Digital Tax Debate:
Where are we today and what is at issue

Current State of Play

- The Secretariat has put forward a compromise “unified” approach, based on three previous Pillar 1 proposals.

- Pillar 2 evolution has been to address technical issues

- Both Pillars have had comments and the Secretariat has met (12.12.19)

General Challenges heard by both Governments and the Private Sector

- No clear principles but could deliver sustainable tax regime.
- Needs careful diplomatic handling to get political agreement.
- Offers something to many jurisdictions.
- Key countries likely to be amenable to the compromise on Pillar 1 not on Pillar 2

Pillar 1: A Unified Approach

Background to the Secretariat Proposal

The Secretariat considers the issues at stake are of highest importance, with the following at risk:

- Fundamental features of the international tax system, including:
  - Allocation of taxing rights between jurisdictions; and
  - Traditional notions of taxable presence and the arm's-length principle for profit allocation;
- The future of multilateral tax cooperation.

Governments are under intense political pressure to change the taxation of highly digitalised MNEs, and as a result, some jurisdictions may be understandably nervous to compromise in reaching a consensus solution.

What does the Secretariat Proposal try to do?

- Develop a consensus solution to the tax challenges raised by digitalization;
- Sets out possible architecture of a unified approach for agreement by January 2020; and
- Bridge the gaps in three previous Pillar 1 proposals.

Output: Secretariat proposal Pillar 1

An additional taxation right imposed by the market jurisdiction (and relieved from the residence jurisdiction) on certain consumer-facing businesses

- **Create a new right to tax** (nexus) to:
  - in the market jurisdiction;
  - dependent not on physical presence, but
  - (largely) on in-country sales.
- **Broad scope**, applying to:
  - highly digitalised business models, AND
  - non-digital businesses that are:
    - consumer facing, AND
    - use "digital technology".
- **Formulaic approach** to profit allocation:
  - applies to "above normal" profits;
  - the traditional arm's-length principle applies to normal profits.
- **Neutral** as to what type of business model is used (local branch/subsidiary or remote seller).

Pros and cons of Secretariat proposal

Pros:

- Minimizes change to existing framework (by overlaying new taxing right).
- Mechanical test for:
  - when a market jurisdiction has taxing rights (i.e. volume of sales); and
  - amount allocated.
- Should be straightforward to apply in the future, minimizing complexity for taxpayers and tax administrations.
- Applies to non-digital businesses as well as digital businesses.
- Applies equally to groups that sell into a market through a local distributor as well as distance sellers.

Cons:

- Triggers for definition and quantum are arbitrary/compromise and will be open to political debate.

Technical issues still to be resolved: Pillar 1

- Which businesses fall in scope? **If it is "consumer facing" how to define consumer?**

- Revenue threshold for establishing taxing rights? **Small may be big to developing countries**
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- Taxpayer global size de minimis?

- How to mitigate the risk of double taxation on the same profits arising from 3-tiered approach to profit allocation? **Can developing countries have certainty that they can calculate "normal profits" (Transfer pricing)**

- Calculation of "above normal" profit?
  - What proportion of "above normal" profit should go to market jurisdictions?

- How to collect the tax (withholding tax)?

- How to address cyclical businesses?

Pillar 2: Global Base Erosion (GloBE) proposal

Pillar 2: Background to Global Base Erosion (GloBE) proposal

Measures to address profit shifting to entities subject to no or very low taxation

Income inclusion rule

Operates as a minimum tax (top-up like US GILTI)
Tax income of a subsidiary if not taxed enough
Protects the tax base of the parent jurisdiction
Carve-outs for compliant FHTP & blending (GILTI)
Can supplement or replace CFC rules

Undertaxed payments rule

Right to “tax back” profits undertaxed by others
Denies a deduction for a payment to related party if that payment was not taxed at a minimum rate
Conduit arrangements & indirect payments
“Undertaxed” test (entity vs. transaction)

GloBE rules

Switch-over rule

Switch from exemption method to credit method under treaty if source country applies low tax rate
Same if income benefits from preferential tax treatment introduced after signing the tax treaty
Credit method as sole treaty based mechanism

Subject to tax rule

Denies treaty benefits in absence of sufficient tax
Applies withholding or other tax at source
Requires changes to domestic laws & tax treaties
Priority given to interest and royalties (like Dutch)
Applies to related parties & maybe unrelated too

Pillar 2 Concerns

- How will the 4 rules interact? Will there be any safeguards against double or multiple taxation?
- What will the rank ordering be of rules? (sequencing? If one applies the others do not?)
- Will there, can there be any agreement on the minimum rate?
- What is the scope (tax base)? CFC base? Using agreed upon accounting to determine consolidated base?
- Blending: can an entity consolidate activities in a low-tax with a high-tax jurisdiction, weighted, to average out?
  - And scope of blending: transaction, jurisdiction, global?
- Carve outs and thresholds? What MNEs should not be subject to minimum tax (compliant with BEPS 5?), de minimus thresholds (if so developing country issue).