Briefing

International review for October

Speed read

The OECD released its public consultation document on a 'unified approach' to the taxation of the digitalised economy. Mexico is the latest jurisdiction to announce unilateral measures, whilst Italy has revised its rules on a digital services tax. France and Mexico introduce various tax changes in their respective budgets, including measures aimed at increasing compliance with the BEPS recommendations. Malta has introduced a patent box regime. The Hong Kong tax authority has changed its view on the deductibility of foreign taxes. The Australian tax authority maintains its transfer pricing focus on the life sciences sector.

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The past month has seen further developments in the OECD's push to address the taxation of the digitalised economy. The release of the latest document focusing on pillar one of the programme of work discusses a 'unified approach' to deal with these challenges. It kick-starts a short consultation period, which will culminate in a public consultation taking place mid-November. Taxpayers and tax administrations alike are watching this space closely; now is the time to take stock of these developments that are expected to usher in significant (and unprecedented) global tax reforms. Meanwhile, unilateral measures continue to proliferate. Italy has released revised rules on a digital services tax (DST) and Mexico has also made a move in this space.

Recent developments in international tax are not only about 'BEPS 2.0' and the taxing the digital economy initiative. In other developments, Malta has introduced new patent deduction rules; France a new Finance Bill; Hong Kong has issued new guidance on deductions for foreign taxes; and recent Swiss tax reforms have seen the country being removed from the EU's grey list of non-cooperative jurisdictions. Countries are focusing their attentions on other areas of tax policy, whether by clamping down on BEPS-related tax avoidance or by introducing tax-competitive measures.

Taxation of the digital economy

Following a meeting of the OECD task force on the digital economy, the OECD Secretariat released a public consultation document on 9 October that sets out a proposal for a 'unified approach' to nexus and profit allocation rules. The focus is on pillar one of the OECD's programme of work on addressing the tax challenges arising from the digitalisation of the economy, published earlier this year. The proposal under pillar one grants greater taxing rights to market jurisdictions and intends to ensure greater taxation in jurisdictions in which significant business is conducted, even without a physical presence.

One might wonder what is so 'unifying' about this unified approach. Put simply, the revised approach is built on significant commonalities previously identified in the programme of work. It blends together some elements of the 'user participation', 'marketing intangibles', and 'significant economic presence' proposals. Each of these proposals envisaged (i) reallocating taxing rights in favour of the user/ market jurisdiction; (ii) a new nexus rule largely based on sales; (iii) going beyond the arm's length principle and departing from the separate entity principle; and (iv) simplicity and administrability of the rules, as well as stabilisation of the tax system.

It's notable that the scope of the new proposal is wider than just highly digitalised businesses. It focuses on large, consumer-facing businesses. The paper mentions that certain sectors (for example, extractive industry, financial services and commodities) may be carved out. Size limitations are also possible (most likely a €750m threshold, but flexed in relation to the size of a given market).

A new formulaic approach to allocating profit via a three-tier mechanism is also considered. 'Amount A' will represent a share of deemed residual profit allocated to market jurisdictions using a formulaic approach based on sales; 'amount B' will represent a fixed remuneration for baseline marketing and distribution functions that take place in the market jurisdiction; and 'amount C', will represent an allocation based on traditional TP rules where in-country functions exceed the baseline activity compensated under 'amount B' (mandatory binding arbitration will likely apply to this element).

It is pertinent to note that this publication does not constitute a consensus position within the OECD Inclusive Framework, and represents only a single unified Secretariat proposal. Whilst this development is another positive step forward in seeking to tax the digitalised economy there are still many issues that need to be addressed, particularly around scoping, elimination of double taxation, determining the amounts used in the new formula and dispute resolution. The OECD still faces the momentous task of garnering the support of all the countries round the table.

The public has until 12 November 2019 to send comments to the OECD, ahead of a public consultation to be held in Paris on 21 and 22 November 2019.

Italian digital services tax

On 15 October, a decree was approved on amendments to the previously agreed version of the Italian DST. It had never come into force as implementing measures were never adopted. The DST is a 3% tax on revenues generated from certain B2B and B2C digital services rendered to Italian customers. Scoping is two-pronged; businesses must have total worldwide revenues of not less than EUR750m as well as revenues of not less than EUR5m obtained in Italy from digital services (e.g. digital advertising, digital platforms, and transmission of data collected from users). Interestingly, the Italian VAT rules on assessment, penalties, collection and litigation should apply to the DST – an implicit confirmation that the tax has the nature of an indirect tax. It will come into force 1 January 2020 and, similar to the French tax (and the potential UK tax), will be repealed if and when an internationally agreed regime is agreed upon at OECD-level.

Introduction of the Maltese patent box

Malta recently introduced a patent box regime which allows taxpayers actively involved in the development and

exploitation of intellectual property (IP) to opt for the application of special rules on calculating deductions for income tax purposes.

Only income/expenses from IP which meets the definition of 'qualifying IP' is eligible for the patent box deduction. 'Qualifying IP' is broadly defined and does not only cover patents (including those pending issuance or extension) but also non-patent IP protected by legislation (such as those related to plant and genetic materials), orphan drug designations and software protected by copyright. Marketing related IP (such as brands and trademarks) does not qualify. Moreover, taxpayers whose functions do not go beyond pure holding, deriving passive royalty income without contributing (directly or indirectly) to the development of the IP are excluded from applying the rules.

The French Finance Bill for 2020

The 2020 Finance Bill, released on 27 September, sees the introduction of important tax changes in France. Besides amendments to the staggered reduction of the French corporate income tax rate (from a rate of 33.33% in 2018) that will see the rate reach 25% for all companies in 2022, the Finance Bill seeks to address hybrid mismatches via the implementation of ATAD II. The French government also decided to implement article 9a of the EU Directive on reverse-hybrid mismatches which has a later enforcement date dictated by the EU. This will only apply from 1 January 2022.

The Finance Bill also addressed a November 2018 CJEU ruling in *Sofina* (Case C-575/17) that French tax law allows for a mismatch in treatment between non-resident loss-making companies that receive French-source dividends, when compared to the receipt of dividends by a loss-making French resident company. The withholding tax applied in the former scenario has been temporarily frozen.

Parliamentary discussions on the bill began on 14 October and will be finalised by the end of 2019.

EU white-lists Switzerland and the UAE

The EU listing system has three categories: fully cooperative, non-cooperative and a 'grey list' of countries that are non-cooperative but are making steps to become so. On 10 October, EU ministers agreed to remove Switzerland from the grey list of non-cooperative jurisdictions and into the fully cooperative category. This follows a Swiss referendum earlier this year and confirmation that relevant legislation has come into force.

The UAE, having improved its economic substance rules, has now also been added to the white-list. Countries remaining on the black list of non-cooperative countries are Belize, Trinidad and Tobago, American Samoa, the US Virgin Islands, Guam, Oman, Fiji, Samoa and Vanuatu.

Mexico's proposal on sweeping tax reforms

In September, Mexico's federal executive released a proposed bill containing the 2020 tax reform package which could result in a sweeping reform of the Mexican tax system.

The amendments are designed to address concerns highlighted by the BEPS project and include updates to the PE definition, modifications to the tax treatment of payments made to hybrid entities, the introduction of mandatory disclosure rules (MDR) and new limits on interest deductibility.

Notably, they have removed the recognition of fiscal transparency for foreign entities. As drafted, the proposal refers to foreign trusts, associations, investment funds, and any other similar arrangement that does not have 'legal personality.' If the proposed bill is approved without modification, certain entities such as US limited liability companies could no longer be considered transparent, and they may be subjected to a withholding tax applicable to the type of income paid.

There has also been a proposal for the taxation of the digital economy which refers to the OECD's work identifying the issues involved. Under the proposed rules, entities without an establishment in Mexico but that provide services to persons or entities in Mexico through a digital platform would be required to withhold tax or, alternatively, to pay the amount of tax themselves.

Hong Kong: disallowing deduction for foreign taxes

The Hong Kong Inland Revenue Department (IRD) has this month released guidance providing the IRD's new view on deductions for foreign taxes. The IRD expressed the view that foreign income taxes imposed on gross receipts/income (for example, withholding tax imposed on gross royalties, service fees and management fees) are no longer deductible under the general deductibility rules. This is a significant deviation from longstanding practice. Prior to the revision of its guidelines and consistent with historic tax legislation, foreign withholding taxes imposed on gross income were deductible.

The new interpretation is that the deduction for profits tax-type foreign taxes is not available when the tax is paid in a jurisdiction where Hong Kong has entered into a double tax treaty (DTT). Hence, a domestic (Hong Kong) tax resident may no longer claim a deduction for the foreign tax paid in a DTT country in respect of specified interest and gains, but only a tax credit under the applicable DTT.

For multinational groups with global or regional head offices situated in Hong Kong, or for groups with service centres or intellectual property holdings in Hong Kong, the revised policy may have significant implications and increase the overall cost of doing business in Hong Kong. The IRD's revised interpretation and practice notes could mean that taxpayers would need to consider reviewing their transactions and prior-year tax computations to determine the implications for them.

Australia: ATO focus on transfer pricing and life sciences

The Australian Tax Office (ATO) continues to ensure that multinationals operating in the pharmaceuticals and life sciences industry pay their 'fair share of tax'. BEPS blurred the lines between traditional corporate tax and transfer pricing – now, more than ever, the two are intimately linked – and the ATO has re-emphasised this shift in focus. With a focus on the industry and the 'justified trust' program in full flight, ATO engagement is not a case of 'if' but 'when' for many taxpayers in the pharmaceuticals and life sciences industry. When entering arrangements taxpayers should consider how third parties would enter into similar arrangements, show the arrangements make commercial sense, appropriately document transactions, ensure a robust transfer pricing analysis is undertaken and have sufficient and effective governance frameworks in place. ■

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- Unify and conquer: the OECD's 'unified approach' to pillar one (Brin Rajathurai & Murray Clayson, 16.10.19)
- Taxing the digital economy (Deeksha Rathi, 3.6.19).