Euro Tax Flash from KPMG's EU Tax Centre

OECD consultation on a "unified approach" to taxing the digital economy

Digital Economy – OECD – Pillar One – Unified Approach – Nexus – Allocation of Taxing Rights – Arm's Length Principle – Formulary Apportionment – Digital Services Tax

Following a meeting on October 1, 2019 of the OECD Task Force on the Digital Economy (TFDE), the OECD Secretariat published a public consultation document on October 9, 2019 that sets out a proposal for a unified approach to the nexus and profit allocation challenges arising from digitalization. The OECD invites comments from the public with a view to discussing the results during a public consultation on November 21 and 22, 2019. Interested parties are invited to send their comments by email to the OECD no later than 12pm (Paris time) on Tuesday, November 12, 2019, using the email address TFDE@oecd.org.

Background

The taxation of enterprises that use digital technology has been high on the international political agenda and is a key topic of focus in the broader context of the fight against base erosion and profit shifting and the perceived mismatch between taxation and value creation.

Following a mandate issued by the Finance Ministers of the G20 in March 2017, the OECD TFDE published an Interim Report in March 2018 entitled "Tax Challenges Arising from Digitalisation" drawing on the work delivered in 2015 under Action 1 of the BEPS Project. The Interim Report (see ETF 360), which clarified that a consensus approach between members did not yet exist, was presented to G20 leaders on March 19-20, 2018 with the objective of finding a long-term solution for the issue of the taxation of the digital economy.

In January 2019, the OECD TFDE issued a policy note that identified four proposals to explore on a "without prejudice" basis. These proposals were grouped into two pillars. The first pillar (Pillar One) – which is the focus of the consultation paper – concentrated on the allocation of taxing rights and a review of profit allocation and nexus rules. It contained three proposals in relation to “user participation”, “marketing intangibles” and “significant economic presence”. The second pillar focused on measures to achieve minimum effective rates of tax.

In response to the consultation process, on May 28, 2019 a Programme of Work was adopted by the OECD Inclusive Framework on BEPS, an initiative of the OECD involving over 130 countries and jurisdictions. The Programme of Work emphasized the urgent need to agree the outline architecture of a unified approach to the taxation of the digital economy by January 2020. In particular, the Programme of Work noted that there is a considerable risk that uncoordinated unilateral tax measures will be introduced by jurisdictions where a global consensus is not reached, in turn leading to an adverse impact on investment and growth.

The Public Consultation Paper

Following an extensive consultation process and a meeting of the OECD TFDE on October 1, 2019, the OECD Secretariat published a policy paper on a unified approach to the nexus and profit allocation challenges arising from digitalization (the OECD Proposal).

Commonalities of Pillar One proposals

While there is some variation in how the three proposals of Pillar One address the challenges of the digital economy, the OECD paper highlights a number of commonalities between each approach. In particular, each of the proposals in Pillar One would grant greater taxing rights over the profits of businesses to the user/market jurisdiction and would therefore require a new nexus rule that would not be based on physical presence in the user/market jurisdiction. In seeking to reallocate taxing rights, all three suggested approaches would go beyond the arm’s length principle while aiming for simplicity and increased tax certainty.

The Unified Approach

The OECD Proposal attempts to take these commonalities and use them to identify the key features of a possible long-term solution, which would include the following:

- **Scope**: The OECD Proposal seeks to cover highly digital business models but also goes wider, broadly focusing on consumer-facing businesses. Possible carve-outs would also be considered, in particular for extractive industries or financial services. In addition, size limitations (e.g. a EUR 750 million revenue threshold) could be considered.
- **New nexus rule for taxpayers in scope:** The OECD Proposal seeks to create a new nexus for taxpayers that is largely based on sales (as opposed to physical presence). This new nexus could have country specific sales thresholds that are tailored so that smaller economies can also benefit.
- **New profit allocation rule**: The OECD Proposal would extend beyond the arm’s length principle and the physical presence limitations imposed on taxing rights. Amendments to the existing rules will therefore need to be made to ensure that profits can be allocated appropriately between jurisdictions.

As regards profit allocation, the OECD Proposal recognizes that existing profit attribution rules work well for most routine transactions. The OECD Proposal therefore recommends that current transfer pricing rules are retained but are complemented with formula-based solutions to allow for the taxation of business activities in more complex scenarios. Against this backdrop, the proposal calls for the introduction of a three-tier mechanism for allocating profit, consisting of:

Amount A - A portion of the multinational's "deemed residual" profit would be reallocated to market jurisdictions. The "deemed residual" profit would be calculated by deducting a deemed routine return on activities from the multinational group's profit. This approach would require agreement on a consistent measure of profits to be agreed, the level of the deemed routine return to be deducted and also agreement among OECD Inclusive Framework members on the proportion of the "deemed residual" return that should go to the market jurisdiction.

Amount B would establish a fixed return for certain routine marketing and distribution activities taking place in market jurisdictions. These activities would remain taxable according to existing rules, although fixed remunerations would be agreed to reflect an assumed baseline activity. Amount B aims to provide certainty, which is one of the key areas of focus of transfer pricing disputes and the wider BEPS agenda.

Amount C - The OECD Proposal notes that, in certain cases, a return (Amount C) in excess of that calculated under Amount B may be warranted where marketing and distribution functions in a jurisdiction exceed the assumed baseline activity assumed under Amount B, or the MNE group or company perform other business activities in the jurisdiction unrelated to marketing and distribution. The proposal states that any dispute between the market jurisdiction and taxpayer over any element of the proposal should be subject to legally binding and effective dispute prevention and resolution mechanisms (e.g. arbitration).

Next steps

A public consultation is scheduled for November 21 and 22, 2019 to engage with business and other stakeholders. The OECD accepts that there are a number of areas in which further work will be required and has invited the public to respond to the consultation, specifically in relation to the proposed scope of the unified approach, the new nexus rules, the calculation and determination of Amounts A, B and C and appropriate measures for dispute resolution.

The OECD Proposal indicates that the goal would be to advance towards a unified approach for approval by the next meeting of the OECD Inclusive Framework in January 2020 with the final proposals in respect of pillars one and two ready for the G20 meeting in Riyadh in November 2020.

EU Tax Centre comment

The OECD has an ambitious target of reaching agreement on a unified approach by January 2020. However, this timeline is set against a backdrop of jurisdictions continuing to take unilateral steps to tax digital companies (e.g. the introduction of digital services taxes into local law). For a unified approach to succeed, it is likely that members of the OECD Inclusive Framework will need to compromise. This will require countries to take difficult decisions and to be bound by them. Despite the focus politically to address the challenge of taxing digital companies, it remains to be seen whether a consensus can be reached.

Should you have any queries, please do not hesitate to contact KPMG's EU Tax Centre, or, as appropriate, your local KPMG tax advisor.

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