OECD BEPS (In)ACTION 1: FACTOR PRESENCE AS A SOLUTION TO TAX ISSUES OF THE DIGITAL ECONOMY

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BEPS

• Feb. 2013: OECD launches BEPS project
• BEPS is “base erosion and profit shifting,” i.e., tax planning that shifts profits in ways that erode the taxable base to locations with more favorable tax treatment
• Global and comprehensive plan to address issues
• July 2013: Action Plan with 15 actions
• 2015: All final reports for all actions issued
• First substantial renovation of the international tax standards in almost a century
Action 1
Tax Challenges of the Digital Economy

• Identify main difficulties that digital economy poses for applying existing international tax rules
• Develop detailed options to address the difficulties
• Issues included the ability of a company to have a significant digital presence in the economy of another country without being liable to taxation due to lack of nexus under current rules
International Tax Rules

• Income tax only if an enterprise has a sufficient nexus with the economic life of a country, with the present standard physical presence, i.e., a permanent establishment (PE)
• Some treaties provide for taxation if equipment in a jurisdiction or certain services
• Through digital methods, a business can participate in the economic life of a country without physical presence
• Under present tax rules, income can escape taxation
2015 Action 1 Final Report

- Cannot “ring-fence” digital economy
- Does not create unique BEPS issues but it does “exacerbate” them
- Exacerbated risks are substantially addressed by other Actions
- Did not recommend any solution
- In any case, allocating taxation rights is not a BEPS issue
- Gave approval to countries to use any options OECD considered, provided treaty obligations are respected
- Would continue to monitor developments and data with next report in 2020
Final Report - Options

- Significant economic presence nexus
- Withholding tax on digital transactions
- Equalization levy
Unilateral Solutions

• UK 2015: Diverted Profits Tax (DPT)—”contrived arrangements designed to erode the UK tax base” through avoiding creating PE or arrangements with no economic substance; 25% rate versus regular tax rate of 19%

• Australia 2016: DPT and Multinational Antiavoidance Law (MAAL); 40% rate for DPT and 30% for MAAL; regular rate of 30%

• India 2016: Equalization levy; 6% tax on gross business to business payments enforced through withholding; currently only on online advertising

• Israel 2016: Online services create digital presence (online conclusion of contracts, use of online services or products, locally targeted websites, revenue from online activates of users)
Post-Final Action 1 Report
2016-2017

• Relative silence and a general feeling that no action would be taken on changing nexus standard
• March 2017: G20 asked OECD for update
• July 2017: OECD recognized “growing sense of urgency” to address issues
Post-Final Action 1 Report
2016-2017

• Sept. 2017: EC released report
  • International consensus cannot be reached
  • Inaction is unsustainable solution
  • Proposed three interim solutions:
    • Equalization tax on turnover
    • Withholding tax on digital transactions
    • Levy on revenues generated from digital services or advertising
Post-Final Action 1 Report
2016-2017

• Oct. 2017: EC launched public consultation
• Nov. 2017: OECD held public consultation at UC Berkeley
• Dec. 2017: European Council adopted conclusions for EU input
  • Digital businesses must pay their fair share of tax where value is created
  • Encourage implementation of OECD BEPS Actions
  • Lack of physical presence should not prevent taxation in a jurisdiction where there is an appropriate nexus reflecting value creation
  • Recommend considering virtual PE concept
• Dec. 2017: U.S. enacted TCJA, including Base Erosion and Anti-abuse Tax (BEAT) and Global Intangible Low-Taxed Income (GILTI)
March 2018 OECD Interim Report

- Recommended no solution but laid groundwork to reach consensus
- Agreed to undertake review of nexus and profit allocation in order to allocate profits to economic activities and value creation
- Plan to reach consensus-based solution by 2020 and update in 2019
- Addressed potential interim solutions, but, no consensus on whether countries should adopt interim solutions and therefore no recommendation
- Framework for interim solutions:
  - Comply with international obligations
  - Temporary solution
  - Targeted to highest risk companies
  - Minimization of excess taxation, impact on new and small businesses, and cost and complexity
U.S. Treasury Reaction

“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.”
March 2018 EU Impact Assessment and Proposals

• Current situation is “clearly unsustainable”:
  • More tax avoidance opportunities
  • Less tax revenues
  • Negative impact on social fairness
  • Destabilization of level playing fields for businesses

• Cross-border digital businesses have effective tax rate of 9.5% versus 23.2% for traditional businesses

• If no comprehensive global solution, countries will take unilateral measures
March 2018 EU Impact Assessment and Proposals

• Proposed long-term solution of expanding scope of PEs to companies with a significant digital presence:
  • Revenues from digital services in excess of 7 million euros
  • More than 100,000 users OR
  • 3,000 online business contracts

• Proposed interim solution of digital services tax (DST)
  • 3% tax on turnover of large digital companies (more than 750 million euros annual global turnover and 50 million euros annual EU sales)
  • Levied where user located (location of device used to access service)
What happened to EU Proposals?

• Dec. 2018: abandoned proposal as failed to reach agreement
• Mar. 2019: failed to get unanimous consent on a watered-down Digital Advertising Tax (DAT)
More Unilateral Measures

• Countries proposed or enacted DSTs: Austria, Belgium, Chile, Czech Republic, France, Hungary, Italy, Malaysia, Mexico, Spain, United Kingdom,

• Australia considered but decided not to pursue

• United States has vowed to retaliate
Nexus in a Digital Economy

• OECD: The continual increase in the potential of digital technologies and the reduced need in many cases for extensive physical presence in order to carry on business, combined with the increasing role of network effects generated by customer interactions, can raise questions as to whether the current rules to determine nexus with a jurisdiction for tax purposes are appropriate.

• EU: Companies operate in a fundamentally different manner today. Physical presence is no longer required to sell goods and services into a market. International tax rules are “no longer fit for purpose.”
Jan. 2019 OECD Policy Note

• Two pillar approach:
  • Pillar #1: Allocation of taxing rights that expand taxing rights of user or market jurisdiction
  • Pillar #2: Address remaining BEPS issues by strengthening the ability of countries to tax profits where the other jurisdiction with taxing rights has no or low tax rates
• Any new rules will not result in taxation where there is no economic profit, and no double taxation
• Will go beyond arm’s length principle of transfer pricing
• Considered to be major breakthrough
Pillar #1 Proposals

• **User Participation**: revise profit allocation rules to accommodate value creating activities of an active and engaged user base for business models that benefit from user base, even if no physical presence; use residual profit split approach (U.K.)

• **Marketing Intangibles**: part of above-normal profits of all types of businesses allocated to countries where consumers are, even if no physical presence, through transfer pricing and treaty rules to allocate marketing intangibles to market jurisdiction (U.S. favored)
• **Significant Economic Presence:**
  • Taxable presence if purposeful and sustained interaction with jurisdiction via digital technology and other automated means; could allocate profits based on fractional apportionment method (sales, assets, employees, and users)
  • Revenue must be generated through significant economic presence
  • Would additionally require one or more other factors:
    • Existence of user base and associated data input
    • Volume of digital content derived from jurisdiction
    • Billing and collection in local currency or local form of payment
    • Website in local language
    • Responsibility for final delivery of goods to customers
    • Support services such as after-sales service or repairs and maintenance
    • Sustained marketing and sales promotion activities, either online or otherwise, to attract customers
Pillar #2 Proposals

• Tax on base eroding payments; similar to U.S. BEAT
• Income inclusion of foreign branch or subsidiary if low effective tax rate; similar to GILTI
Significant Economic Presence

• EU considered but rejected as too radical a “Destination-based Cash-flow Tax” (DBCFT) with taxation based on location of customers, and physical presence irrelevant

• G24 proposed in January 2019 a significant economic presence PE if business interacts extensively with customers in a market jurisdiction and generates business profits without a physical presence
PROPOSAL: Factor Presence Nexus

• Multistate Tax Commission model statute for business activities taxes, including income tax (2002)
• Ten states have adopted—Alabama, California, Colorado, Connecticut, Michigan, New York, Ohio, Tennessee, Virginia, Washington
Factors

• Taxable presence if exceed certain thresholds for property, payroll, or sales
• Better than single factor, such as sales, that would deem a PE for a company
• OECD agrees sales in themselves are not “sufficient in isolation” for nexus
What Would a Factor Presence Nexus Cover?

• All transactions, not just digital
• Meets OECD’s requirement of no ring-fencing
• Minimum thresholds would reduce compliance costs and administrative burdens
• Would give tax certainty
• How define where revenue generated?
• How avoid companies artificially fragmenting revenue?
How Would a Digital Presence be Measured and Determined?

• No need to have “digital factors”
• Would apply to all companies
How Could Income be Attributed to Factor Presence Nexus?

• Under existing rules, there would be no meaningful income allocation because little assets, functions, and risks

• OECD has suggested allocation “based on game theory that would allocate profits by analogy with a bargaining process within a joint venture”

• Could use profit split method, with OECD recommending that considerations include the particular industry, degree of integration of the company, and type of product or service
Profit Allocation – Formulary Apportionment

• Simplest solution would be to use system of states in the United States and allocate profits based on three-factor formula that parallels factor nexus—sales, property, and personnel
Objections to Factor Presence Nexus

- Main objection: too radical a change
- EC states “there is little appetite for fundamental reform options”
- OECD’s inaction shows cannot make major changes
- Difficult to implement reforms
- Enforcement
- “Value Creation”
Conclusions

• After seven years, there is still no solution
• OECD is moving closer to a consensus, but moving away from significant economic presence
• Without agreement, more and more countries will continue to enact unilateral solutions, making a consensus solution less and less likely
• Factor presence nexus is a straightforward, relatively simple solution; administrable and reasonable compliance costs
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