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The Big Shakeup: Making Sense of the OECD Digital Tax Proposals

by

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- The increased digitalization of the economy has generated controversy over the perceived unfairness of multinational enterprises (MNEs) earning significant profits in places where they have no obligation to pay income tax locally, but in which they nonetheless generate sales to consumers. This has led to political pressures for digital taxation, in Canada and elsewhere, and a pattern of uncoordinated unilateral tax measures aimed specifically at large digital MNEs, such as the French revenue-based digital services tax enacted earlier this year.
- A recent proposal by the Organisation for Economic Co-operation and Development (OECD) responds to this challenge by proposing a multilateral approach. The core feature of the OECD proposal is to provide “market” jurisdictions with a new, internationally agreed, taxing right overriding traditional international income allocation rules. Market jurisdictions would gain the right to tax a to-be-agreed percentage of the so-called “deemed residual profits” of large, affected MNEs that are attributable to that country.
- The key proposed measure would require a tax calculation based on the MNE group’s profits as reflected in its consolidated financial statements. This would introduce a novel form of tax base into the Canadian system: Canada’s *Income Tax Act* generally imposes tax on income of a non-resident entity that carries on business in Canada, and not on separate entities in its corporate group that may themselves have no connection to Canada. Domestic rules would need to be substantially overhauled to align with the OECD proposal.
- A further consultation paper on companion concepts, including in particular a proposed global minimum tax on MNE profits, was released on November 8. The OECD aims to arrive at a consensus solution by the end of next year. It will be interesting to see how these ambitious proposals evolve in the coming months.

A recent OECD Secretariat proposal outlines a new set of international tax rules to facilitate taxation of profits from “consumer-facing businesses” by jurisdictions where multinational enterprises (“MNEs”) generate significant sales without a physical presence.

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The proposal appears in an October 9 consultation document released by the Secretariat (OECD 2019a), which invited public comments by November 12, with a public consultation meeting set for OECD headquarters in Paris November 21 and 22. A separate consultation – to operate alongside the proposed new rules discussed in this E-Brief – is planned for December, regarding a proposal on global minimum taxation, details of which were released on November 8 (OECD 2019b).

The October 9 proposals respond to an emerging pattern of uncoordinated unilateral tax measures aimed at large digital MNEs in jurisdictions where they generate significant sales without a physical presence.

This pattern – exemplified by the revenue-based digital services tax (DST) enacted this year in France, and similar levies proposed by the UK, Spain, Italy, Austria, Poland and other countries – challenges the established international consensus under which a jurisdiction is generally precluded from imposing income taxes on foreign enterprises' profits except to the extent those profits are attributable to a “permanent establishment” located in that jurisdiction.

That consensus, developed almost 100 years ago, and reflected in international tax treaties, has played a key role in mitigating the potential for double taxation on the profits of global enterprises.

With the increased digitalization of the economy, profits are more readily generated with no meaningful physical presence. This has generated controversy over the perceived unfairness of businesses earning significant profits in places where they have no obligation to pay income tax locally, but in which they nonetheless generate sales to consumers. This has led to political pressures for digital taxation in some countries. In Canada, the re-elected Liberals had a revenue-based tax modelled on the French regime in their election platform, while the Conservatives embraced the UK proposals.

Interestingly, the costs associated with the newly enacted French DST have already been passed on to local users in widely reported changes to Amazon's referral fees. This would suggest that, at least in some cases where the MNE has significant market power, the burden of this new tax may actually be borne by domestic residents, and not the MNEs upon which it is technically imposed.

The proliferation of these uncoordinated measures gives rise to significant potential disputes over such matters as the compatibility of these regimes with existing tax treaty obligations and potential double taxation. This can be expected to arise where the “home” jurisdiction does not accept the appropriateness of the source country's imposition of a revenue-based tax.

The core feature of the OECD proposal is to provide “market” jurisdictions with a new, internationally agreed, taxing right.

This would create a new concept of nexus and would override traditional income allocation rules (i.e., the arm's length principle) by allowing the source country to tax a to-be-agreed percentage of the so-called “deemed residual profits” of large, affected MNEs that are attributable to that country. Supporting rules are also proposed to adapt traditional transfer pricing analysis and to provide agreed amounts of fixed remuneration for “baseline marketing and distribution functions.”

The proposed approach would retain the current transfer pricing rules based on the arm's length principle in cases where they are widely regarded as working as intended, but would introduce formula-based solutions in situations where tensions have increased – “notably because of the digitalisation of the economy.”

Unlike the unilateral DSTs noted above, the proposal's scope extends to not only “digital centric businesses,” but also to other so-called “consumer facing businesses.” This suggests the intended target includes consumer-oriented businesses that generate significant profits attributable to intellectual property and other businesses

that have adapted modern business methods to generate sales in a jurisdiction without establishing a physical presence.

Under traditional transfer pricing constructs, the bulk of the returns from exploitation of intellectual property would not normally be allocated to market jurisdictions; rather, profits would be allocated based on a functional analysis that focuses on functions performed, assets used, and risks assumed in each jurisdiction. The proposal appears to upend the core features of the arm's length principle in situations beyond purely digital businesses. The consultation paper acknowledges that further discussion is required to define the proposal's scope; for now, the proposal merely notes that extractive industries and commodities would be exempt but does not specify whether financial services businesses would be affected.

Where the new taxing right applies, the proposal abandons the longstanding "separate entity" theory that underlies both the Canadian and international tax systems.

The Canadian tax system is premised on the "single entity" theory. Canada's *Income Tax Act* generally imposes tax on the income of a non-resident entity that carries on business in Canada, and not on separate entities in its corporate group that may themselves have no connection to Canada. The domestic statutory rules generally work well with the long-established international consensus on allocation of taxing rights but would need to be substantially overhauled to align with the proposal.

In an unprecedented proposal for a substantive (as opposed to compliance-based) provision, the key measure requires a calculation based on the MNE group's profits as reflected in its consolidated financial statements. This would introduce a novel form of tax base into the Canadian system.

It is also unclear how relief from double taxation will be granted where income for ordinary income tax purposes is materially different, as it often can be, from accounting income, which is prepared according to different accounting standards around the world. The OECD proposal includes "binding and effective dispute prevention and resolution mechanisms" with a view to achieving "tax certainty." Experience suggests this is an ambitious goal.

Following release of the proposal, several European governments, including France and Germany, are reported to have reacted positively, while the reaction of other countries, including Ireland and the US was reported as more neutral. The OECD aims to arrive at a consensus solution by the end of next year. It will be interesting to see how this ambitious proposal evolves in the coming months.

References

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