OECD Holding Public Consultation on the Tax Challenges of Digitalization

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Key Points

- Public consultation follows release of OECD discussion draft on potential tax changes to address difficulties in taxation caused by the digital economy.
- OECD hopes to produce "consensus document" with proposed solution by 2020.

The Organisation for Economic Co-operation and Development (OECD) will kick off tomorrow a public consultation on its most recent foray into the tax challenges arising from the digitalization of the economy. The consultation follows the release of a discussion draft last month that provided five different policy options under two different "pillars" for addressing potential difficulties in taxation caused by the digital economy. The discussion draft asked for feedback on design considerations, scope limitations and best approaches to reduce complexity for the various policy options, and over 200 stakeholders submitted written comments by the March 6 deadline. The Treasury Department has signaled that it supports the "marketing intangibles" option – an approach that would apply across industries and would allocate taxing rights to businesses' extraordinary returns from marketing intangibles to market jurisdictions. The public consultation will run through Thursday and will be broadcast live on OECD WebTV.

Background:

The recent focus on the tax challenges surrounding the digital economy began at the OECD in 2013, when the OECD and G20 governments launched the Base Erosion and Profit Shifting (BEPS) project. The BEPS project identified fifteen different "action" areas where tax rules could be strengthened to prevent BEPS, and "Action 1" focused on the tax challenges of the digital economy.

In 2015, the first report on each of the 15 action areas — *Addressing the Tax Challenges of the Digital Economy, Action 1 – 2015 Final Report* — was delivered. The report identified the challenge of allocating taxing rights on income generated from cross-border activity in the digital age and the accompanying BEPS concerns, but did not recommend any proposals to address the challenge (and pointed out that any potential solution should not attempt to "ring-fence" the digital economy due to the increasingly pervasive nature of digitalization). However, they did renew the mandate of the Task Force on the Digital Economy (TFDE) – the Task Force that produced the Action 1 report – to continue to monitor developments in respect to digitalization.

In March 2017, G20 finance ministers mandated the TFDE's current effort, asking the TFDE to deliver a final report in 2020 with the goal of coming to a "consensus-based solution" addressing the profit allocation and BEPS concerns caused by the digital economy. Last month, the TFDE released a "Discussion Draft" that gave the most detailed view yet of what these solutions could possibly be, and a public consultation the public consultation on these proposals kicks off tomorrow.

Interim Efforts:

Despite the fact that the OECD's effort has acknowledged that it would be difficult to "ring-fence" the digital economy, it has not stopped some countries from trying. Among others, in March 2018 the European Union introduced a "Digital Services Tax" that imposed a 3 percent levy on revenues derived from the selling of advertising space, digital intermediary activities like online marketplaces, and sales of user-collected data (the proposal has since been stripped back to target just digital advertising). The UK has proposed a 2 percent tax on revenues of search engines, social media platforms and online marketplaces. France has proposed a levy of up to 5 percent on revenues derived from digital ads, marketplaces and the re-selling of personal data.

U.S. officials have routinely denounced such one-off efforts. Secretary Mnuchin has highlighted his "strong concern with countries' consideration of a unilateral and unfair gross sales tax that targets our technology and internet companies." In January, Finance Chairman Grassley and Ranking Member Wyden sent a letter to Secretary Mnuchin expressing their "serious concern regarding unilateral action by foreign countries to establish digital services taxes designed to discriminate against U.S.-based multinational companies." Ranking Member Brady has also routinely rejected such one-off efforts.

The TFDE's discussion draft:

The TFDE's discussion draft on possible solutions is broken down into two different types of proposals: proposals that revise profit allocation and nexus rules, and proposals that address general BEPS concerns. The different proposals have different champions within the OECD. For example, the U.S. has championed the "marketing intangibles" approach, the UK has championed the "user participation" approach and France and Germany have pushed the "minimum tax" proposals.

Proposals that revise the profit allocation and nexus rules:

The "user participation" proposal (UK)

- Modifies current profit allocation rules to require that an amount of profit be allocated to jurisdictions in which businesses participatory user bases are located, regardless of whether the business has a local physical presence.
- This proposal would only apply business models that use social media platforms, search engines and online marketplaces. (The limited scope of the proposal seems to be at odds with the general TFDE premise that proposals should not "ring-fence" the digital economy)
- The proposal takes a three-step approach to reallocating these profits: (1) calculating the non-routine profits of the businesses operations (i.e., the profit

attributable to intangibles), (2) attributing a portion of those profits to the activities of users and then (3) allocate those profits between the jurisdictions where the business has users.

- Design Issues: how to determine non-routine profits, attribute those profits to activities of users and allocate the profits between jurisdictions.
- The policy rationale behind the proposal is that the sustained engagement and active participation of users is a critical component of value creation in these types of business models, and the traditional tax framework does not give enough credit to this kind of value creation.

The “marketing intangibles” proposal (U.S.)

- Modifies current profit allocation rules to require that non-routine income of the business attributable to marketing intangibles[1] be allocated to the marketing jurisdiction.
- Applicable to all types of businesses.
- The proposal takes a three-step approach to reallocating these profits: (1) calculating the non-routine profits of the businesses operations (i.e., the profit attributable to intangibles), (2) determine the amount of non-routine profit that is attributable to marketing intangibles (vis-à-vis technology intangibles) and then (3) allocating the income derived from marketing intangibles to each market jurisdiction.
- Design Issues: how to calculate “non-routine” profits (traditional transfer pricing or profit split?); how to determine amount of non-routine profit attributable to marketing intangibles (e.g., costs incurred to develop marketing intangibles vs. costs incurred for R&D intangibles); how to attribute marketing intangibles to market jurisdictions (revenues from each jurisdiction?); whether these rules should apply in a non-consumer facing context (i.e., should business to business transactions be exempt?).
- The policy rationale behind the proposal is that the value of some marketing intangibles, such as brand and trade name, are reflected in the favorable attitudes in the minds of customers in market jurisdictions, and other marketing intangibles, such as customer data, relationships and lists are derived from activities targeted at customers and users in the market jurisdiction. Given that this value flows from the market jurisdiction, the proposal posits that it is appropriate to allocate profits to these jurisdictions for tax purposes.

The “significant economic presence” proposal (India)

- This proposal contemplates the reallocation of profits (using some sort of fractional apportionment) based on “significant economic presence.”
- The existence of significant economic presence would be based on a number of factors including revenue from the market jurisdiction, existence of user base and

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[1] The report uses the OECD’s transfer pricing guidance to define “marketing intangibles”. According to the guidance, marketing intangibles are “an intangible . . . that relates to the 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.

the associated data input, the volume of digital content derived from the jurisdiction, billing and collection in the local currency, maintaining a website in a local language and sustained marketing and sales promotion activities.

- The proposal admits that there are multiple design issues once a significant economic presence is established. Among other things are (1) definition of the tax base to be divided, (2) the determination of the allocation keys to divide that tax base and (3) the weighting of these allocation keys.
- This proposal is motivated by the view that the digitalization of the economy and other technological advances have enabled business enterprises to be heavily involved in the economic life of the jurisdiction without having a significant physical presence. According to this view, these technological advances have rendered the existing nexus and profit allocation rules ineffective.

Global anti-base erosion (minimum tax) proposals:

Income Inclusion rule ("GILTI"-like tax) (Germany / France)

- The income inclusion rule would ensure that the income of a multinational group is subject to tax at a minimum rate thereby reducing the incentive to allocate returns for tax reasons to low-taxed entities.
- The minimum tax rate would apply on a per-jurisdiction basis.
- Design issues include: mechanisms for avoiding double taxation (i.e., foreign tax credits), the types of entities covered and the definition of the minimum level of ownership required to be subject to the tax, and how to allocate income to shareholders.

Undertaxed payments rules ("BEAT"-like tax) (Germany / France)

- Would deny a deduction for defined categories of payments made to a related party unless those payments were subject to a minimum effective rate of tax.
- Design issues include: the scope of the payments covered by the rules, the threshold for related party status, the mechanics of this effective tax rate and whether the rule should deny deductibility in full or on a graduated basis.

Treasury / Hill Stance:

As mentioned above, the Treasury Department has consistently supported an approach that would allocate marketing intangibles to market jurisdictions (and has consistently signaled that they see this approach as the most likely basis of a consensus). This approach, which would replace existing profit allocation rules, would most likely use mechanical formulas to determine non-routine returns, attribution of profit from non-routine returns to marketing intangibles and allocation of marketing intangibles to the market jurisdiction according to Treasury officials.

Treasury has indicated that it does not feel that the profit allocation and minimum tax proposals are mutually exclusive. Last weekend in France, Secretary Mnuchin said that the minimum tax concept was "something we absolutely support, that there's not a chase to the bottom on taxation." As shown in the table above, the Global Intangible Low-Taxed Income (GILTI) and Base Erosion and Anti-Abuse Tax (BEAT) provisions in the Tax Cuts and Job Act of 2017 can be roughly compared to the minimum tax proposals in the OECD discussion draft.

For the most part, the Hill has not gotten into the details of any of the proposals, and has generally limited its public comments to being supportive of Treasury using the OECD process to ward off any one-off measures. In their January letter, Sens. Grassley and Wyden said "[w]e are supportive of the United States Treasury Department's active participation in the ongoing negotiations at the OECD regarding these new tax challenges. We urge you and your OECD counterparts to work expeditiously to achieve agreement on a measured and comprehensive approach to how international tax rules might be crafted to address such challenges."

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