OECD/G20 Base Erosion and Profit Shifting Project

Addressing the Tax Challenges of the Digitalisation of the Economy – Policy Note

As approved by the Inclusive Framework on BEPS on 23 January 2019

OECD

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1.1. Background

The tax challenges of the digitalisation of the economy were identified as one of the main areas of focus of the Base Erosion and Profit Shifting (BEPS) Action Plan, leading to the 2015 BEPS Action 1 Report (the Action 1 Report). The Action 1 Report found that the whole economy was digitalizing and, as a result, it would be difficult, if not impossible, to ring-fence the digital economy. The Action 1 Report also observed that, beyond BEPS, the digitalisation of the economy raised a number of broader direct tax challenges chiefly relating to the question of how taxing rights on income generated from cross-border activities in the digital age should be allocated among countries.

Following a mandate by G20 Finance Ministers in March 2017, the Inclusive Framework, working through its Task Force on the Digital Economy (TFDE) delivered an Interim Report in March 2018, *Tax Challenges Arising from Digitalisation – Interim Report 2018* (the Interim Report). The Interim Report provided an in-depth analysis of value creation across new and changing business models in the context of digitalisation and the tax challenges they presented.[1] These challenges included risks remaining after BEPS for highly mobile income producing factors which still can be shifted into low-tax environments. While members of the Inclusive Framework did not converge on the conclusions to be drawn from this analysis, they committed to continue working together towards a final report in 2020 aimed at providing a consensus-based long-term solution, with an update in 2019.

Conscious of the G20 time frame and the significance of the issue, the TFDE further intensified its work since the delivery of the Interim Report. Drawing on the analysis included in the Action 1 Report as well as the Interim Report, and informed by recent discussions at the July and December meetings of the TFDE on a "without prejudice" basis, a number of proposals have been made. These proposals, together with the recent discussions and comments from members of the Inclusive Framework, lay the grounds for the Inclusive Framework to come to an agreement on the way forward.

1.2. Proposed way forward

Consistent with the analytical framework of both the Action 1 Report and the Interim Report, there is agreement to examine proposals involving two pillars which could form the basis for consensus. One pillar addresses the broader challenges of the digitalised economy[2] and focuses on the allocation of taxing rights, and a second pillar addresses remaining BEPS issues. A two pillar approach would recognise that the digitalisation of the economy is pervasive, raises broader issues, and is most evident in, but not limited to, highly digitalised businesses. It raises questions of where tax should be paid and if so in what amount in a world where enterprises can effectively be heavily involved in the economic life of different jurisdictions without any significant physical presence and where new and often intangible value drivers more and more come to the fore. At the same time, the features of the digitalising economy exacerbate BEPS risks, and enable structures that shift profits to entities that escape taxation or are taxed at only very low rates. A solution would therefore require comprehensive work that covers the overall allocation of taxing rights through revised profit allocation rules and revised nexus rules, as well as anti-BEPS rules.

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[1] See Chapter 2 "Digitalisation, business models and value creation" of the Interim Report.

[2] As described in the Action 1 Report and the Interim Report.

Under the first pillar, focused on the allocation of taxing rights including nexus issues, several proposals have been made that would allocate more taxing rights to market or user jurisdictions in situations where value is created by a business activity through participation in the user or market jurisdiction that is not recognised in the framework for allocating profits. The Inclusive Framework agreed to explore these proposals on a without prejudice basis. The Inclusive Framework recognises that the implications of these proposals may reach into fundamental aspects of the current international tax architecture. Some of the proposals would require reconsidering the current transfer pricing rules as they relate to non-routine returns, and other proposals would entail modifications potentially going beyond non-routine returns. In all cases, these proposals would lead to solutions that go beyond the arm's length principle. They also go beyond the limitations on taxing rights determined by reference to a physical presence generally accepted as another corner stone of the current rules. The Inclusive Framework agreed that issues of profit attribution and nexus would need to be developed contemporaneously with each playing a key role in any solution ultimately adopted, noting that they may require changes to tax treaties. On nexus, the Inclusive Framework agreed to explore different concepts, including changes to the permanent establishment threshold, such as the concept of "significant economic presence" which was discussed in the Action 1 Report or the concept of "significant digital presence", as well as special treaty rules.

The work of the Inclusive Framework will be driven by finding the right balance between accuracy and simplicity. This means that any solution needs to be administrable by tax administrations and taxpayers alike and take account of the different levels of development and capacity of members. The Inclusive Framework is open to exploring solutions, administrative simplifications and collection mechanisms, which should all be principle-based and could include withholding taxes where they do not result in double taxation.

The Inclusive Framework recognises that what is proposed may affect not only a small group of highly digitalised businesses but could affect a much wider group of enterprises with cross border business operations, for instance those with marketing intangible profits but limited risk distribution structures in market jurisdictions. Further technical work on the design considerations of the proposals would be required, taking into consideration potential scope limitations, business line segmentation, profit determination and allocation, as well as nexus and treaty considerations.

Under the second pillar, the Inclusive Framework agreed to explore on a "without prejudice" basis taxing rights that would strengthen the ability of jurisdictions to tax profits where the other jurisdiction with taxing rights applies a low effective rate of tax to those profits. These proposals recognise that in part the tax challenges of the digitalisation of the economy form part of the larger landscape relating to remaining BEPS challenges and further reflect more recent developments such as US tax reform.

The proposal under this pillar would be designed to address the continued risk of profit shifting to entities subject to no or very low taxation through the development of two inter- related rules, i.e. an income inclusion rule and a tax on base eroding payments.

The proposal under this pillar does not change the fact that countries or jurisdictions remain free to set their own tax rates or not to have a corporate income tax system at all. Instead, the proposal considers that in the absence of multilateral action there is a risk of un-coordinated, unilateral action, both to attract more tax base and to protect the existing tax base, with adverse consequences for all countries, large and small, developed and developing.

Members of the Inclusive Framework discussed these innovative proposals, stressing the need for more in-depth analysis of each proposal and their interlinkages, and noting the importance of the assessment of revenue, economic and behavioural implications before decisions can be taken. They are cognisant that taking on these challenges, together, and on a co-ordinated, multilateral basis could ease the growing tension within the international tax architecture with a number of countries having taken unilateral measures over recent years.

Members of the Inclusive Framework also agreed that any new rules to be developed should not result in taxation when there is no economic profit nor should they result in double taxation. They stressed the importance of tax certainty and the need for effective dispute prevention and dispute resolution tools. The members were mindful of the need to ensure a level playing field between all jurisdictions; large or small, developed or developing. Also mindful of compliance and administrative burdens, members will strive to make any rules as simple as the tax policy context permits, including through the exploration of simplification measures.

In light of the novelty of the approaches and significant development work required, members of the Inclusive Framework have agreed that this work would be conducted on a “without prejudice basis.” Furthermore, given the interlinked nature of the issues to be discussed, the challenging time frame, and the fundamental nature of the changes proposed, the Inclusive Framework decided to mandate the Steering Group to elaborate a detailed programme of work together with detailed instructions to subsidiary bodies to which the Inclusive Framework could agree at its May meeting, with a view to reporting progress to the G20 Finance Ministers in June 2019 and deliver the solution in 2020.