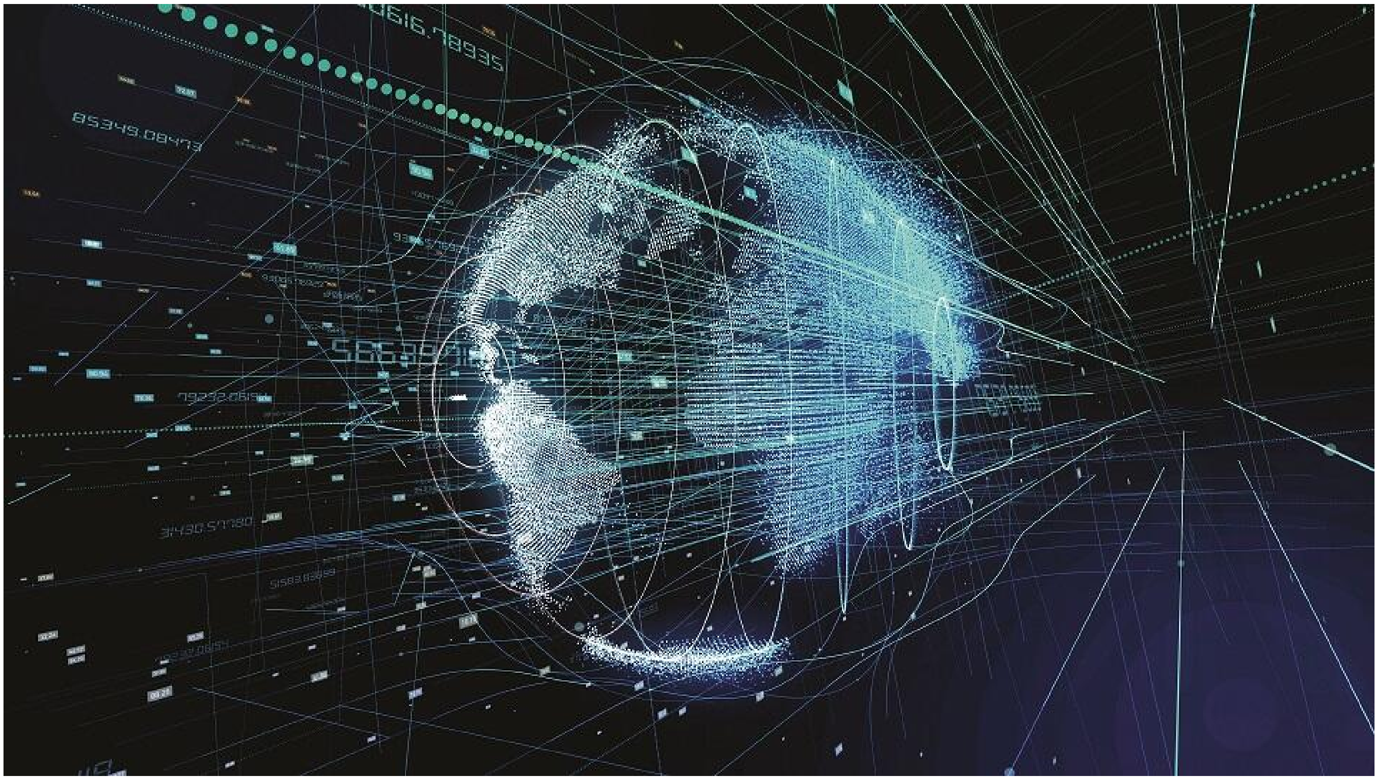
Global actions

International Tax | Large Corporate | Management of taxes



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James Ross and *Sarah Gabbai* consider the national and international responses to BEPS concerns arising from highly digitalised businesses

Key Points

What is the issue?

The OECD, the EU and certain countries, including the UK, have taken the view that the current international tax system is no longer fit for purpose in the digital age, and have sought to identify and address certain tax challenges exacerbated by digitalization.

What does it mean to me?

The tax issues in this article are likely to be relevant for large multinational enterprises (MNEs) with a highly digitalised business, particularly those in the technology sector.

What can I take away?

Although the OECD's final conclusions are not expected to be published until 2020, certain countries are none the less implementing their own unilateral measures ahead of the OECD, in order to address these tax challenges – the UK's recently-announced digital services tax (DST) being one such example.

In its 2015 Final Report: *Addressing the Tax Challenges of the Digital Economy* (Action 1), the OECD identified three broad direct tax challenges associated with digitalisation. These are:

1. how nexus is determined;
2. how value is attributed to data and content generation; and
3. how payments made in the context of digital business models should be properly characterised for tax purposes.

To address these challenges, Action 1 considered a nexus-based 'significant economic presence' rule, a withholding tax on digital transactions, and an equalisation levy. These are interim proposals with the ultimate aim of taxing remote online sales to customers in market jurisdictions.

Since Action 1 was released, significant developments have occurred both nationally and internationally to address BEPS concerns exacerbated by digitalisation. At an international level, 85 countries so far have signed a Multilateral Instrument (MLI) implementing various anti-BEPS treaty-related measures. Multinational enterprises (MNEs) have responded to the impact of the MLI by aligning their transfer pricing positions with, and relocating their intangibles to the situs of, the MNE's real economic activity.

The EU has enacted two Anti-Tax Avoidance Directives requiring Member States to introduce, amongst others, controlled foreign company (CFC) rules and anti-hybrid measures, and has also put forward two Directive proposals for an interim 3%

‘digital services tax’ and a longer-term corporate income tax on a ‘significant digital presence’, for implementation by Member States by 2020, although the interim proposal has since been abandoned. At a national level, certain countries have either already unilaterally implemented their own tax rules ahead of the OECD and the EU, or are in the process of doing so.

National measures

United States

US tax reforms adopted in late 2017 are intended to impose a minimum level of taxation on global income of US-based MNEs and US source income of non-US-based MNEs. The US enacted the base erosion and anti-abuse tax (BEAT) as part of these reforms. Although the BEAT seeks to impose US tax on certain types of ‘base-eroding’ outbound payments in certain circumstances and has been cited by the OECD as one of the tax policy developments potentially relevant to digitalisation, it does not fit neatly into any of the Action 1 proposals, perhaps because it is not specifically aimed at digital businesses. All MNEs are evaluating their effective tax rate structures in view of these and other developments, with digital simply being one element of the overall process.

The BEAT applies to US taxpayers within MNE groups whose average annual gross receipts from US-based activities exceeds USD$500m over a three-year period and whose ‘base eroding payments’ (i.e. certain payments to foreign related parties, including payments for intangibles) account for 3% or more of the taxpayer’s total deductions claimed. The BEAT is calculated as the excess of 10% of the taxpayer’s modified taxable income over the taxpayer’s regular 21% corporate income tax liability. (The 10% is reduced to 5% for 2018 and increased to 13.5% from 2026.)

The US Supreme Court ruled on 21 June in *South Dakota v Wayfair* that state and local governments could begin collecting sales tax from online retailers, overturning the precedent set by *Quill v North Dakota* in 1992. While the Court held that a physical in-state presence was no longer required in order for remote sellers to collect in-state sales tax, it stopped short of formally declaring that the South Dakota sales tax statute was valid under the Commerce Clause, leaving this issue and related constitutional matters to be resolved on a case-by-case basis. Meanwhile, South Dakota has enacted legislation to expedite remote sales tax collection with effect from 1 November 2018. In brief, South Dakota's economic nexus thresholds require remote sellers to collect tax if they have more than $100,000 of annual in-state sales or engage in more than 200 transactions per year within South Dakota. A number of other US States have enacted similar measures.

United Kingdom

The UK already has its own version of a nexus-based rule in the form of the diverted profits tax (DPT) regime, enacted in Finance Act 2015. Broadly, the DPT applies a 25% tax, for accounting periods beginning on or after 1 April 2015, to non-UK companies with an 'avoided PE' in the UK, or to UK companies that engage in related party transactions with insufficient economic substance. However, the DPT is not specifically aimed at digital transactions or digital businesses, unlike the interim digital services tax (DST) recently announced in the 2018 Budget and covered in the article 'A Radical departure' by Matthew Stringer and Amanda Collinson in the December 2018 issue of *Tax Adviser*.

The DST came about as a result of proposals put forward by HM Treasury in its November 2017 and March 2018 position papers on taxation of the digital economy. It is similar to the earlier original EU proposals,, only more narrowly targeted, and at a lower rate. For accounting periods ending on or after 1 April 2020, a 2% DST will apply to certain UK user-derived revenues in excess of £25m generated by social networks, search engines and online marketplaces with global revenues of at least £500 million. Low-margin businesses will benefit from a 'safe harbour' in which they will either pay a reduced DST rate or, if they are loss-making, will not pay any DST at all. Thus, in practice, the DST is unlikely to affect the vast majority of tech businesses.

For UK companies, DST will be deductible for corporation tax purposes if it is an allowable trading expense, which may or may not be the case depending on the factual circumstances. For all companies, it is expected to be imposed on revenues net of any VAT. However, DST is not covered by double tax treaties, meaning that double taxation could, for example, arise in respect of corporate income taxes on a non-UK resident company's profits, or other turnover-based taxes imposed by another country on the same revenues. DST compliance and reporting will be broadly aligned with that of corporation tax, and may be done by a nominated company on behalf of affected group members. Payments will be due in quarterly instalments under the same payment schedule as those of very large corporates.

HM Treasury and HMRC are, in the meantime, consulting on the design and detail of the DST, with responses from stakeholders due by 28 February 2019.

Budget 2018 also announced a new direct income tax from 6 April 2019 on offshore IP owners' intangible income referable to UK sales in excess of £10m. The tax replaces the earlier proposals for a royalty withholding tax and will apply, for example, to royalties paid to an IP-holding entity in a low-tax non-treaty jurisdiction by a (related or unrelated) foreign distributor for the use of the IP in selling products and services to UK customers. As such, it is likely to have limited practical effect, as most of the planning opportunities afforded by these types of arrangements have already been closed down. For those that remain, a targeted anti-avoidance rule will apply to arrangements entered into on or after 29 October 2018 to avoid the tax.

Australia

Australia enacted its own DPT regime in April 2017 to complement its existing Multinational Anti-Avoidance Law, which targets a specific type of 'deemed PE' structure. Under this structure, an overseas company concludes sales contracts entered into by local employees for supplies of products and services to Australia-based customers. A 30% withholding tax also applies to any royalties paid by the deemed PE. The regime applies a punitive 40% corporate income tax charge to the amount of tax benefit secured by a transaction or arrangement, the principal purpose of which is to secure that tax benefit. The rule mainly targets cross-border IP transfers or licensing arrangements within MNEs.

Italy

Italy's recently enacted digital transactions levy (also known as the 'web tax') has become effective as of 1 January 2019. The levy applies a 3% tax on consideration (net of VAT) for digital services supplied electronically by large resident and non-resident enterprises to Italian business customers and, like the Indian equalisation levy, operates in a similar fashion to the equalisation levy described in Action 1.

International approach

With the exception of the UK's Budget 2018 measures and US state tax on interstate e-commerce transactions, the taxes described above are examples of some of the national-level tax policy developments which have influenced the OECD's thinking in its 2018 Interim Report: Tax Challenges Arising From Digitalization (the Interim Report). The Interim Report also considers countries which have targeted specific types of digital services, such as online advertising (India, Hungary) and online video-on-demand services (France).

Chapter 2 of the Interim Report identifies the salient characteristics of highly digitalised business models as:

- the ability to achieve cross-jurisdictional scale without mass;
- heavy reliance on intangibles; and
- heavy reliance on data and user-generated content.

These characteristics challenge nexus and profit allocation on the basis that they create outcomes that do not align the country in which profits are taxed with the country in which the ‘real’ economic activities occur. At the heart of this tension lies the concept of value creation, which the OECD views as a highly complex area that does not have any obvious ‘one size fits all’ definition. This as-yet-unknown definition of value creation underpins the present difficulty in reaching a global consensus on a revised international tax system to suit the digital economy. Given that the OECD is not expected to conclude its work in this area until 2020 at the earliest, it seems that the EU and other countries have jumped the gun ahead of the OECD with no obvious justification for doing so other than to take political aim at the larger tech MNEs.

What next?

At a UK level, the Government’s consultation aims to ensure that the DST is proportionate and not unduly burdensome for affected businesses. Time will tell whether it achieves this objective, although it would appear to fall short in this regard where double taxation is concerned. Although it considers the DST to be treaty-compliant in the sense that it does not discriminate against non-UK businesses, it nevertheless specifically precludes the availability of double tax treaties for treaty relief purposes. Also, despite being fairly detailed on compliance issues, it does not address the possibility of administrative co-operation in the event of inadvertent non-compliance by non-UK resident companies under self-assessment.

At an EU level, the proposed 3% digital services tax failed to receive the required unanimity from all Member States, although France, Spain and Austria have recently announced plans to implement their own measures unilaterally. These measures are similar to the original EU interim proposals and will take effect in 2019 and 2020.

At an international level, a potential solution to the 'virtual PE' conundrum may be for the OECD to expand the PE concept to include digital transactions. The means of allocating income between countries could evolve as a formulary matter by reference to an allocation key based on downloads or other appropriate metrics, thus potentially limiting the relevance of the arm's length standard for transfer pricing purposes. While the arm's length standard may suit companies with a physical PE in another country, a profits split/formulary apportionment method may well be more appropriate for digital/virtual PEs, particularly where hard-to-value intangibles are involved. The OECD's thinking seems to be heading in this direction, with a view to resolving the perceived misalignment between the taxing jurisdiction and the jurisdiction in which value is created. Indeed, the OECD published a Policy Note on 23 January 2019 outlining a proposed way forward for addressing the tax challenges posed by digitalization, which included proposals for allocating taxing rights through revised profit allocation and nexus rules that the OECD believes could go beyond the arm's length principle, thus effectively limiting the arm's length principle to routine returns. The Note also contains proposals for certain anti-BEPS measures such as income inclusion and a tax on base-eroding payments.

Given the significance of these new proposals for the international tax system, the Inclusive Framework will issue a consultation document that describes these proposals in more detail, and a public consultation will be held on 13 and 14 March 2019 as part of the meeting of the Task Force on the Digital Economy. Further details on the consultation process, the consultation document and how stakeholders can participate will be published in the coming weeks. The OECD's final conclusions are expected to be published in a final report in 2020.