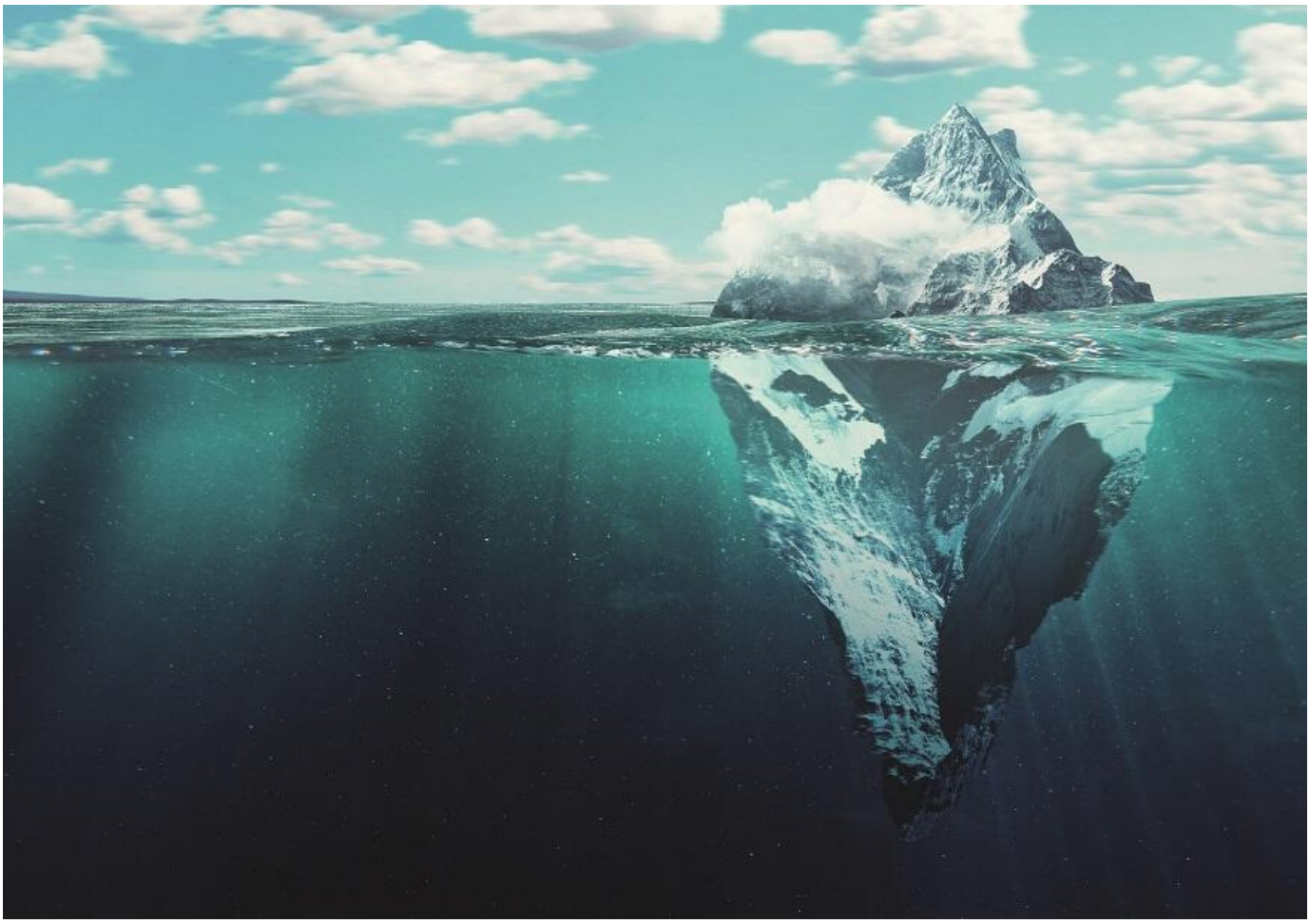
The tip of the iceberg

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Alison Lobb and *Jennifer Breeze* examine the OECD Consultation Document 'Addressing the Tax Challenges of the Digitalisation of the Economy'

Key Points

What is the issue?

On 13 February 2019 the Organisation for Economic Co-operation and Development (OECD) released a public Consultation Document on ‘Addressing the Tax Challenges of the Digitalisation of the Economy’ (‘the Consultation Document’).

What does it mean to me?

The proposals outlined in the Consultation Document are varied, with a potentially wide scope, and are at an early stage of development with all detailed design work still to be done.

What can I take away?

While the Consultation Paper does not represent any agreement on the way forward, it is a signal from the OECD Inclusive Framework countries that they will try to work together to come up with a unified, long-term solution.

On 13 February 2019 the Organisation for Economic Co-operation and Development (OECD) released a public Consultation Document on ‘Addressing the Tax Challenges of the Digitalisation of the Economy’ (‘the Consultation Document’).

The Inclusive Framework on BEPS, working through its Task Force on the Digital Economy (‘TFDE’), issued an Interim Report in March 2018 elaborating on the Tax Challenges Arising from Digitalisation.

The publication of the Consultation Document, which was foreshadowed with the release of a short Policy Note in January, reflects the work by the TFDE of considering the tax challenges arising from digitalisation and identifying potential ways to address them. There are currently four proposals being considered, which could if agreed by the OECD Inclusive Framework countries, form part of a long-term solution to the broader challenges arising from the digitalisation of the economy.

The first three proposals are focused on revising profit allocation and nexus (taxable presence) rules and, in different ways, seek to recognise value created by a business activity or participation in user/market jurisdictions that is not recognised in the current framework for allocating profits:

- The ‘user participation’ proposal
- The ‘marketing intangibles’ proposal

- The ‘significant economic presence’ proposal

The fourth proposal sets out a broad ‘global anti-base erosion’ proposal designed to give jurisdictions the right to tax profits that are taxed only at low effective tax rates elsewhere.

The work undertaken to date by the OECD has made it clear that the digital economy is increasingly widespread, and as a result it would not be feasible to ring-fence it from the rest of the economy for tax purposes. Pascal Saint-Amans, the Director of the OECD Centre for Tax Policy and Administration, reiterated this when speaking in January following the release of the Policy Note. Most of the proposals set out to change the international tax architecture could potentially affect all cross-border businesses, and not just those that are highly digitalised.

In addition to this potentially widespread application, the TFDE have not restricted themselves to application of the long established ‘arm’s length principle’ (the basic rule for transfer pricing that says that intercompany transactions should be priced as if the parties are dealing with each other at arm’s length) when considering how to address the challenges of digitalisation.

The user participation proposal

The user participation proposal seeks to create a mechanism that enables a portion of profits to be allocated based on location of an active user base, regardless of whether a business has any actual physical presence in the user jurisdiction.

This proposal envisages a narrow focus on some highly digitalised business models, specifically social media platforms, search engines, and online marketplaces. Underlying the user participation proposal is the premise that value is created in some highly digitalised businesses through developing an active user base and soliciting data and content contributions from those users. This data is then monetised, leading to income and profits which arise in another jurisdiction (for example, via sale of advertising). The Consultation Document specifically notes that ‘*[f]or businesses that have more traditional relationships with customers, there would be no change in the profit allocation or nexus rules.*’

The Consultation Document specifically sets out that the value created by user activities cannot be determined through the application of the arm’s length principle. Instead, this proposal contemplates that the profit allocated to the user

country be calculated through a 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 and the arm’s length principle. The effect of the proposal would be to reallocate a portion of the non-routine profit of the business to the countries in which users are located.

The definitions of ‘routine’ and ‘non-routine’ functions are not discussed in the Consultation Document, and are not specifically defined within the OECD Transfer Pricing Guidelines. Determining what is the non-routine profit (to be used as the starting point for allocating a portion of that profit to the countries in which users are located) will be subject to some of the pricing challenges that already exist in the current rules. This is acknowledged in the Consultation Document, which also notes that there would be additional difficulties in trying to calculate non-routine profit at the level of an individual business line.

If this proposal is developed, the precise mechanism will clearly be the subject of significant additional work. When determining the allocation of a portion of the non-routine profits to the countries where users are based, the Consultation Document suggests that using formulae will be considered a pragmatic approach for allocating profit.

The marketing intangibles proposal

This proposal contemplates identifying valuable marketing intangibles and assigning some or all of the return on those intangibles to the market jurisdictions. When introducing these proposals, Pascal Saint-Amans noted that the United States is an advocate of this approach.

Importantly, the Consultation Document indicates that this proposal would apply to all businesses and not just highly digitalised 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 of the economy.*'

When considering this proposal, the definition of what is meant by a marketing intangible is the natural place to start. The consultation paper references the term

as defined in the OECD Transfer Pricing Guidelines as follows:

'An intangible that relates to marketing activities, aids in the commercial exploitation of a product or service and/or has an important promotional value for the product concerned. 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.'

This is in contrast to a trade intangible, which has a limited definition of being '*[a]n intangible other than a marketing intangible*' with no further detail, although patents are elsewhere provided as an example of a trade intangible (OECD TPG paragraph 2.144). It is expected that software and other technology intangibles will be considered trade intangibles.

This proposal would modify current transfer pricing and treaty rules to require that marketing intangibles and risks associated with them be allocated to the market jurisdiction, with some or all of the profit attributable to those intangibles taxable in the market jurisdiction.

Where these rules apply to a highly digitalised business that derives revenue from marketing activities in a particular market jurisdiction, the expected outcome is similar to the expected outcome of the user participation model. However, significantly, the proposal contemplates that, unlike the user participation model, the changes would apply equally to traditional consumer businesses that use marketing intangibles.

The Consultation Document describes the mechanics of this proposal as requiring that the non-routine or residual profit of the group is attributable to marketing intangibles and their attendant risks are allocated to the market country. All other profits, such as those attributable to technology-related intangibles generated by research and development and profits attributable to 'routine' functions, including routine marketing and distribution functions, would continue to be allocated based on existing profit allocation principles.

The actual method of allocating non-routine profits between marketing intangibles and other income-producing factors remains to be determined and consideration will be given to normal transfer pricing principles and other methods such as a residual profit split analysis, similar to that outlined above.

Significant economic presence proposal

The final proposal that focuses on nexus, uses the term ‘fractional apportionment’ to describe a mechanism to allocate profits to a significant economic presence, although it closely resembles what the OECD has more commonly termed ‘formulary apportionment’. Pascal Saint-Amans noted that this proposal has been advocated by India (OECD Tax Talks Webcast, Tuesday 29 January 2019), among others.

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.’*

The allocation method would require the application of three steps:

- The definition of the tax base to be divided;
- The determination of the allocation keys to divide that tax base; and
- The weighting of these allocation keys.

According to the Consultation Document, the tax base could be determined by applying the global profit rate of the multinational group to the revenue 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’.

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.

The discussion of this proposal in the Consultation Document is limited to six paragraphs and it is acknowledged that the significant economic presence proposal is a more recent addition to the options under consideration.

Global anti-base erosion proposal

The final proposal addresses the risk of profit shifting to entities subject to no or very low taxation. This proposal is distinct from the profit allocation and nexus rules. It is

an extension of some of the proposals looked at under the BEPS project in 2013-15, in particular in relation to Controlled Foreign Company (CFC) rules.

The anti-base erosion proposal has two elements:

- An income inclusion rule – this has similarities with the US's new 'GILTI' regime, although done on a country-by-country basis, which would require a shareholder in a business to bring into account a share of profit, if that profit was not subject to tax at a minimum rate. This rule would supplement rather than replace a country's CFC rules; and
- A tax on base-eroding payments in the event that the profits are not taxed at a sufficient rate or picked up by an income inclusion rule. This would include both 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 only grant certain treaty benefits if the item of income is sufficiently taxed in the other country.

The rate that is to be set as the minimum is not discussed in the Consultation Document.

It is acknowledged that there are many questions around the design of the rules that will need to be addressed, particularly around scope, thresholds and any safe harbours.

One key point for consideration will be whether the additional tax charged should be at the level of the minimum tax rate or up to the full rate of the country taxing the amount, under an income inclusion or undertaxed payment rule. It will also be necessary for the OECD to consider whether there should be an exemption for genuine economic activities, in line with the European Court of Justice's CFC decision in *Cadbury Schweppes*.

This proposal goes further than addressing the tax challenges of the digitalised economy and may apply to businesses in any sector. Pascal Saint-Amans commented that Germany and France are two of the advocates of this proposal.

Certainty and double taxation

A welcome development in the Consultation Document is the emphasis on countries' commitment to avoiding double taxation and providing certainty, including the

recognition of the need for effective dispute resolution. There is also acknowledgement of the benefits of simplicity from both a business compliance and tax authority administrative perspective.

What happens next?

The proposals outlined in the Consultation Document are varied, with a potentially wide scope, and are at an early stage of development with all detailed design work still to be done. While the Consultation Paper does not represent any agreement on the way forward, it is a signal from the OECD Inclusive Framework countries that they will try to work together to come up with a unified, long-term solution. Such a long-term solution has to be in the interests of businesses, as the alternative is the proliferation of uncoordinated and unilateral measures, including at the turnover rather than profit levels. Following the consultation process and a public meeting at the OECD in Paris on 13-14 March, the TFDE will report to G20 Finance Ministers in June and agree a work plan for the next 18 months, with a consensus solution to be agreed upon by the end of 2020. Given the potentially wide ambit of the proposals and fast pace of development of fundamental new rules, businesses will need to follow developments closely.