OECD Policy Note on addressing the tax challenges of the digitalisation of the economy

Background

The Base Erosion and Profit Shifting (BEPS) Action Plan 1, Addressing the Tax Challenges of the Digital Economy, was released in October 2015 as part of the 15 BEPS Action Plans. Action Plan 1 considered the tax challenges raised by digitalisation for both direct and indirect taxation.

The 2015 Action Plan 1 Report also identified a number of broader tax challenges raised by digitalisation, notably in relation to nexus, data and characterisation. These challenges go beyond BEPS and chiefly relate to the question of how taxing rights on income generated from cross-border activities in the digital age should be allocated among countries.

To tackle the broader direct tax issues raised by digitalisation, the Action Plan 1 report analysed three options, namely (i) a new nexus rule in the form of a Significant Economic Presence (SEP) test, (ii) a withholding tax which could be applied to certain types of digital transactions, and (iii) an Equalisation Levy (EL), intended to address a disparity in tax treatment between foreign and domestic businesses where the foreign business had a sufficient economic presence in the jurisdiction. Though, none of these options were ultimately recommended in the 2015 Action Plan 1 Report, however it was concluded that countries could introduce any of these options in their domestic laws as additional safeguards against BEPS, provided they respect existing treaty obligations, or in their bilateral tax treaties.

Subsequently, the OECD/G20 Inclusive Framework on BEPS was established in June 2016. 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. 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.

The Policy Note

Recently, TFDE of OECD has released a ‘Policy Note’ which, amongst other things, has dealt with a number of proposals to address the tax challenges of the digitalisation of the economy.

Aligning with the analytical framework of both the Action Plan 1 Report and the Interim Report, TFDE has agreed to examine four proposals involving two pillars which could form the basis for consensus. One pillar addresses the broader challenges of the digitalised economy and focuses on the allocation of taxing rights, and a second pillar addresses the 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.


2 www.oecd.org
The following proposals have been discussed under the 1st pillar:

- **Market/User contribution** – Based on the allocation of taxing rights including nexus issues, the objective under this proposal is to 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. This proposal would apply to digitalised business models based on advertisement in a third country or the platform on the gig economy. This would recognise the value created by users of the digital services.

- **Marketing intangibles** – The second approach has some commonalities with the first approach. Under this approach, there is a need to recognise the ‘marketing intangibles’ which belong to the market. When implementing both the nexus and the transfer pricing rules, there should be a recognition of the value created by the marketing intangibles. There should be a taxing right belonging to the market jurisdiction. This broad proposal would not only address the digital economy but also address the traditional economy.

- **SEP** – The third proposal has already been discussed in the BEPS Action Plan 1 report. There should be a nexus where there is a certain degree of sales in a jurisdiction. This should result in a new allocation of taxing rights. This has been supported by many developing countries like India, Columbia, etc.

Under the 2nd pillar, the Inclusive Framework agreed to explore 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.

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 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.

The first feature of the aforesaid proposals is that there is no agreement to adopt on any of the specific aforesaid proposals. There is agreement to explore all the proposals because they are the ones that may support a consensus-based solution. The second feature under the first pillar is to go beyond the arm’s length principle for allocating profits. For the residual profits, the three proposals will explore new methods which may go beyond the arm’s length principle. The 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. It also acknowledged the views expressed by particular countries, especially China, that the rules need to provide a greater degree of certainty to tax administrations and taxpayers.

**Next steps**

OECD will release a public consultation document in the second week of February 2019, for the stakeholders to provide comments. OECD will hold public consultation in March 2019 to have a conversation between the members of the TFDE and all the stakeholders that have provided comments.

The next meeting of the Inclusive framework will be in May 2019 with a view to report the progress to the G20 Finance Ministers meeting in June 2019. A detailed programme of work will then follow till the end of 2020. The aim is to develop solutions so that at the end of 2020 there would be one solution agreed by consensus which would have all the elements ready to use for governments to change the rules to ensure that the tax challenges of the digitalisation of the economy are addressed.

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2 As mentioned by Mr. Pascal Saint-Amans in the OECD webcast on the ‘OECD Tax Talks’ on 29 January 2019
Our comments

Though Action Plan 1 analysed three options to address the tax challenges arising out of the digitalisation of the economy, it does not provide any recommendations. The other Action Plans viz. Action Plan 2 to 15 have all reached a finality in terms of the recommendations made and there have also been peer review stages in certain Action Plans to monitor whether the recommendations’ made by OECD have been adopted by various countries/regions.

On the lines of BEPS Action Plan 1 report which suggested that countries could introduce any of the three options analysed in their domestic law as additional safeguards against BEPS, India has been in the forefront in introducing an ‘Equalisation Levy’ in 2016. Further, India has also amended the nexus rules for taxation of business income of non-resident in India in the domestic law by incorporating the concept of SEP in 2018 to enlarge the scope of ‘business connection’. Even countries like Israel have introduced the concept of SEP to address the challenges of the digital economy.

Thereafter, OECD released the interim report in March 2018 that dealt with the complexities revolving around the framework of the international tax rules arising out of the digital economy. Though the report provided an in-depth analysis of the main features frequently observed in certain highly digitalised business models and value creation in the digitalised age, as well as the potential implications for the existing international tax framework, the report further stated that much work is desirable to enable carrying out an analysis of the value contribution of certain characteristics of highly digitalised business models as well as digitalisation more broadly.

Pursuant to India adopting the early measures, many countries like the U.K., Australia, Spain, etc. as well as European Union have followed suit and proposed measures for the taxation of digital business activities in spite of the fact that the BEPS Action Plan 1 has merely suggested introduction of any of the three options analysed to be adopted to tackle the issues arising out of the digitalised business models. Further, most of these countries have also declared that such measures are temporary. BEPS Action Plan 1 also states that it would require further calibration/adaptation to ensure consistency with the existing international legal commitments. However, India on the other hand has introduced these provisions in the domestic law and it seems that these provisions have been introduced on a permanent basis.

The proposals being considered by OECD in the Policy Note appear to be impacting businesses across the globe especially the digitalised business models. These proposals may go beyond the arm’s length principle in the context of transfer pricing regime which could influence the way profits are allocated between jurisdictions.

Given the time frame of around 18 months, commencing from June 2019 till the end of 2020; this appears to be a stiff deadline for the OECD to transpose the deliberations culminating into broader consensus-based recommendations especially when an attempt is being made to deal with all the facets of international taxation (including the aspects of the digital economy). It would be a very interesting to follow these developments in the times to come.
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