EDITORIAL

Developments on the Digital Economy Front: Progress or Regression?

On 29 January the OECD published another policy note on behalf of the inclusive framework concerning the taxation of the digital economy.[1] The note includes some careful, vague language accompanied with a statement that all it says is 'on a without prejudice' basis, yet among the diplomatic language one could identify two avenues for reform that deviate from the prior solutions floated by the OECD, and from the original possible solutions presented by the final action 1 report[2]: first, it claims to examine a nexus approach, although recent OECD statements seem to emphasize the profit allocation aspects of that approach rather than the nexus (PE) question, and second, a new approach targeting income not fully taxed elsewhere, using a minimum tax imposed by residence states and denial of deductions on base eroding payments, supposedly by the source states. The note states that the purpose of the work on these two solutions is to counter unilateral actions by states, actions that would threaten the stability of the international tax regime to the detriment of all. It also reiterates the commitment to not ring-fence the digital economy.

The policy note is part and parcel of a continuous chain of releases by the OECD in the context of the taxation of the digital economy that should be disturbingly worrying to serious tax people. The original examination led to three types of solutions: virtual PE, a withholding tax, and an equalization levy, with later work emphasizing the possibilities that interim measures, such as the equalization levy and other turnover taxes, presented, and now the focus is on the protection of residence taxation. Such leaps have not been accompanied by rigid analyses or explanations.

In any event, the policy note's immediate statement is quite transparent: in the last few months policy circles related to the taxation of the digital economy have shifted their focus from so-called interim measures, epitomized by the Indian equalization levy, to proposals made by the classic OECD powers that had dominated the international tax regime until BEPS – United States (US), United Kingdom (UK), Germany & France – none of which fully address the entire challenge presented by the digital economy. The German and French proposal is essentially the second solution mentioned above, fashioned after the recent US tax reform GILTI regime,[3] while the UK proposal (and the substantively similar US proposal) is essentially the first mentioned solution focusing on profit allocation fixes. The vague language could not hide, first, that, as already mentioned, each OECD statement since the launch of BEPS in the context of action 1 followed a very different approach from its predecessor with no explanation why and for what purpose; second, That the most recent work is dominated by the most powerful nations in disregard to the alleged universal perspective that the inclusive framework was supposed to take; and third, that the original BEPS goals, and most importantly the goal of fairer distribution of taxing right, specifically more source taxation, have been abandoned. At the present these proposals are not detailed and therefore could not be comprehensively analysed, yet from what is known one could make a few observations, none of which are flattering to the proposals.

The first proposal seems to maintain the nexus approach, or the virtual PE as a viable solution, yet instead of elaborating on the technical details of the solution that are crucial for the success of the nexus approach, it shifts the focus to the profit allocation question, using the known value creation mantra, yet clearly enough to say that the primary interest of the proposal is the appropriate profits to be allocated to (we can assume)

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1 OECD, *Addressing the Tax Challenges of the Digitalisation of the Economy – Policy Note*, OECD/G20 Base Erosion and Profit Shifting Project (OECD Publishing 23 Jan. 2019), http://www.oecd.org/tax/beps/policy-note-beps-inclusive-framework-addressing-tax-challenges-digitalisation.pdf (accessed 8 Feb. 2019).

2 OECD, *Addressing the Tax Challenges of the Digital Economy, Action 1–2015 Final Report*, OECD/G20 Base Erosion and Profit Shifting Project (OECD Publishing 5 Oct. 2015).

3 26 US Code §951A.

the market or user economies. This seems to be a change of course for the nexus approach that till the present concentrated on finding consensus over criteria that could trigger PE treatment without physical presence. One viable proposal was made and later discussed in multiple fora,[4] yet it has never been fully adopted (neither has a different proposal been adopted) or elaborated on in the BEPS context. The current proposal seemingly assumes that we already know how to establish nexus, focusing instead on the next step: the allocation of profits to the PE once triggered. The UK proposal is to change the profit allocation rules to take account of user participation in the user's country.[5] The proposal is therefore to permit countries where certain users truly provide a benefit to certain businesses of the type that significantly benefit from the contribution of users, such as social media platforms, to effectively declare nexus and require allocation of some profits to such nexus with the view of having consequent jurisdiction to tax such profits.

The obvious critique of the UK proposal is that it requires distinctions among business, granting special treatment only to those benefiting from said user participation, an obvious ring-fencing exercise that clearly violates what was supposed to be the one ground rule that could not be broken. Naturally, it would be very difficult to draw the lines implementing this solution and even more difficult to allocate profits to such virtual PEs. The UK proposal acknowledges that the arm's length standard could not be applied, suggesting instead the use of residual profit split with the final residual profit (the 'upside') allocated based on a pre-agreed formula. It is unclear how this exact proposal will fare with the arm's length orthodoxy that dominates the OECD when they come to specify the rules, yet what is clear is that this proposal results in very little shifting of revenue to source jurisdictions, especially to poor jurisdictions. It definitely does not resolve the challenges presented by digital businesses that do not depend on user participation of the sort mentioned in the UK proposal (the large majority of businesses).

The US proposal, not yet fully exposed in an official document,[6] uses the same approach as the UK proposal but with a view to apply it to all businesses, avoiding the ring-fencing trap. This proposal views the participation of a business in the source economy in the form of the development of marketing intangibles that trigger a sufficient link to the market economy to justify taxation by the latter. This proposal is slightly more sophisticated than the UK proposal (in concept – we have not seen a detailed proposal): first, it avoids ring-fencing; second, it does not reformulate the PE definition but rather suggests to alternatively allocate profits to marketing intangibles in a manner analogous to allocation of profits to a PE; third, it will probably suggest to use the current transfer pricing rules to determine proper allocation rather than fall into the formulary allocation trap. But, the proposal, similarly to the UK proposal, will clearly result in little shifting of profits to the poor jurisdictions and may even result in an even less fair division of tax bases than the current regime since the richest countries may claim, as the US has been claiming for a while (that was the reason for the invention of the marketing intangible concept in the first place) that more profit needs to be allocated to them rather than to traditional source jurisdictions. Even more obviously, the more powerful and more sophisticated jurisdictions will have more resources to fully implement these difficult to implement rules. It is too early to technically assess a not-yet-existing proposal, yet one can easily understand the difficulty of reaching consensus over marketing intangibles and their values, perhaps a more difficult exercise even than the attribution of profits to user participation. The US will probably suggest resolution of difficulties through mandatory arbitration, a good proposal on its own, yet a problematic one in this context: first, because all countries except for the very rich oppose it, making it a disingenuous solution to the above problem; and, second, because it will reinforce the belief of countries opposed to mandatory arbitration that it is merely a device in the hand of the richest countries to further exploit the poor, further deepening the distrust in this system.

The second solution suggested by the policy note is clearly based on a German and French minimum tax proposal, itself fashioned after the GILTI rules adopted in the 2017 US tax reform. The proposal will impose a minimum tax on income of foreign branches and controlled entities when the establishment/residence countries do not tax or low-tax such income. The tax will be accompanied by a denial of deductions (or treaty benefits) to base eroding payments not sufficiently taxed as income. The basic idea of this rule is that multinational enterprises ('MNE') will be taxed at a minimum level on a non-deferral basis by their residence jurisdiction, and therefore should not have the incentive to shift profits to low tax jurisdictions. Again, the first thing that one notices is that the proposal shifts taxes to residence rather than to source jurisdictions, defying, similarly to the other solutions considered by the OECD the fundamental goal of fairer division of tax jurisdiction and more source taxation. Moreover, once one begins to think about the details of such a proposal, it is easy to observe

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[4] P. Hongler & P. Pistone, *Blueprints for a New PE Nexus to Tax Business Income in the Era of the Digital Economy* 2, Working Paper No. 20, (IBFD 2015).

[5] HM Treasure, *Corporate Tax and the Digital Economy: Position Paper Update* (Mar. 2018), https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/689240/corporate_tax_and_the_digital_economy_update_web.pdf (accessed 8 Feb. 2019).

[6] Yet orally and indirectly outlined by various government officials and media outlets.

that there indeed lies the devil: every decision will be politically contentious and result in significant impact on different countries (what is sufficient taxation, for example), which begs the question of who decides which countries win and which lose. The likely scenario of bias in favour of residence, primarily OECD, countries will satisfy the latter, perhaps, but will not garner consensus, as has been clearly demonstrated by the unilateral actions, such as India's equalization levy, taken out of frustration with the OECD's failure to address the need for fairer division of tax bases in BEPS. Finally, this proposal is naturally complementary to the BEPS work on action 3 and the push for standard, universal CFC rules, which was basically rejected by BEPS stakeholders and should fare worse in the inclusive framework. Such attempt to bring this idea in the backdoor via the action 1 work is both disingenuous and unlikely to convince its original opponents. Supporters of the proposal may argue that it is, like the US GILTI rules, complementary to the CFC rules, and would operate with them, Side by side, yet again CFC rules are very different in different countries and many countries do not use them, making the proposal incompatible with most countries tax systems. One of the reasons for not adopting CFC legislation or adopting minimal CFC legislation is the cost of enforcement and the sophistication required by revenue agents auditing MNE on deferred income, which obviously disadvantages the poorer countries and make such legislation often wasteful for them. The above proposal should be similarly unattractive to such countries, and therefore cannot expect to receive their support.

The complementary anti base-erosion element does not compensate for the unattractive impact of the minimum tax on source jurisdictions: first, because it requires the source jurisdictions to deny a deduction, consistent with the anti-hybrids rule of BEPS action 2, a very problematic rule that is unlikely to be in the interest of developing countries that starve for foreign investment, and will surely complicates the source country's tax system since, for example, a domestic entity doing exactly the same thing and claiming the exact same expense will get the deduction for it while the equivalent foreign investor won't; and, second, because a heavy administrative burden is imposed on the source jurisdiction, most importantly to determine whether the payment is subject to sufficient taxation in the payment's target jurisdiction. Better cooperation among jurisdictions, including more effective exchange of information about taxation of cross-border payments would be a valiant goal, but it could not be made the sole responsibility of the source jurisdiction. I note that a less burdensome, more compatible with BEPS goals solution for base eroding payments was on the table of the OECD, as recorded in the final action 1 report, using a withholding solution.[7]

In conclusion, although not yet publicly available in detailed format, the recent proposals that seem to occupy the attention of the OECD and the inclusive framework in the context of the taxation of the digital economy should be regretted. It is of course useful to consider all the options where real reform is needed, yet at this point, more than five years after the launch of BEPS, some clear signals should have been made, a policy direction should have been adopted. Regretfully, the current proposals do not follow the three principles that seemed acceptable by all during the process (no ring-fencing, more source taxation, and the curtailing of BEPS planning), they demonstrate disregard for the quest for fairer division of tax bases, which had been a fundamental trigger of the BEPS project, and they are presented with no explanation of the supposed abandonment of the prior BEPS work on solutions for the challenges presented by the digital economy. Therefore, these proposals should be summarily rejected by a large number of countries within the inclusive framework.

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[7] *See* Y. Brauner & A. Baez Moreno, *Withholding Taxes in the Service of BEPS Action 1: Address the Tax Challenges of the Digital Economy*. W.U. Int'l Tax'n Res., Paper No. 2015–14 (IBFD, 2015).