Corporate Education

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The Sea Change in International Taxation: Taxing the Digital Economy

Executive Summary

Executive Summary. Base erosion and profit shifting (BEPS) refers to tax planning strategies that exploit gaps and mismatchesin tax rules to make profits ‘disappear’ for tax purposes or to shift profits to locations where there is little or no real activity but the taxes are low, resulting in little or no overall corporate tax being paid.

At the center of the current debate is whether international income tax rules, developed in a "brick-and-mortar" economic environment more than a century ago, remain applicable in the modern global economy. The fundamental elements of the global tax system which determined where taxes should be paid ("nexus" rules based on physical presence) and what portion of profits should be taxed ("profit allocation" rules based on the arm's length principle), have served their purpose well. Namely, they have enshrined tax certainty and helped to eliminate double taxation stimulating global trade.

The International Tax standard for nearly 100 hundred years, the Arm’s Length Principle (ALP), is under intense scrutiny in the highly digitized business environment.

The Problem

- **Current nexus:**
  - Physical presence
  - Incorporation of a subsidiary or set up a branch in a jurisdiction

- **Allocation rule:**
  - Arm's length principle
  - Profit allocated to the place where functions are performed, assets are used or risks are assumed
  - Destination not relevant

- **Arguments to reform:**
  - Digital transformation of the economy questions whether the international tax system remains fit for purpose\
  - Unilateral measures (e.g. French digital service tax)
  - Increase in audits and tax disputes

Background

- Tax System – World Wide - Treaties – Credits – Double Taxation
- MNCs,MNEs, Transnational Corporations – OECD
- Arm's Length Standard – 85 years old this year
- Global Value

  chains BEPS -

  (2012 – 2018)
- Article 1 – Taxation in the Digital Economy – No physical presence - <u>Is a new Tax Standard needed??</u>
- The OECD Unified Approach: Pillars one and Two

Digitalisation

The Wayfair case (USA), June 21, 2018

- In 2016 South Dakota enacted legislation confering nexus for sales tax purposes upon remote sellers provided:
  - > $100,000 in annual sales into South Dakota; or
  - Engage in 200 or more separate transactions for the delivery of goods or services

The Wayfair case (USA), June 21, 2018

- This legislation contradicted the US Supreme Court 1992 decision in *Quill Corporation v North Dakota* that required physical presence for remote sellers for the purposes of sale tax nexus upon a remote seller ;

- Nexus was determined, but not limited to:
  - possessing inventory in a jurisdiction;
  - owning or leasing real or tangible property;
  - having agents or personell conducting solicitation activities in person;
  - conducting services locally (installation, repair, etc)

The Wayfair case (USA), June 21, 2018

- In 2017 the South Dakota Supreme Court rules that the law violated Quill and was unconstitutional
- June 21, 2018 the US Supreme Court (in a 5-4 decision) however ruled in favor of the South Dakota State

"[…] the physical presence rule of Quill is unsound and incorrect and the Court's decision in Quill…should be a now are overruled."

Where do we come from?

BEPS Action 1 Report

October 2015

Features highly digitalised business models:
1. scale without mass;
2. reliance on IP; and
3. data and user contributions.

March 2018

Interim Report

Policy Note

January 2019

Agreement to examine proposals involving <u>two Pillars</u> which could form the basis for consensus:
1. seeks to develop new profit allocation rules that deviate from the current profit allocation rules; and
2. focuses on achieving a minimum income taxation for MNEs.

Solutions go beyond ALP.

13 February – 6 March 2019

Public Consultation Document

Three proposals
1. user participation;
2. marketing intangibles; and
3. significant economic presence.

Programme of Work

May 2019

9 October – 12 November 2019

Public Consultation Document on a Unified Approach (Pillar One)

Public Consultation Document on "GloBE" (Pillar Two)

8 November – 2 December 2019

"Four Components":
1. Income Inclusion Rule;
2. Undertaxed Payments Rule;
3. Switch-over Rule; and
4. Subject to Tax Rule.

What's at Stake

What's at Stake:

- the allocation of taxing rights between jurisdictions;
- the future of multilateral tax co-operation;
- the prevention of aggressive unilateral measures; and the intense political pressure to tax highly digitalised MNEs;
- [and]fundamental features of the international tax system, such as the [. . .] applicability of the arm’s length principle (ALP).

In other words, we are witnessing a watershed moment in International Taxation

A MNE Global Supply Chain

The Standard for Intra-Firm Trade is the Arm's Length Principle: Prices are Market Based

- Global trade has two components
  - Intra-firm Trade – MNEs - arm's length standard
  - International Trade - arm's length market prices
  - 80% of trade takes place in ‘value chains’ linked to transnational corporations, UNCTAD report says (United Nations Conference on Trade and Development)
  - Majority of "TRADE" is intra-firm tied to MNEs or transnational corporations global value chains

ALP served the Global Economy well over the last 85 years

However, in 2012, an OECD/G20 initiative called

BEPS was undertaken to limit the artificial shifting of profits to low or no-tax locations. Fifteen articles Finalized in 2015.

Starbucks was the whipping boy in the UK on this matter
Dell, Apple, Microsoft, Caterpillar - all were tainted

The BEPS actions consists of 15 actions to help Governments address tax avoidance – in effect in July 2018

Profits will be taxed where value adding functions are performed

This serves to reinforce the idea of economic substance in taxation

TAXING THE DIGITAL ECONOMY: Challenges

Digital MNEs are therefore perceived to be more difficult to tax than ‘‘brick and mortar’’ firms.

Digital multinationals (MNEs) are highly mobile.

While the technologies employed by digital businesses vary widely (e.g., robotics, cloud computing, social platforms, 3D printing), they share key features such as scale without mass, heavy reliance on intangibles, data, and network effects

The OECD argued that the digital economy exacerbated BEPS issues and created challenges for ensuring that profits were taxed where economic activities occurred and value was created

The question therefore for the OECD was whether new policies were needed or old policies could be fine-tuned for the digital economy

These concerns have been exacerbated by the potentially large amounts of global profits being earned by these new digital businesses, creating a “virtual land grab’’ by tax authorities eager for new sources of revenues.

In particular, the so-called “Big Five’’ digital giants: Alphabet (Google), Amazon, Apple, Facebook, and Microsoft are sitting targets.

Their market capitalization in May 2019 totaled $4.22 trillion.

The Big Five represent 11% of total U.S. market capitalization and 5% of world market capitalization, or 20.5% of U.S. GDP and 5% of world GDP.

Forbes estimates that 12 of the top 20, and 39 of the top 100 digital companies, are headquartered in the U.S. in 2019. Thirteen are headquartered in Japan and nine in mainland China (12 if Hong Kong is included).

In a race to raise revenues from digital MNEs, several governments have either introduced (e.g., France and Hungary) or proposed (e.g., Spain, Italy, the U.K., India, and New Zealand) digital sales/services taxes (DSTs). The question facing the U.S. government, and other home countries to the digital MNEs, is how to respond to the flurry of new DST proposals

The question for other governments, particularly the so-called ‘‘market jurisdictions’’ where digital users/consumers reside, is whether to jump on the band-wagon with their own DSTs or work together on a coordinated solution to taxing digital MNEs.

The precipitating factor behind the OECD’s Pillar One proposals has therefore been the immediate threat of multiple, unilateral DSTs if the OECD could not get consensus on a coordinated approach.

Proposed Solutions: BEPS and Unified Approach Pillars 1 and 2

BEPS Action 1 discusses the tax challenges of the digital economy

Key features of the digital economy:

- Scale without Mass

- Higher reliance on IP

- Role of users in value creation

Pillars One and Two:

The Policy Note released by the OECD on **January 30, 2019** focused on two proposals or ‘‘pillars’’ for handling taxation of the digital economy: Pillar One on the allocation of tax rights among jurisdictions and Pillar Two on remaining BEPS (base erosion and profit shifting) issues.

Two Pillar Approach

PILLAR I

Model based on three separate returns to the market / user jurisdiction

Amount A
Portion (%) of deemed residual profit

- New taxing right.
- Independent of physical presence, i.e. going beyond ALP.
- Using a formulaic approach.

Amount B
Fixed return for marketing/distribution functions

- No new tax right.
- Merely a modified operation of the ALP.
- Follows the separate entity approach .

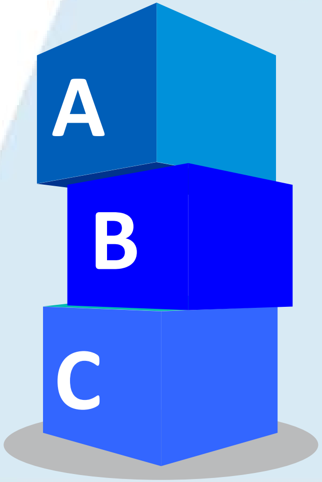
Amount C
Additional return based on TP analysis

PILLAR II

- Global anti-base erosion rules
- Deals with "remaining BEPS issues"
- Focuses on achieving a **minimum income taxation** for multinational enterprises
  - This Pillar entails measures aimed at reducing the incentive to shift profits to low-tax jurisdictions and effectively achieving a minimum taxation on income of MNEs.
  - The rationale given is that the proposal provides jurisdictions with the ability to "tax back" group profits that are subject to a low effective rate.

The Unified Approach

Keeps current TP rules & complement with formula-based profit attribution rules to the market/user jurisdiction, based on 3 separate returns:



Amount A

- Portion of the MNE “deemed residual” profit to be reallocated to market jurisdictions.
- Calculated by deducting a deemed routine return on activities from the MNE profit.
- Require agreement on (1) a consistent measure of profit, (2) the level of routine return and (3) the proportion allocated to the market jurisdiction.

Amount B

- Fixed return for certain routine marketing and distribution activities in the market/user jurisdiction
- Activities taxable according to existing rules + a fixed remuneration to reflect assumed baseline activity.
- Targeted at low risk distributors

Amount C

- Return in excess of Amount B (additional profit), or if the MNE perform other business activities in the market/user jurisdiction unrelated to marketing and distribution.
- Apply arm's length principle & introduce binding and effective dispute resolution mechanisms

Pillar One

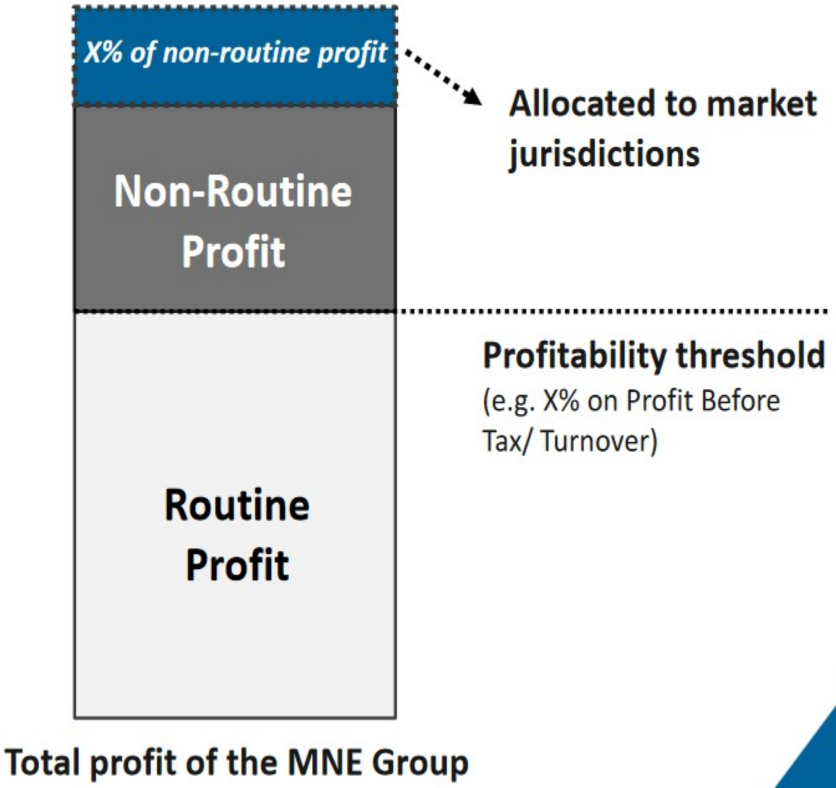
Amount A (New Taxing Right): A new taxing right would be created for market/user jurisdictions, which would be based on a fractional share of an MNE group's deemed non-routine global profits.

Amount B: Local activities (e.g., marketing and distribution) in market/user jurisdictions would be allocated ''fixed remunerations reflecting an assumed base-line activity,'' i.e., there would be a fixed minimum floor for local marketing and distribution activities.

Amount C: An additional amount over and above Amount B could be added for situations where the tax-payer or tax authority, using the ALP, argued for a re-turn to local marketing and distribution (or other local) ctivities above ''baseline functionality'' and the fixed minimum return.

Pillar 1: Amount A

- **Substantial reallocation of taxing rights** across jurisdictions
- **Going beyond physical presence** to determine taxing rights
- **Considers MNE groups as a whole** rather than entity-by-entity
- **Allocates some tax base to market jurisdictions based on a formula**



The Pillar 2 proposal is focused on designing two interrelated rules:

- an income inclusion rule and
- a tax on base eroding payments.

The “GloBE” Proposal

Implementation via:	Income inclusion rules	Tax on base eroding payments
Domestic legislation	**Income inclusion rule** • This rule would operate as a minimum worldwide tax by including the income of a foreign branch / controlled entity in the tax base of the controlling taxpayer if that income was not effectively taxed at a minimum rate. • This rule would be more far-reaching than traditional CFC rules.	**Undertaxed payments rule** This rule would deny the deduction or impose source-based taxation for payments to a related party if that payment was insufficiently taxed beforehand.
Tax treaties	**Switch-over rule** This rule would allow the state of residence to apply the credit method instead of the exemption method where profits attributable to (i) a PE or (ii) derived from IP (which is not part of a PE) are subject to tax at an effective rate below the minimum.	**Subject to tax rule** • This rule would grant tax treaty benefits only if the beneficiary is “sufficiently taxed” in the other treaty jurisdiction. • For at least interest and royalty payments, with the possibility of extension to other income
	A parent / residence-based tax if the source country levies no / not enough tax	A tax at the source if the parent / residence country levies no / not enough tax

So the proposals work as a global minimum corporate tax with either the source or residence jurisdiction picking up the tax if the other does not!

No consensus yet

"[…] We believe the issues are not unique to technology companies but also relate to other companies, particularly those with valuable intangibles. I have instructed our team to continue their efforts in the OECD so that we can make progress on these issues quickly. I highlight again our strong concern with countries' consideration of a unilateral and unfair gross sales tax that targets our technology and internet companies. A tax should be based on income, not sales, and should not single out a specific industry for taxation under a different standard. We urge our partners to finish the OECD process with us rather than taking unilateral action in this area."

U.S. Treasury Secretary Steven T. Mnuchin,
25 October 2018

Conclusions:

- International Taxation is leaving the ALP behind and moving to a formulary approach
- This approach will allocate more intangible income to local (source) and market facing companies
- US high tech companies will be disadvantaged by this while overall global tax revenue will increase
- The digital economy cannot be ring-fenced
- All companies are now digital companies

Thank You!

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