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The 2019 OECD Proposals for addressing the tax challenges of the digitalization of the economy: an assessment


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Executive summary

Background

1. The Public Consultation Document “Addressing the Tax Challenges of the Digitalization of the Economy”, released by the OECD on 13 February 2019 [hereinafter: the 2019 OECD Public Consultation Document] marks a significant step forward in the technical debate on taxation of the digitalized economy, since it acknowledges the right of market countries to exercise their taxing powers in connection with remotely operated business and correspondingly allocates profits to such states.

2. This document aims to provide a scholarly and independent contribution to the debate concerning the adaptation of international tax nexus and the allocation of taxing powers to make them suitable for addressing the challenges of the digitalized economy.

3. This document puts a specific emphasis on the need to achieve a fairer allocation of taxing rights among jurisdictions that are directly or indirectly connected with the value creation operations of companies’ value chains related to the digitalized economy.

Scope and structure

4. Each of the Three Proposals has merits and shortcomings. For this submission, the Task Force has deemed it appropriate to focus its analysis solely on the Three Proposals contained in the First Pillar of the OECD Policy Note released on 23 January 2019 and contemplated in the “Revised profit allocation and nexus rules” indicated in Section 2 of the Public Consultation Document.

5. The first section of this submission analyses overarching issues that are common to the Three Proposals, emphasizing the problems of fair allocation of taxing rights between states arising in the current international framework. Such issues are particularly visible in key remotely operated business models that are typical of the digitalized economy (namely, the resale of tangible goods, intermediation platforms for the sharing economy, social media networks and cloud computing). The IBFD Task Force on the Digital Economy has summarized the current terms of the debate surrounding profit allocation methods, weighing the merits and drawbacks associated with the main options for reform contemplated by the ongoing discussion, including, in particular, the approaches based on residual profit split and fractional apportionment.

6. The second section addresses the “Questions for Public Comment” included in Section 2.4 of the Public Consultation Document. Some of these questions can only be solved by jointly considering the three submitted Proposals, while other questions have required each Proposal to be treated separately (respectively, in section 2 for the “User Participation” Proposal; section 3 for the “Marketing Intangibles” Proposal; and section 4 for the “Significant Economic Presence” Proposal). Section 5 is then devoted to common issues in relation to the current international double taxation framework and section 7

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1 This is a major achievement compared to the doubts that were raised on the need to allocate taxing rights on cross-border income that existed at the time that the IBFD Task Force on the Digital Economy started its studies on taxation of the digital economy and remotely operated business models. See P. Hongler & P. Pistone, Blueprints for a New PE Nexus to Tax Business Income in the Era of the Digital Economy, IBFD White Paper (2015); A. Báez Moreno & Y. Brauner, Withholding Taxes in the Service of BEPS Action 1: Address the Tax Challenges of the Digital Economy, IBFD White Paper (2015).
contains the Conclusions, which are preceded by two sets of comparative charts (at section 6).

**Methodology**

7. First, and for each of the Three Proposals, the IBFD Task Force on the Digital Economy assessed the respective policy objectives within the framework of the following key benchmarks:
- Compliance with the policy principles outlined in the Ottawa Taxation Framework;
- The impact of the Proposals in ensuring inter-nation equity and the fair allocation of taxing rights (inter-nation fairness).

Each Proposal addresses the need to reflect the role of “remote active presence”\(^2\) in the allocation of taxing rights as per international rules, taking as a point of departure that this role is currently not acknowledged sufficiently by existing international tax rules.

8. Second, the overall goal of this submission is to provide feedback on the questions contained in the 2019 OECD Public Consultation Document. The analysis is supported by practical case studies reflecting specific remotely operated business models and are summarized in the synoptic charts attached in Annex 2. This document also addresses the potential spillovers that each Proposal may exert on other forms of business conducted within the economy at large.

9. Third, for each Proposal, the IBFD Task Force on the Digital Economy addressed specific design issues, focusing in particular on critical features such as scope, thresholds, factors to be used in connection with profit allocation methods, the treatment of losses and the elimination of double taxation.

10. Fourth, the IBFD Task Force on the Digital Economy assessed possible features to reduce complexity, to ensure (early) tax certainty and to avoid or solve cross-border disputes (involving two or more jurisdictions).

11. Finally, the IBFD Task Force on the Digital Economy assessed the interaction of the Proposals with the existing treaty framework. In particular, the IBFD Task Force on the Digital Economy examined the possibility of implementing the Proposals through the Multilateral Instrument and the relationship between the multilateral Proposal and unilateral measures – typically based on turnover taxes – recently introduced or proposed by several countries.

**A concise overview of the main findings**

12. All the Proposals acknowledge that value can be created in a jurisdiction where users or customers are located, even if the enterprise has no physical presence and, as a consequence, that it is possible and necessary to allocate taxing rights to such a country correspondingly.

13. Each Proposal has its own approach to the problem and reflects specific policy priorities: whilst the “User Participation” Proposal has the narrowest scope and shows a clear ring-fencing effect, the “Significant Economic Presence” Proposal has the broadest scope and better preserves neutrality with other forms of remotely (digital and non-digital) operated business as well as traditional business. A concise overview of such issues is contained in the synoptic chart in Annex 1, which compares the Proposals against the benchmarks of the Ottawa Taxation Framework.

14. The “User Participation” Proposal may raise issues of “ring-fencing by design” in the sense that it would seem to be conceived expressly to apply only to a fairly limited set of representative business models expressed by the digitalization of the economy. By contrast, the “Marketing Intangibles” Proposal could have a much broader scope of application and would thus preserve neutrality with the various forms of remotely (digital and non-digital) operated as well as traditional businesses. Still, the implementation of the latter Proposal requires a corresponding amendment to the OECD Transfer Pricing Guidelines and article 9 of the OECD Model.

15. Furthermore, considering the narrow scope and limited changes in the allocation of taxing powers, the Task Force believes that the impact of the “User Participation” Proposal on the necessary reform of international taxation will be reasonably limited. Nevertheless, the Task Force welcomes the fact that this Proposal acknowledges the contribution of users to value creation, as it would allow the capturing of location-specific rents that otherwise escape the current nexus and international allocation rules on income and consumption taxation.

16. The chief merit of the “Marketing Intangibles” Proposal is that it preserves neutrality among different industries and forms of conducting business. The main criticalities of this Proposal would lie in concerns regarding its distributional outcomes vis-à-vis market countries and the high degree of complexity of the Proposal. These criticalities are, however, not foreign to the “User Participation” Proposal also and have thus been addressed jointly by the Task Force.

17. First, if a policy perspective inspired primarily by inter-nation fairness is adopted, the central

\(^2\) This is understood as the active presence of an enterprise in a jurisdiction without having physical presence within its territory.
criticality of these Proposals would lie in that they only allocate residual profits to the market jurisdiction, based on the per se not so bright-line distinction between routine and non-routine activities.

18. Second, operating in line with the arm’s length principle would, in most cases, require applying profit split methods that are too complicated for developing countries. Furthermore, the current Authorised OECD Approach (AOA) does not remunerate activities with an impact in the market jurisdiction, as it is impossible to find local assets, risks or people functions associated with said activities.

19. Third, although this may be dictated by practical necessity, both Proposals would have to rely on inconsistent approaches to profit attribution, namely adopting traditional arm’s length criteria concerning routine activities and a residual profit split approach for non-routine ones. However, the dividing line between the routine and non-routine spheres does not appear clear both in qualitative as well as quantitative terms. In the case of the latter, besides the above-mentioned inconsistency, it seems clear that the vital issue to be addressed would be the quantification of the proportion of returns from non-routine activities that would be attributed to the market country.

20. Fourth, when a company reports losses, as often happens in digitalized business models, this may imply that the market country will not be allowed to exercise its taxing powers, even though value is produced on its territory. Also, the market jurisdiction will have to accept deductions and carry forward loss compensations.

21. The Task Force is also concerned that the complexity presented by the application of these solutions, including a uniform and consistent differentiation between routine and non-routine functions, and the precise identification of non-routine functions in respect of the various scenarios arising within the digitalized economy, could increase the uncertainty and controversy between states without a meaningful increase in income allocation, or could lead businesses to reshape their features in order to circumvent such problems.

22. The IBFD Task Force on the Digital Economy expresses a general preference for the “Significant Economic Presence” Proposal, for reasons briefly summarized below and more extensively addressed in section 4 of this document, and reflected in the final conclusions.

23. The “Significant Economic Presence” Proposal allows the market country to exercise its jurisdiction on business profits derived by remotely operated businesses that lack a physical presence in its territory, whenever such businesses actively participate in the economic life of that country. The IBFD Task Force on the Digital Economy suggests that this change be introduced by the Multilateral Instrument (or any other equivalent instrument targeting digitalized businesses) and regarded as an additional minimum standard for tax treaties.

24. The “Significant Economic Presence” Proposal can shape nexus in line with the permanent establishment (PE) concept and stretches it out by deeming the existence of a virtual (or digital) PE when the remotely operated business interacts on a non-occasional basis with local users and customers, as more thoroughly addressed in section 4 of this document.

25. The “Significant Economic Presence” Proposal is inclusive, neutral, fair, effective and simple. It is inclusive since it solves the international tax nexus and allocation problems by adjusting the categories of international taxation without ring-fencing digitalized business. It is neutral since it does not create tax biases across the different business models. It is fair since it recognizes that market jurisdictions have taxing rights on remotely operated businesses in the absence of a physical presence when such businesses actively participate to the economic life of a country, even when there is a net loss situation. This is particularly important for developing countries, which suffer a reduction in tax revenue collected from corporations physically present in their territories, since remotely operated business keeps growing at a steady pace and is concentrated in a limited number of countries of the world. It is effective since it allows the market jurisdiction to collect revenue in the presence of business operating in its territory, even in the presence of foreign losses incurred by the remotely operated business. It is simple, since it requires no assessment of complex factors (such as the differentiation between routine and non-routine functions, or the actual boundaries of marketing intangibles), thus being more friendly to non-sophisticated tax authorities (such as the ones in developing countries), that are already familiar with the concept of permanent establishment.

26. Furthermore, since the “Significant Economic Presence” Proposal broadly corresponds to the reform option suggested by the European Commission in 2018, it could, therefore, aggregate consensus and more easily operate also in this region of the world.

27. The “Significant Economic Presence” Proposal, as presented in the 2019 OECD Public Discussion Document, allocates taxing powers using fractional apportionment. This can simplify the actual levying of taxes and prevent cross-border disparities, but may also produce problems of consistencies with the existing double tax treaties, as well as turn into the source of a different standard if a corresponding shift does not take place in respect of the brick and mortar economy. Yet, the “Significant Economic Presence” Proposal can also operate in line with the requirements of the arm’s length principle, as
suggested in the Proposals drafted in 2015 by the IBFD Task Force on the Digital Economy.

28. The inter-nation fairness pursued by the “Significant Economic Presence” Proposal could be further enhanced by allowing the market jurisdiction to levy a withholding tax as toll fee in respect of sales that are connected with the significant economic presence of the remotely operated enterprise. This withholding tax could be levied at 1% of the value of the sales connected with a significant economic presence in the market jurisdiction. This measure could be a trade-off to be bundled together with the prohibition to apply unilateral levies on turnover or digital services, which could be introduced in tax treaties.

29. While the Task Force believes that the “Significant Economic Presence” Proposal would more comprehensively and sustainably address the international tax challenges arising from the digitalization of the economy, the Task Force finds that the Three Proposals calling for a revision of profit allocation and nexus rules are not mutually exclusive and could, therefore, be bundled together in different ways.

30. The levying of withholding taxes could also operate in conjunction with the “User Participation” and “Marketing Intangibles” Proposal. If combined with the “User Participation” Proposal, the “Marketing Intangibles” Proposal would have a narrower effect than what would arise when operating in connection with the latter one. Yet, especially because of the residual allocation of taxing rights, the functioning would be in both cases more modest than under the “Significant Economic Presence” or on a standalone basis.

31. In all circumstances, withholding taxes should only be used insofar as “they do not result in double taxation”.

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