Pillar One: Taxing the Digital Economy

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Main features

What	» Proposal for a unified approach from 137 countries of the Inclusive Framework on BEPS on the taxation of the digital economy
Why	» To tackle the challenges of the digitalization of the economy
Who	» Automated digital services and consumer-facing businesses
How	» Reallocation of taxing rights, new profit allocation rules and new nexus rule
When	» Final report to the G20 expected in 2020

What

» The Pillar One Proposal (“Proposal”) aims to unify the different responses in the context of the tax work of the OECD/G20 Inclusive Framework on BEPS, on the digitalisation of the economy.

» The Proposal focuses on the reallocation of taxing rights, with the aim to undertake a coherent and concurrent review of profit allocation and nexus rules.

» On January 31, 2020 the OECD published an update statement (the “Statement”) on the Digital Tax Initiative, highlighting progress on the scope of the new taxation rights and agreeing to a timeline to reach a consensus position by the end of the year.

Why

» The purpose of the Proposal is to tackle the tax challenges of the digitalisation of the economy by:

- › Reallocating taxing rights in favour of the countries and jurisdictions where highly digitalized businesses which are able to operate remotely and/or profitable, have their users/markets;
- › Restoring stability and certainty in the international tax system;
- › Simplifying the tax system and addressing possible overlaps with existing rules; and
- › Mitigating the risks of double taxation.

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Who

- » The scope of the Proposal is broad and covers:
  - › **Automated digital services:** businesses which develop an active and sustained presence in remote locations without physical presence (e.g. online search engines, social media platforms or online gaming).
  - › **Large consumer-facing businesses,** which include businesses which interact remotely with users, who may or may not be their primary customers, but that generate revenue from supplying consumer products and services (e.g. software, clothing, luxury goods or automobiles, as well as franchise business models)
- » A minimum size-based threshold could be introduced (maybe as in CbC reporting requirements, i.e. €750m revenue).
- » Some industries would be carved out – i.e. extractive industries, commodities, some financial services as well as airline and shipping businesses. According to the Statement, businesses selling intermediate products and components should also be out of scope, subject to possible exceptions.
- » Several issues with regards to the scope are still open for discussion: e.g. the development of appropriate revenue and profit thresholds, the definition of carve-outs, the segmentation of business lines between in-scope and out of scope activities or the implications of a “safe-harbour” regime.

How (I)

» The Proposal provides that MNEs conducting significant business in places where they do not have a physical presence would be taxed in those jurisdictions, beyond the arm's length principle, and through the creation of new rules:

› **Nexus rule**: where tax is to be paid is largely based on sales instead of physical presence of the business; and

› **Profit allocation rules:** on what portion of profits the MNEs are to be taxed should be determined irrespective of whether they have an in-country marketing or distribution presence (PE or separate subsidiary) or they sell via unrelated distributors, based on new rules which would go beyond the arm's length principle. Current transfer pricing rules are complemented with formula based solutions in controversial areas.

How (II)

(1) The Nexus Rule

- » The nexus will generally be determined based on the revenue threshold
  - › However, for consumer-facing businesses, the nexus rule will also be based on indicators of a significant and sustained engagement with a certain market.
- » The revenue threshold could be adjusted depending on the size of the market jurisdiction and should take into account certain activities, such as online advertising services that are directed to non-paying users in that jurisdictions (even though the revenue related to such activity may be recorded somewhere else).
- » The revenue threshold should also apply to groups that sell in a market through a distributor (whether a related or unrelated local entity) in order to ensure neutrality between different business models and capture all forms of remote involvement in the economy of a market jurisdiction.
- » The Proposal indicates that the new nexus should be a standalone treaty provision, operating on top of the permanent establishment rule. It is suggested that taking this approach would limit unintended spill-over effects on other existing rules.

How (III)

(2) The Three Tier Mechanism

» The Proposal suggests that the new and revised profit allocation rules, taken together with existing transfer pricing rules, will need to be simple, avoid double taxation, and significantly improve tax certainty relative to the current position. The technical issues are classified in three blocks:

- **Amount A:** Creation of a new taxing right with respect to residual profit (= profit remaining after allocating deemed routine profit on activities to countries where activities are performed). Allocation to the markets following the new nexus rule based on sales.
    - According to the Statement, the profit before tax (“PBT”) would be the preferred profit measure to calculate the “deemed residual” profit.
- **Amount B:** Activities in market jurisdictions, in particular distribution functions, would remain taxable according to existing rules (arm’s length principle and PE allocation). Here the possibility of fixed remunerations is being explored.
- **Amount C:** Design of instruments to ensure full implementation and efficient administration of the new taxing right, including effective elimination of double taxation and binding dispute resolution.

Outstanding issues

- Methods to quantify profits and to allocate these profits among the involved market jurisdictions.
- The “Unified Approach” open the doors to global formulary apportionment (“GFA”).
- Elimination of double taxation and risks of double counting.
- Other implementation issues with regards to administration, compliance, adaptation of tax treaties or withholding mechanisms. The Statement envisages further development of the “one-stop shop” approach, which would limit filing to the ultimate parent jurisdiction.
- Addressing specific features of Amount A (scope, quantum, revenue sourcing) and Amount B (definition of “base line” distribution activities, quantum, exemptions, implementation…).
- Development of effective dispute prevention and resolution mechanisms.
- Importance of simultaneous implementation to ensure a level playing field:
    - The US has already stated that it firmly opposes digital services taxes, and in particular any departures from arm’s length transfer pricing and taxable nexus standards. The US proposed the implementation of Pillar One as a **safe-harbor approach** which is being explored by the Inclusive Framework members.

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Updates under the January Statement

- The Statement confirms that the nearly 140 member countries of the Inclusive Framework (IF) affirmed their support to the Unified Approach as the basis to address the taxation of the digital economy and changes to the international tax rules.
- The delegates of the IF confirmed their commitment to reach an agreement on a consensus-based solution by the end of 2020.
- The Statement proposes that any consensus-based agreement will include a commitment by members to withdraw unilateral actions on Digital Tax.
- The Statement contains further guidance on key policy and technical matters that will be further developed according to the timeline included in the document itself:
  - The IF meeting of July 2020 is a fundamental milestone: the goal of that meeting is to reach agreement on the key technical issues of the new taxing right.
  - A final report is envisioned by the end of 2020.

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WTS Global Comments on Pillar One

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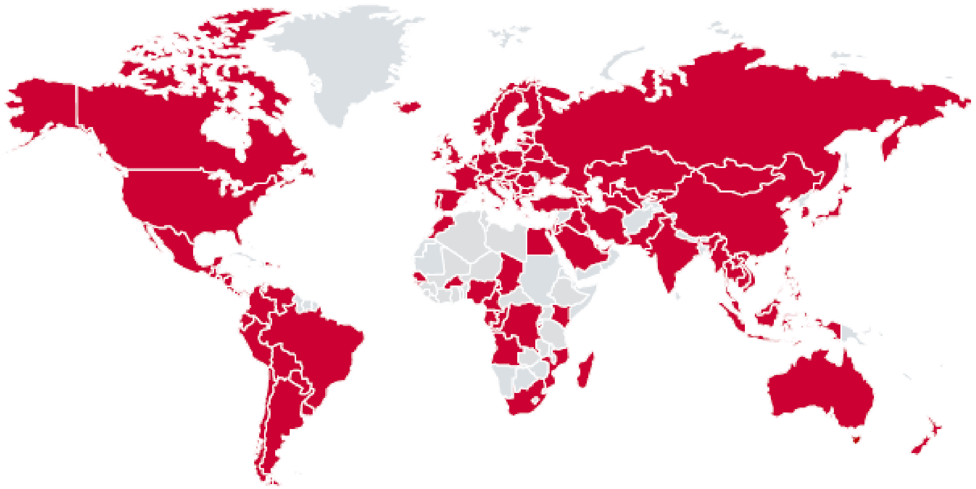

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