BEPS 2.0 - Taxation of Digitalised Businesses?

The OECD’s BEPS 2.0 initiative has the potential to change the global tax landscape significantly by changing how profits are allocated between jurisdictions (known as Pillar One) and introducing a new globally coordinated regime for a minimum tax and anti-base erosion measures (known as Pillar Two). There is no shortage of challenges and opportunities facing today’s online and digital businesses and their tax functions, whereas the latest initiative could present a new set of pressures.

The Past and the Present

In 2015, the Organisation for Economic Co-operation and Development (OECD) issued its final report on its Base Erosion and Profit Shifting (BEPS) project. While the initial objective of the first Action 1 Report was to address the tax challenges of the digital economy, the OECD has recently gone a step further to propose new rules to tighten the noose, which are currently at public consultation stage.

The OECD’s latest initiative will affect online and digital multinationals more than any other BEPS proposals in the last decade. The work in this area is currently partitioned into two pillars: Pillar One dealing with the allocation of taxing rights and profits, proposing new ways to apportion income between taxing jurisdictions, and Pillar Two tackling , as a ‘backstop’ imposing a minimum tax and denial of deductions or imposition of withholding taxes on payments made to ‘low tax’ entities.

On 9 October 2019, the OECD Secretariat released a new proposal under Pillar One.

The Proposed New Rules

Under the proposed new rules, profits of multinational enterprises would be allocated based on digital presence in a jurisdiction. Accordingly corporate income taxes could be levied on a company in a particular jurisdiction, notwithstanding the absence of a physical business connection with such jurisdiction. Highly digitalised businesses, including the e-gaming industry sector that prevalently conduct their activities online, may therefore expect to incur additional tax obligations in multiple jurisdictions where their customers are located, based on the newly proposed digital presence concept.l tax obligations in multiple jurisdictions where their customers are located, based on the newly proposed digital presence concept.

Unilateral Implementation of the New Tax Rules has begun

Certain jurisdictions have already taken unilateral steps (among which are several EU member states such as France, Italy, Hungary, Spain, United Kingdom and non-EU countries such as India etc.) by creating additional frameworks for the taxation of highly digitalised businesses models. Such steps are at different levels of implementation in these jurisdictions. While some have passed through local parliaments and have fully come into effect (even retroactively in certain cases), some are still in the pipelines.

For instance, in France, the French Digital Services Tax (DST) law has already come into effect, given that it was signed and published to be retroactively applicable as from 1 January 2019. Under the French DST, a 3% tax applies on gross revenues deriving from i) the provision of a digital interface (i.e. intermediation services); and ii) targeted advertising and transmission of data collected about users for advertising purposes. The tax applies only to companies exceeding in the previous taxable year the following thresholds: i) €750M in worldwide revenue and ii) €25M in taxable services supplied in France; the two thresholds are cumulative conditions and are to be calculated at the consolidated group level.

Italy has introduced a DST of 3% on gross revenue derived from i) advertising on a digital interface, ii) multilateral digital interface that allows users to buy/sell goods and services, iii) the transmission of user data generated from using a digital interface. The DST applies to both resident and non-resident companies with total group revenue of €750M and total revenue from digital services supplied in Italy of at least €5.5M. It has been announced that Italy’s DST will take effect from 1 January 2020.

In Spain, the government proposed a budget bill for 2019, which included a 3% digital tax that would apply to companies with more than €750M of annual global revenue and €3M in annual revenue in Spain from certain digital business models. Companies that are primarily engaged in online advertising services; selling of online advertising (space) and selling of data. Parliamentary approval is yet to be obtained on this draft law.

In the United Kingdom, a draft DST legislation has been published stating that with effect from April 2020, the government will introduce a new 2% tax on the revenues of search engines, social media platforms and online marketplaces which derive value from UK users. These businesses will be liable to the DST when the group’s worldwide revenues from these digital activities are more than £500M and more than £25M of these revenues are derived from UK users. The DST will be payable and reportable on an annual basis.

Italy

- New tax introduced by the Budget Law 2019 approved in Dec 2018
- 3% tax levied on:
  - revenues generated from certain digital services (scope broadly in line with EU proposal)
  - rendered to Italian B2B and B2C customers
  - by companies whose total worldwide revenues > EUR 750 million and revenues from digital services realized in Italy > EUR 5.5 million
- Implementing decree?

Spain

- Approved by the government on January 18, 2019
  - 3% tax on online advertising services, brokering services, and the sale of user data
  - Following the EU Commission's proposal, incl. thresholds and scope

France

- Draft Law published in March 2019
- The tax will be levied
  - at a rate of 3%
  - on revenues generated from certain digital services (targeted online advertising, sale of user data for advertising purposes, and intermediation activities by platforms)
  - by companies whose total worldwide revenues > EUR 750 million and revenues generated in France > EUR 25 million
  - deductible for corporate income tax purposes
- The bill passed the National Assembly April 9, 2019 and by the Senate May 21, 2019, and will apply retroactively as of Jan 1, 2019.

United Kingdom

- 2% on in-scope revenues, targeted at revenue streams **linked to UK** users derived from **in-scope business models**
- Draft bill April 2019
- In-scope business models:
  - Search engines
  - Social media platforms
  - Online marketplaces
- Effective in January 2020, with the first tax bill due in April 2020.

What to Expect

Compared to the current system, the proposed changes will - broadly speaking - re-allocate profits and taxable proceeds from "residence" or "source" countries to "destination" countries, being the countries where customers are located. As with any change, the OECD proposal will result in winners and losers. But which countries are the likely winners and which are not?

In an e-gaming context, taxing rights would be affirmed for countries where players are located, notwithstanding the absence of physical presence in the jurisdiction. Therefore, it can be expected that profits which have previously been attributed to activities such as head office activities, R&D, and to brands and technology, will now be attributed to 'sales' activities in jurisdictions where players are present, at least in part.

As a corollary to these new rules, the practical concerns that can be envisaged include:

- Potential additional taxation in multiple jurisdictions, with heightened risk of double or multiple taxation;
- Increased incidence of multilateral tax disputes which existing double tax treaties are not necessarily equipped to address. Significant costs to dispute resolution can also be reasonably expected;
- Increased tax compliance obligations to satisfy the new compliance demands;
- Increased need for adequate transfer pricing and profit allocations analyses.

Although the proposal is still a draft and many implementation aspects still need to be defined, including the level of routine profit and the share of surplus profit to be reallocated, we can get a glimpse of the future by considering that:

- countries with large B2C sectors will be affected more than countries with large B2B sectors;
- countries with strong high-end/high-value consumer product sectors are more likely to be affected than countries with low-margin industries;
- exporting countries are more likely to lose while importing countries are more likely to win.

Grey Areas: Who is Safe from the Reach of the Proposed New Rules?

The OECD Secretariat acknowledges that the published proposal represents an architectural framework on which to build, and that it requires significant work before it will be usable. Nevertheless, pending the day when the OECD might be able to hammer out many details of the proposal, the recent draft and enacted unilateral DST measures by some jurisdictions as mentioned above already undermine tax certainty. Without consensus within a relatively short timeframe, it appears likely that more countries will adopt unilateral alternatives, making it increasingly difficult to navigate the global tax landscape. Recognising this challenge, the French government announced that the DST will be repealed as soon as an international agreement is reached and companies will be refunded the difference between the French DST paid, and the yet-to-be-agreed-upon international digital tax. It is yet to be seen whether the other countries will follow suit.

It is important to note that the new proposal does not apply to all companies, nor does it ring-fence the digital economy subjecting the highly digitalised businesses to a separate regime. Several implementation aspects of the proposal are still to be defined, including the exact sectors to which it will apply, whether it will affect all multinational corporations (MNCs) or only those with revenues in excess of €750 million, noting that some clarifying rules and carve-outs will likely be needed.

Preparing for the Future

Given the present uncertainty in the international tax terrain, MNCs have recognised the need to take proactive steps by commencing discussions with their tax advisors to mitigate the potential impact of the incoming rules. It is therefore essential that MNCs in the services industry – such as groups in the e-gaming sector whose business models are, by necessity, driven by digitalised business models – assess their readiness for BEPS 2.0, ensuring that the latest developments do not catch their businesses unaware.

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