Briefing

International tax review for February

Speed read

The OECD's pursuit for a multilateral solution to digital services tax headlines our tax update this month, with four possible options set out as to how such a tax would operate. Details are provided of a unilateral digital services tax in Spain. The OECD's Forum on Harmful Tax Practices has released an update on its work performed in countering harmful regimes under BEPS Action 5. Related to this, and the desire to fall outside of the criteria of the EU's blacklist, several lower tax jurisdictions have enacted legislation requiring local entities to have adequate economic substance. The Australian Tax Office has released guidance on the operation of its anti-hybrid rules.

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Digital tax continues to be the key discussion topic of the international tax landscape with an update from the OECD on multilateral action and news of draft legislation for a proposed Spanish unilateral measure. At the time of writing, the OECD's consultation paper considering the four potential solutions in further detail (summarised below) is hot off the press, and has started the clock on an intensive two and a half week consultation phase. I will of course provide more information on the consultation next month, when we may also have an indication of the preferred option(s) and likely direction of travel for future OECD work.

OECD: digital tax developments

On 29 January 2019, the OECD released a policy note, *Addressing the tax challenges of the digitalised economy*, approved by the inclusive framework of over 125 countries, bringing the support of a broad cross-section of developed and developing countries. This was followed by the publication of a consultation paper on 13 February, marking the start of a four week consultation process – written comments from interested parties are to be submitted by 1 March, and there will then be a public consultation in Paris on 13 and 14 March.

The OECD has acknowledged the growth in unilateral measures, and remains hopeful that a multilateral solution will be delivered. Multilateral solutions are, of course, more difficult to agree than unilateral solutions, and this is illustrated by the fact that there remains four different proposals in play. More widely, there remains some apprehension on the extent that any final proposal will deviate from the well-established arm's length principle.

These four proposals are divided into two 'pillars' of work.

Pillar 1 (nexus and profit attribution):

- Proposal 1 (user contribution): Routine profits would continue to be allocated on an arm's length basis with non-routine profits allocated on the basis of active-user contribution. This proposal would be restricted to highly digitalised models that are based on active user contribution (e.g. social media platforms) and would be an explicit deviation from the arm's length principle.
- Proposal 2 (marketing intangibles): Routine profits would continue to be allocated on an arm's length basis with non-routine profits deemed to be trade intangibles and allocated in line with DEMPE principals (development, enhancement, maintenance, protection and exploitation). A greater portion of non-routine profits would be allocated to market jurisdictions, and again, this proposal is an explicit deviation from the arm's length principle in its treatment of marketing intangibles.
- Proposal 3 (significant economic presence): Retention of the existing system but with a revision to nexus rules. Where there is significant economic presence (i.e. sales exceed a certain threshold), the market jurisdiction would exercise taxing rights over those sales. This proposal may require an explicit deviation from the arm's length principle as the mechanisms that govern existing profit allocation rules do not allocate meaningful profits to significant economic presence.

Pillar 2 (completion of work from BEPS):

- Proposal 4 (minimum taxation): Development of additional rules designed to allow a minimum level of taxation in the jurisdictions of source and residence, similar to the 'GILTI' regime in the US. These rules could operate independently of the pillar 1 proposals, and three possible options include:
  - Full or partial inclusion rules: residence countries would include untaxed or low-taxed income derived from source countries;
  - Tax on base eroding payments: deductions would be denied for a wider range of transactions (e.g. excessive royalties); or
  - Coordination rules: rules to eliminate or mitigate the risk of double taxation.

There remains considerable work to be done before a multilateral agreement is found, with different OECD members favouring different solutions. These solutions are intended to be further developed in a report due in May 2019 and then will be presented to the meeting of G20 finance ministers in June 2019.

These rules should not be dismissed by those outside of the technology sector: the proposals are broad and are likely to impact all businesses with any element of digital within their operating model. I strongly recommend you continue to keep a close watch on these developments.

Spain: DST proposed in pending legislation

Spain has become the latest country to draft digital services tax (DST) legislation. A bill for a DST was published on 25 January 2019 and once enacted, is expected to apply during the second half of 2019, to all taxpayers that render digital services – including online marketing services and online mediation services. The tax also would be imposed on services that allow third parties to contract and conclude supplies of goods and services, or that transfer data.

As drafted, the DST will apply when both of the following thresholds are satisfied:

- the total net turnover of the business in the calendar year exceeds €750m; and
- the total amount of income derived from rendering digital services (subject to the tax) in the previous calendar year exceeds €3m.

If a company is part of a global group, the €750m threshold refers to the global group, but the €3m threshold would apply only in respect of the company (and thus would not exclude the intra-group provision of such digital services).

The proposed rate of tax is 3% and would be applied against the amount of digital services income (excluding VAT) earned by the taxpayer in Spain.

BEPS Action 5: Forum on Harmful Tax Practices

Back with the OECD, the Forum on Harmful Tax Practices (FHTP) has continued its work on the review of preferential regimes under BEPS Action 5 on Harmful Tax Practices, which aims to ensure a level playing field in tax practices throughout the world. Since the start of the BEPS project, the total number of regimes reviewed now totals 255, from 70 jurisdictions. Of the regimes investigated, there currently remains only two regimes that continue to be classified as harmful regimes.

The results to date show that all previously harmful IP regimes are now either abolished or have been amended to comply with the nexus approach (the nexus approach requires a link between the income benefitting from the IP regime and the extent to which the taxpayer has undertaken the underlying research and development that generated the IP). These changes mean that it is no longer possible to shift income from IP assets into a preferential regime without having undertaken the underlying research and development activity to create that IP in that jurisdiction.

There has also been evidence of changes made to non-IP regimes, to comply with the required OECD standards. For example, ring-fencing features which were designed to attract investment while protecting the domestic tax base have been removed by almost all jurisdictions, either by abolishing the regime altogether or opening the regime to the domestic market. In addition, regimes that lacked transparency have also been amended to ensure that the conditions for entry to the regime are clear and known in advance.

Going forward, the FHTP will look to review regimes in non-tax and nominal tax rate jurisdictions, with the aim of levelling the tax playing field for all jurisdictions.

Economic substance requirements for 'key' offshore jurisdictions

A number of offshore jurisdictions, including the British Virgin Islands, Cayman Islands, Bermuda, Guernsey, Jersey, and Isle of Man have enacted legislation requiring local entities carrying on specified activities in these countries to have adequate economic substance.

These changes are a response to recently released EU economic substance requirements and the new global OECD standard on substantial activities requirements for no tax (or only nominal tax) jurisdictions.

In recent years, the EU has taken action through its Code of Conduct Group to identify non-cooperative jurisdictions based upon a criteria of tax transparency, fair taxation and compliance with the OECD's BEPS requirements. A number of offshore jurisdictions made commitments to reform their economic substance requirements by the end of 2018 to bring them into line with EU's 'fair taxation' principle that 'a jurisdiction should not facilitate offshore structures or arrangements aimed at attracting profits which do not reflect real economic activity in the jurisdiction', and avoid their inclusion in the EU's list of non-cooperative jurisdictions (the EU blacklist).

While each jurisdiction has independently drafted and enacted their own economic substance legislation, the requirements are broadly similar across each of the offshore jurisdictions. The substance requirements took effect from 1 January 2019, with a six-month grace period given to existing entities to meet the requirements.

The rules require both local and foreign registered companies and limited partnerships which carry on 'relevant activities' in an offshore jurisdiction and are not tax resident in another jurisdiction, to comply with the relevant economic substance requirements for such activity. The economic substance that needs to be established and maintained is determined by management of the entity, income generating activities, physical presence, number of employees and operating expenditure incurred.

There are certain exceptions to these general economic substance requirements for holding companies (which will only be required to meet a reduced test for economic substance) and intellectual property companies (which will face more onerous requirements).

The EU will also be reviewing the legislation enacted by the various offshore jurisdictions to determine whether their new substance measures meet the EU's 'fair taxation' principles. If the EU concludes that the legislation does not meet these principles, offshore jurisdictions risk being included in its blacklist.

Enterprises and individuals that have offshore entities within their existing investment and/or operating structures should take action to understand the substance requirements applicable for the offshore jurisdiction(s) in which they operate, and to determine what steps may need to be taken to comply with these measures.

ATO guidance on operation of Australian anti-hybrid rules

The Australian Taxation Office (ATO) has recently released draft guidance providing the ATO's view on what arrangements will be considered a 'structured arrangement' and whether an entity will be a party to the structured arrangement for the purposes of the Australian hybrid rules (law companion ruling LCR 2018/D9, together with *Practical compliance guidelines: OECD hybrid mismatch rules – concept of structured arrangement* (PCG 2018/D9)).

The ATO's view on 'structured arrangement' is significant as it will determine the commencement date of the imported hybrid mismatch provisions. Where an offshore hybrid mismatch exists within a multinational group, and is directly or indirectly connected to an Australian deductible payment (which is deemed a 'structured arrangement'), the 12 month deferral of the commencement date will not apply. In these circumstances the imported hybrid mismatch provisions will apply from income years starting on or after 1 January 2019.

The 'structured arrangement' definition is satisfied in respect of a payment giving rise to a hybrid mismatch if one of the following two limbs are satisfied:

- the hybrid mismatch is priced into the terms of a scheme under which the payment is made; or
- it is reasonable to conclude that the hybrid mismatch is a design feature of a scheme under which the payment is made.

Much of the debate turns on whether it is reasonable to conclude the hybrid mismatch is a 'design feature of the scheme'. This determination requires an objective test based on the relevant facts and circumstances of the scheme.

Should the ATO maintain its view through the consultation stage, Australian subsidiaries of foreign parent entities should consider their exposure to the imported hybrid mismatch provisions from 1 January 2019. ■

For related reading visit www.taxjournal.com

- OECD's digital economy tax reform: the race to consensus (Tom Roth, Kate Alexander & Allen Tan, 7.2.19)
- Corporate residence and the economic substance requirements (Andrew Parkes & Zoe Wyatt, 7.2.19)