are required, is still progress.

We expect that the BEPS actions which are in the process of being implemented will go a long way towards mitigating the effect of mismatches and missing elements of the international tax system that some highly digitalised businesses may have been

able to take advantage of. These changes should be given time to be fully implemented and take effect throughout the international tax system before further changes are recommended in regard to base erosion and profit shifting as such. Any work now should focus on considering whether the definition of and attribution of value to supply chains with a significant degree of digitalisation can be improved.

As noted above, the BEPS Action 7 measures have increased the compliance burden as a result of creating additional PEs. We noted that any further measures which would result in additional 'digital' PEs would exacerbate these burdens, and should be weighed against any theoretical improvement in the accuracy of profit attribution, especially where such attribution is likely to be small. We suggested therefore that, if the proposals around a significant economic presence are developed, there should be suitable de minimis thresholds, so that the measures do not impose a prohibitive compliance burden on companies with only very few transactions in a jurisdiction, and that consideration is given to encouraging countries to adopt other domestic legislation, such as remote e-filing, that would reduce the administrative burdens.

We said that in our view both withholding taxes and the digital equalisation levy are blunt instruments likely to lead to double taxation. Taxes which are directly calculated from revenues will only reflect profit attributable to the territory where sales are made in a minority of cases. The imposition of such taxes is likely to lead to double taxation in many instances, as states where 'production' takes place are unlikely to want to compensate for over-taxation where sales are made. Whilst this could, in theory, be tackled by setting the rate of tax at very low levels, this is likely to lead to a tax with disproportionate collection and administration costs. Even then it is likely many tax treaties would need to be revised before these taxes, particularly a digitalisation levy, could be fully creditable. Revenue based taxes are also likely to load additional costs onto businesses in a start-up phase and slow down development, as they will generally be levied before profits are made.

Our full response can be found on the CIOT website.