Overview

This program addresses tax challenges affecting businesses engaged in cross-border transactions, with particular attention to the effects of digital goods and services. Business advisors need to understand the changing tax landscape, including new definitions for nexus and new approaches to sourcing and allocating taxable income, which will have far-reaching effects throughout the international business community. This program is not just for large tech companies and multinationals!

Innovation in internet and related communication technology has spawned new ways for firms to tap into foreign markets. Business models built on digital platforms can generate significant income from remote markets through network connections, without a significant physical presence in the form of facilities or personnel. The sharing economy, cloud computing, streaming services, electronic marketplaces, advertising, and software services provide examples of activities that can target remote markets from operational bases that could be anywhere. Moreover, these activities are a common part of many business models.

Digital operations have eroded the state’s power to tax effectively. As the value chain for providing goods and services continues to expand across jurisdictional boundaries, governments have struggled to address their ability to capture an appropriate share of cross-border activity. The “permanent establishment” concept utilized in treaties over the past century to allocate taxing authority can leave significant gaps, allowing firms without a physical presence in a market state to avoid income taxation there. Moreover, firms have also developed clever techniques to shift income from high-tax to low-tax jurisdictions, which further erode the tax
base. Governments have responded by developing various anti-avoidance rules to protect their
domestic tax base and prevent shifting profits elsewhere.

The Organization for Economic Cooperation and Development (OECD) has been the leading
NGO devoting efforts toward study and policy development for a coordinated response to this
changing tax environment. While sovereign states maintain their own power to impose taxes,
coordinated approaches offer advantages, including more efficient compliance and the avoidance
of double-taxing or double-non-taxing income.

Beginning with a 2013 report on base erosion and profit shifting (“BEPS”), the OECD identified
the jurisdiction to tax digital goods and services as one part of a multi-pronged action plan to
address the changing tax environment. However, the complexities of the digital landscape and
differences in policy commitments among state participants have contributed to disagreements.
If rules change to allow market states to tax more of the income generated by the digital
economy, states which previously taxed that income – including those where intellectual
property, capital, and management skills are located, will be losers.

While the OECD continues to work on a coordinated solution, other governments are working on
their own solutions. The EU launched a coordinated digital tax proposal of its own in 2015,
which targeted large businesses utilizing digital platforms. However, EU countries have also
failed to reach an agreement on a coordinated approach for member nations. Some EU countries
(and in some cases, states within those countries) have resolved to forge ahead with digital tax
proposals of their own, including the UK, Spain, France, and Italy. Outside of the EU, other
countries are modifying their tax laws to address their conception of the value proposition
inherent in the digital environment, including the role of their consumers.

So far, these country-specific approaches have taken four primary forms: (1) changing the PE
threshold; (2) withholding taxes involving payments for digital goods and services; (3) so-called
“turnover taxes” on gross receipts from firms offering digital goods and services; and (4) specific
taxes targeting large multinational enterprises with digital activities. The OECD will be taking
these approaches into account in its quest to find a coordinated approach.

Although one might be tempted to dismiss these tax developments as creating problems that only
affect the largest multinational firms, think again. Approaches based on changing the PE
concept will likely have the most far-reaching effects on firms conducting business abroad,
including smaller ones. If the PE concept is modified to permit a significant digital or online
presence, income tax possibilities become magnified. India, the Slovak Republic, and Israel
have all started down this path. Still unresolved is the manner of solving competing claims for
allocating income among different states.

While most firms engaged in cross-border businesses have experiences with withholding taxes,
expanding the withholding tax base from traditional categories of interest, dividends, and
royalties to include certain kinds of digital and technical services will change the economics of
delivering those services as well as present new compliance challenges. While business
customers in a market state may bear some of the compliance burdens, firms dealing directly
with consumers may face special compliance challenges as rules emerge to shift the locus of collection and payment responsibilities.

When tax obligations are based on reaching minimum thresholds (such as gross receipts or the number of transactions within a jurisdiction), business planners and tax policymakers will both need to carefully think through the significance of legal structures for delivering products and services to foreign markets.

Concerns about double-taxation in this regime are well-founded, particularly when states use different approaches. These tax changes are likely to enhance the possibilities of conflict with taxing authorities of multiple states. Such problems are akin to those experienced on a sub-national level in the United States, where U.S. states adopt different income allocation approaches. Bilateral tax treaties and the foreign tax credit regime are both designed to address the double-taxation concern. Treaty protections will require new scrutiny, and some of these taxes will also present U.S. taxpayers with challenges in obtaining a foreign tax credit to offset taxes imposed elsewhere. A creditable tax must have a predominant character as an income tax in the U.S.; gross receipts taxes may not be able to satisfy these requirements.
Digital Taxation: Expanding the Jurisdictional Reach

ABA Business Law Section Annual Meeting
September 13, 2019
Washington, DC
Panelists:

• **Jeremiah Coder**  jeremiah.coder@pwc.com
  
  *Director - Global Tax Policy, PricewaterhouseCoopers, LLP, Washington, D.C.*

• **Pamela A. Fuller**  Pafuller@global-tax-strategies.com
  
  *Of Counsel, Royse Law Firm, Menlo Park, California*
  
  *Of Counsel, Tully Rinkey, PLLC, New York, New York*

• **Edward A. Morse**  morse@creighton.edu
  
  *Professor of Law, Creighton University School of Law, Omaha, Nebraska*
Overview: Goals for this Program

• Provide a framework for understanding the challenges in the current trans-national tax environment, with particular emphasis on digital goods and services.

• Examine country-specific efforts to tax digital goods and services and potential impacts on businesses in this space.

• Explore OECD role in coordinated solutions to taxing income generated in the digital economy and tensions that are preventing agreement on a common approach.

• Discuss legal and strategic considerations for business advisors to assess and address tax risks in the current environment.
Jurisdiction: Sovereign Power to Tax

• Jurisdiction is a prerequisite to taxation, which is recognized as a prerogative of a sovereign state.
• Source-based and residence-based approaches justify the exercise of sovereignty to tax income within a state’s borders.
  • Source looks to the jurisdiction where income is earned.
  • Residence looks to one who earns or controls income within the jurisdiction.
• World-wide vs. territorial approaches also affect the jurisdictional reach.
• Citizenship and/or domicile concepts work reasonably well for individuals, but corporations present challenges: they can be formed anywhere and operations often span multiple jurisdictions.
Physical Presence: A Jurisdictional Marker

• In a mercantile world, goods have to be made, transported, stored, and used somewhere, opening the likelihood of a physical connection to the jurisdiction.

• Where those activities span multiple jurisdictions, a “Permanent Establishment” (PE) concept emerged to establish a jurisdictional threshold for sovereign taxing rights over the income of a nonresident.
  • A foreign corporation is taxed on income effectively connected to its PE.
  • A foreign corporation could potentially avoid PE status by using an independent domestic agent, but the agent would then become taxable on its earnings.
  • Either way, the market state potentially got to tax some of the income.
  • PEs also provide a locus for payment/collection of other taxes, too, such as property taxes and consumption taxes (sales, VAT).
Tax Avoidance Rules

• Accurate country-specific profits requires tax avoidance rules.
  • Transfer pricing problems create challenges for determining the portion of income effectively connected to a particular PE
    • E.g., Manufacturer (High-Tax Country A) sells to Marketing Subsidiary (Low-Tax Country B) at cost, moving profits to the low-tax jurisdiction.
    • Arm’s length principle used to address this problem, but fraught with complexity.
    • Documentation, transparency, and disclosure is required to make this effective.
  • Controlled Foreign Corporation Rules (Subpart F) may also deter through allowing Country A to tax Manufacturer on Subsidiary income, too, even though that income is not repatriated from Country B.
  • Interest, royalties, and other deductible payments between related parties likewise shrink the tax base, calling for still more rules to protect the tax base.
Tax Competition

• High-tax jurisdictions face competitive pressures, as investment and income-producing activity moves elsewhere.
  • Corporate tax rates have been trending downward (US: 35% to 21%)
  • Lowering rates reduces incentives for tax avoidance activity.
  • But remember: Tax = Rate x Base. Base matters, too.

• Sovereignty without coordination equals potential conflict.
  • Double taxation can result.
  • But double-non-taxation can also result.

• Treaties provide a basis for coordination and dispute resolution; so do international NGOs like OECD, UN, etc.
Tax Challenges Emerging from Technology

• Technological change has accelerated international tensions over tax.
• Global value chains reflect fragmented production across borders.
  • Value creation disproportionately comes from the knowledge economy, affecting development/design and marketing/branding activities.
  • Trade barriers and transportation costs are falling, accelerating global movement of goods and services.
• Internet and communication technologies not only enhance the ability to trade and move operations, but they also create new economic activities based on remote interaction with market states.
• But of course, technology sometimes favors the tax collector: more information, more processing, more
Tax Challenges of the Digital Economy

• Firms can interact with customers and deliver digital goods and services apart from any physical presence in a market jurisdiction.
  • This creates opportunities to generate income from customers within a state without the state’s ability to tax that income under traditional features.
  • Intangibles embedded in these businesses can be created and maintained outside the jurisdiction, further depriving the state of tax revenues.
  • The customer state provides infrastructure and support for consumers, who in turn provide data that can be further monetized by businesses through other value-creating activity, such as advertising.

• Do we understand these business models well enough to allocate value appropriately?

• Note that business without a PE also potentially affects the collection of consumption taxes (e.g., sales or VAT) on such goods and services, particularly in the B-C context.

• States have responded to similar challenges with familiar strategies. For example:
  • Treaties addressed insurance premiums without a PE – a form of remote services.
  • Withholding taxes may be imposed on those who pay a nonresident firm, effectively taxing them on gross receipts (e.g., royalties based on the use of IP within the market state, interest, or dividends).

• But states are also seeking to expand their tax jurisdiction in other ways.
“Unilateral” Initiatives by Nation-States (and EU)
Interim Measures – an OECD misstep?

2008 Interim Report on Digital Economy

• Design considerations:
  – Compliance with international obligations; temporary nature; minimize over-taxation; minimize impact on startups/SMEs; minimize cost/complexity

• Potential side effects:
  – Impact on innovation, investment, growth; over-taxation; compliance costs; administrative problems;
Unilateral measures – Big Picture

- Modification of PE definition
- Turnover tax/ Withholding tax
- Combination BEAT/ GILTI

*Non-exhaustive overview. Some measures are proposed and have not yet been formally introduced.
Recent unilateral measures

**DPT (and MAAL, Aus)**
- **Rate:** 25% / 40%
- **Effective from:** 2015/18, 2016
- **Countries:** United Kingdom, Australia

**Virtual PE**
- **Rate:** 28% / TBC
- **Effective from:** 2019, TBC
- **Countries:** Italy, Korea

**Novel new source / deeming provisions**
- **Rate:** 20% / CT rates
- **Effective from:** 2017 / 2018 / 2019
- **Countries:** United Kingdom, Hong Kong, Taiwan

**Significant Economic Presence**
- **Rate:** CT rates
- **Effective from:** 2019
- **Countries:** India

**Equalisation Levy**
- **Rate:** 6% / 5% / 10%
- **Effective from:** 2016, 2019, TBC
- **Countries:** India, Pakistan, Chile

**VAT / Sales Tax**
- **Rate:** Various
- **Effective from:** 2016, 2017, 2018, 2019
- **Countries:** Russia, Israel, Saudi, Canada...

**Digital Services Tax**
- **Rate:** 2% - 7%
- **Effective from:** 2019, 2020
- **Countries:** France, Italy, UK, Spain, Czech Republic, Poland

**Digital Advertising Tax**
- **Rate:** 3% / 5%
- **Effective from:** In force, 2020
- **Countries:** Hungary, Austria
“Non-turnover-based” Unilateral Measures: Virtual/digital PEs and significant economic presence

**European Union**
- Directive on significant digital presence (i.e. digital PE)
  - Threshold
    - 3000 contracts; or
    - 100,000 users; or
    - €7m revenues in a Member State
  - Scope
    - Broad – almost all digitally supplied services, except specific exemptions
  - Basis
    - Income allocated by profit split on destination favourable factors
  - Application
    - From January 1, 2020
  - Status: under negotiation (although not currently being focused on)

**India**
- New threshold introduced under Finance Act 2018
  - Threshold
    - Revenues from physical goods/services (TBC)
    - Revenues from digital goods/services (TBC)
    - Number of users (TBC)
  - Scope and Basis
    - Broad – income from India (from services above) deemed to arise in India
  - Application
    - From April 1, 2019
  - Status: comes into force on April 1, 2019; guidance expected on detail imminently (following consultation in 2018)

**Italy**
- New threshold introduced under Finance Act 2018
  - Threshold
    - “A significant and continuous economic presence in the territory of the State set up in a way that it does not result in a substantial physical presence in the same territory”
  - Basis
    - No change from previous application; OECD TPG
  - Application
    - From January 1, 2018
  - Status: in force

• Only applicable where no relevant bilateral tax treaty
Turnover-based Unilateral Measures: Equalization levies and digital service taxes (DSTs)

<table>
<thead>
<tr>
<th>India</th>
<th>European Union</th>
</tr>
</thead>
</table>
| • Indian Finance Act 2016  
  • Threshold  
  - Online advertising supplied to Indian residents by non-Indian residents  
  • Scope  
  - Online advertising services  
  • Basis  
  - Gross revenues, tax to be withheld and remitted by the payer  
  • Rate  
  - 6%  
  • Application  
  - From June 1, 2016  
  • **Status: In force**  
| • Directive for a common digital services tax (DST)  
  • Threshold  
  - €750m global turnover, with >€50m from EU  
  • Scope  
  - Advertising  
  - Intermediation of Platforms  
  - Transmission of User Data  
  • Basis  
  - Where user (rather than payer or payee) is located  
  • Rate  
  - 3%  
  • Application  
  - From January 2020  
  - From January 1, 2021  
  - Sunset clause – 2025, or OECD or EU agreement |
**Turnover-based Unilateral Measures:**
**Digital service taxes and equalization levies**

**France**
- **Effective date:** from 1 January 2019
- **Rate:** 3%
- **Global threshold:** €750m
- **French local threshold:** €25m deemed revenue
- **Scope:**
  - Provision of a digital interface allowing users to interact for the supply of goods or services
  - Provision of advertising targeting services based on users’ data
  - Sale of data collected online for targeted advertising
- **Exclusions:**
  - Sale of goods and services, including digital content; communication services or payment services
  - Financial services provided to regulated users (subject to Ministerial Order)
  - Intra-group services (avoid double counting)

**United Kingdom**
- **Local law announced in advance of EU negotiations reaching initial conclusions. Tax based on user participation.**
- **Threshold**
  - £500m global turnover, with >£25m from in scope, UK activities
- **Scope**
  - Search engines
  - Social media
  - Online marketplaces
- **Basis**
  - Direct or indirect revenues from activities in scope relating to UK users
- **Rate**
  - 2%
  - Safe harbour for low margin businesses (unclear how this margin/profitability will be calculated)
- **Application**
  - From April 1, 2020
Letter of 24 June 2019 by Senators Grassley and Wyden to US Treasury Secretary Mnuchin re: French DST

“We write to encourage you to intensify your efforts to convince the French government that it would be unwise and short-sighted to implement a digital services tax (DST) while France, the United States, and other countries are expeditiously working to reach a consensus at the Organisation for Economic Co-operation and Development (OECD) on the tax challenges arising from the digitalization of the economy.”

The DST would unfairly target certain U.S.-based multinational companies, apply retroactively to the beginning of this year, and potentially lead to significant double taxation
Treasury Deputy Assistant Sec’y for Int’l Tax Affairs, Chip Harter, comments of 12 March:

- French proposal could be challenged as discriminatory vis-à-vis US companies under the WTO, specific trade agreements, and treaties (no mention of IRC § 891)
- “The U.S. is opposed to any digital services tax proposals…. [U]ser participation is just not a sound basis for taxing companies….”
- “users are unrelated parties and…their input is purchased on barter basis [for] a free service.”
“The U.S. firmly opposes proposals by any country to single out digital companies. Some of these companies are among the greatest contributors to U.S. job creation and economic growth. Imposing new and redundant tax burdens would inhibit growth and ultimately harm workers and consumers. I fully support international cooperation to address broader tax challenges arising from the modern economy and to put the international tax system on a more sustainable footing.”

Secretary of the Treasury Steven Mnuchin (March 16, 2019)
U.S. Retaliatory Measures - Toolkit

- **Trade/tariffs**
  - USTR initiated 301 investigation into whether French DST is discriminatory; public hearing on Aug 19; USTR can determine range of sanctions (e.g., tariffs)
  - The U.S. could bring a WTO challenge against France re: the DST (however, long adjudicatory period and U.S. not keen on WTO)

- **Tax**
  - Congressional leaders have indicated that Treasury should consider using Code Sec. 891 to impose double tax on French citizens subject to U.S. taxes (never been used before since enacted in 1938)
Multilateral Initiatives
### Post-BEPS concerns raised

#### OECD Interim Report 2018

<table>
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<tr>
<th>Scale without mass</th>
<th>Heavy reliance on intangible assets</th>
<th>Data &amp; user participation</th>
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<tr>
<td>Existing profit allocation rules &amp; nexus rules</td>
<td>Effectiveness of BEPS actions</td>
<td>DEMPE / Risk</td>
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<td>Ability to limit local functions and serve market remotely</td>
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<td>Avoided PEs</td>
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<tr>
<td>Current rules do not grant sufficient taxing rights over intangible property in new settings</td>
<td></td>
<td>Treaty access</td>
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<tr>
<td>Certain aspects of digitalizing economy, often based on data and users, create under taxed value</td>
<td></td>
<td>Tax competition</td>
</tr>
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</table>

While BEPS was effective … not effective enough
### OECD Public Consultation: An Overview

#### Pillar 1
**Broader challenges of digitalized economy and allocation of taxing rights**

- Where should taxes be paid (nexus / allocation of taxing rights)?
- How can profits be allocated to be locally taxed (profit attribution)?
- Attempt to avoid uncoordinated unilateral action

**Proposals (beyond the arm’s length principle):**
1. “user participation”
2. “marketing intangibles”
3. “significant economic presence”

#### Pillar 2
**Remaining BEPS Issues: Base erosion and profit-shifting**

- How could, in particular, the risk of profit-shifting be addressed?
- Attempt to avoid uncoordinated unilateral action

**Proposal:**
1. “income inclusion rule” combined with
2. “tax on base eroding payments”

**Starting Point**

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- **Interim Report 2018**
- **BEPS Inclusive Framework, BEPS Action 1**
OECD Consultation Documents

- 2 anti-base erosion proposals
  - Both recall harmful tax competition concern
  - Income inclusion proposal
    - Policies of the GILTI regime (min tax on CFCs)
  - Low-tax proposal
    - From the standpoint of hybridity being only one form of tax arbitrage; US’s own anti-hybrid regs are lacking just as Action 2.
    - This though would be very complicated (ETR + imported mismatch rules for all payments etc)
Pillar 1: Revised profit allocation and nexus rules

A) User Participation
- Developed by UK; Key DST idea
- Social media, search engines, online marketplaces

B) Marketing Intangibles
- Getting very serious consideration; US is major proponent
- Intent is to reallocate some income to destination jurisdiction. Simplified/formulaic (non-ALS) approaches being considered

C) Significant Economic Presence
- Reduced nexus threshold plus formula apportionment; India + G24
- Lowers nexus threshold; formula apportionment of unitary/group wide income
# OECD Project Timeline

<table>
<thead>
<tr>
<th>Date/Period</th>
<th>Event Description</th>
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<tbody>
<tr>
<td>31 May 2019</td>
<td>Workplan released</td>
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<tr>
<td>June 2019</td>
<td>G20 meetings; Work Plan endorsed by Finance Ministers</td>
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<tr>
<td>June/July 2019</td>
<td>IF meetings</td>
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<tr>
<td>July 2019</td>
<td>G7 Finance Mins meeting (France)</td>
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<tr>
<td>Fall 2019</td>
<td>Public consultation &amp; intermediate econ. analysis released</td>
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<tr>
<td>December 2019</td>
<td>IF Progress report</td>
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<tr>
<td>January 2020</td>
<td>Political agreement on unified approach</td>
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<tr>
<td>Through 2020</td>
<td>Detailed technical work by working parties</td>
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<tr>
<td>Fall 2020</td>
<td>G20 Finance Mins meeting (Sep/Oct)</td>
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<td></td>
<td>Final Report to G20 Leaders (Nov)</td>
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</tbody>
</table>
OECD Pillar I
Proposal A

“User Participation” Test
OECD Public Consultation – Pillar 1 (A)

(A) “User Participation” Proposal

“User participation”
- Gives more taxing rights to user jurisdictions
- Limited scope: social media platforms / search engines / online marketplaces
- Nexus based on (valuable) user participation
- Non-routine / residual profit split approach (beyond arm’s length principle) to determine value created by users, i.e., current rules would continue to be used for determination of profits connected to routine functions
- Formula based determination of user value
- Strong dispute resolution component
- Critics: Value creation by business or by third parties (users)? Relevance beyond highly digitalized businesses? Sustainable solution? ...
Pillar 1: Revised profit allocation and nexus rules:

(A) User Participation

Rationale

• Activities and participation of “users” are a critical component of value creation, both absolutely and relatively
• This is only true for certain highly digitalised businesses

Business models in scope

• Social media
• Search engines
• Online marketplaces

Proposed methodology

• Calculate “residual” profits
• Attribute portion of residual to “user base”
• Allocate between jurisdictions where users are located
• Give rights to jurisdictions to tax these profits
OECD Pillar I
Proposal B

“Market Intangibles” Test
Pillar 1: Revised profit allocation and nexus rules

(B) Marketing intangibles

**Rationale**

- Remote / limited access to markets can allow for development of large customer bases / user bases
- Customer data and relationships contribute to brand / marketing intangibles (more than favourable demand conditions alone)
- Distinction between “trade” and “marketing” intangibles

**Option 1**

- Update transfer pricing rules to recognise “marketing” intangibles (and risks) separate to “trade” intangibles
- Allocate to “market” jurisdiction based on agreed metrics (e.g. revenues or users)

**Option 2**

- Undertake a residual profit split (functional or formulaic) following allocation of routine functions
- Allocate to “market” jurisdiction based on agreed metrics (e.g. revenues or users)
Pillar 1: Revised profit allocation and nexus rules
(B) “Marketing Intangibles”

- Gives more taxing rights to market jurisdictions
- Wider scope than the user participation approach (intrinsic functional link between marketing intangibles and a market jurisdiction)
- Nexus based on marketing intangibles allocated to market jurisdictions:
  - Activity in a market jurisdiction without taxable presence would become taxable based on non-routine income
  - LRD-structures (highly digitalized and consumer product businesses) would be taxed on a broader tax basis
- Non-routine income connected with marketing intangibles and attendant risks, i.e., current rules would continue to be used for determination of profits connected to routine functions
OECD Public Consultation – Pillar 1 (cont.)

- Fractional apportionment method:
  - Tax base (global profit rate of the MNE group)
  - Allocation keys (sales, assets, employees, user in specific businesses)
  - Weighing

- Modified deemed profits methods
OECD Public Consultation – Pillar 1 (cont.)

- Attribution of income irrespective of the legal owner in the group, of the execution of the DEMPE functions or the risk-relations according to the current TP rules

- Allocation methods:
  - Application of the transactional TP rules (determination of the marketing intangibles and the allocated profit under two assumptions)
  - Revised residual (non-routine) profit split analysis and application to the market jurisdictions

- Marketing intangibles (remotely controlled, e.g., by usage of a LRD or a limited physical presence (online retailer)) vs. trade intangibles; DEMPE functions could be avoided in the market jurisdiction

- Critics: Intrinsic link given, e.g., in case of not significantly local user-tailored marketing? B2B vs. B2C? ...
OECD Public Consultation (cont.)

- Pillars influenced by US marketing intangible proposal and GILTI
  - And see remarks of Treasury Dep. Asst Sec’y for Int’l Tax Affairs Harter above

- Johnson & Johnson letter per OECD Consultation for market country return:
  - Marketing intangible proposal would be complicated leading to disputes re system profit/routine returns/residual profit from marketing intangible/apportionment
OECD Public Consultation (cont.)

Instead: market country share from Local Mkt Distributor (deemed if digital):

- Base return of a % of ROS
- Adjusted up/down for high/low oper. Margin
- Adjusted up/down for targeted marketing spend above/below a certain % of sales
- Capped at a % of group business line profit
- Functions not part of mktg/sales/distribution would remain outside this regime.
OECD Pillar I
Proposal C

“Significant Economic Presence”
OECD Public Consultation – Pillar 1

(C) “Significant Economic Presence”

- **“Significant economic presence”** (also see Action 1 report)
  - Reconsideration of existing nexus concepts (see also Supreme Court Decision 21 June 2018: South Dakota v. Wayfair, Inc., 17-494)
  - (Cumulative / alternative) Factor-approach, e.g.,
    - Existing user base and associated data input
    - Volume of digital content derived from a relevant jurisdiction
    - Billing and collection in local currency or with local form of payment
    - Maintenance of a website in a local language
    - Responsibility of the final delivery of the goods to customers or the provision by the enterprise of other support services (after-sales, repairs, maintenance)
    - Sustained marketing and sales promotion activities to attract customers
  - Thresholds? Types of transactions covered?
Pillar 1: Revised profit allocation and nexus rules:
(C) Significant Economic Presence

Rationale

• Similar to (B), would apply to all businesses considered to be generating value from interactions with customers/users
• However, intended to be simpler to apply for developing countries, and would thus be closer to global formulary apportionment in practice

Nexus: Revenue + (one or more of...)

• Users
• Volume of digital content derived
• Billing/collection currency
• Local payment systems
• Local language website
• Sustained marketing activities

Allocation: Fractional apportionment

• Define tax base to be divided (e.g. global profit margin * local sales)
• Use weighted allocation keys (e.g. users sales, assets, employees...)


OECD’s “Significant Economic Presence” Test

- Taxable presence in a country on the basis of factors that evidence a purposeful and sustained interaction with the economy of that country via technology and other automated tools
- Factors: Revenue generated on a sustained basis + Users / Volume of digital content derived / Billing/collection currency / sustained marketing activities, etc.
- Profit allocation to SEP on fractional apportionment method
- Aiming for a simplified solution
Significant Economic Presence: India

- 2017 Update to OECD Model Tax Convention - India reserved right to include in Article 5 a SEP test (based on criteria identified in BEPS Action 1 Report 2015) will for establishing a permanent establishment

- 2018 Finance Act - Introduction of SEP by expanding definition of ‘business connection’ under Indian law, to be effective April 1, 2019

- SEP means –
  - transactions in respect of any goods, services or property, including download of data or software
  - systematic and continuous soliciting of business or engaging in interaction with users

- Threshold – Revenue, number of users - Not yet notified

- Not applicable in a treaty scenario unless Article 5 of India’s treaties are modified

- Proposed amendment to PE profit attribution rules - apportioning profits on basis of four factors of sales, employees, asset and users (different weightage for low / medium user intensity v. high user intensity)

- Temporary measure until global consensus?
OECD Pillar 2

The “Base Erosion” Proposal and Minimum Tax
**Tax and the digitalization of the economy**

**Pillar 2: Global anti-base erosion erosion proposal**

### Rationale

- Existing BEPS rules do not provide comprehensive solution to risk of moving profits to low/no tax jurisdictions
- Particular concern in relation to intangibles (which are prevalent in highly digitalised businesses, among others)

### Income inclusion rule

- Minimum taxation at shareholder level for significant direct / indirect ownership
- Foreign branch exemptions “switched” off if minimum tax not met
- Supplement (not replace) existing CFC rules
- EU could implement via Directive

### Tax on base-eroding payments

- Denial of deduction for certain payments to related parties (common ownership) not subject to a minimum effective taxation by recipient
- Treaty benefit restriction where payments were “undertaxed” (limiting the application of Articles 7, 9, 10, 11-13 and 21) – some of which may also apply for third parties
Tax and the digitalization of the economy

Pillar 2: Global anti-base erosion proposal (cont. 1)

• **Rational for proposal:** While BEPS measures further “aligned taxation with value creation, and closed gaps that allowed for double taxation, BEPS has not provided a comprehensive solution to … structures that shift profits to entities w/no or very low taxation. Underlying policy concern about global “race to the bottom” and other countries’ tax bases in general…

• Proposal is *not limited* to highly digitalized businesses.

• Proposal is broadly systemic, and designed to ensure that ALL internationally operating businesses pay a minimum level of tax.

• Proposal does not tolerate the allocation of a high level of risk-related returns to jurisdictions where there is really only a “modest” level of substance.
Tax and the digitalization of the economy

Pillar 2: Global anti-base erosion proposal
(cont. 2) A two-part inter-related proposed rule

- **Income inclusion rule:** would tax the income of a foreign branch or a 25% “controlled” entity IF that income is otherwise subject to a low effective tax rate in the jurisdiction or “establishment or residence.”
  - Would supplement, not replace, countries’ CFC rules
  - Commanders criticized entire concept as being too complicated, and aimed at same thing at which BEPS provisions are aimed. Also, 25% threshold would conflict with most countries’ CFC rules (with use > 50%).

- **Tax on base eroding payments:** would deny a deduction or treaty relief for certain payments unless that payment was subject to an ETR at or above a minimum.
  - “Undertaxed payments rule” would deny dds for paymts to related party if below minimum rate
  - “Subject-to-Tax rule” in tax treaties would grant certain treaty benefits only if the item of income is sufficiently taxed in the other state. (like Action 2 hybrid rules….but focused on the rate?)
Tax and the digitalization of the economy
Pillar 2: Global anti-base erosion proposal (cont.)
Pros, Cons, and Criticisms

• **Pros:** Could provide “full lifetime employment to international tax lawyers” given its inherent complexity—i.e., global GILTI rule + a global BEAT rule

• **Cons:**
  - *Represents real infringement on national sovereignty* (Countries should be able to choose their corporate tax rate to support their own needs, infrastructure.)
  - *Extremely complex in application,* and yet does not appear sufficiently tailored to its stated purposes (i.e., to address risk of profit shifting to entities subject to no or low taxation).
  - *Would target genuine investments* that lead to real economic activity
  - *Could create real barriers to trade* where payments represent real economic costs and are made to real biz operations
  - *Distortive behavioral economic effects* of establishing a “one-size-fits-all” global minimum rate (especially when it is imposed country-by-country)
  - *Overly broad:* proposal goes way beyond targeting
Strategic Considerations

• Where appropriate, do some internal economic modeling to understand how various Pillar 1 profit allocation options might affect ETR
• Identify jurisdictions where would have tax exposure under revised nexus standard
Mythbusters

• *This only affects digital/tech companies*
  
o  No. The OECD’s work will likely impact the international tax rules by introducing new concepts of nexus and profit allocation that will be generally applicable regardless of industry/business model.

• *C-Suite can wait until the final report is written in 2020 to think about this*
  
o  No. The OECD expects a political solution to be reached in 2019, and the technical rules to be written in 2020. Any ability to influence the conversation needs to happen now through engagement with the OECD/Inclusive Framework members or participation in business advocacy groups.