

OECD Policy Note scopes work on the future of the international taxation system

1 February 2019

In brief

On 29 January, the OECD released a [policy note](#) (approved by the 127 members of its Inclusive Framework (IF)) and hosted a webcast which together outlined options that the IF will examine for addressing the tax challenges of the digitalisation of the economy.

The policy note recognises "*that the digitalisation of the economy is pervasive, raises broader issues, and is most evident in, but not limited to, highly digitalised businesses*". Importantly, the webcast noted explicitly that the proposals may go beyond the arm's length principle and also consider innovative types of nexus that would not require a physical presence. Four proposals are being examined under two pillars, both of which affect how business broadly is taxed, not only those businesses that are "highly digitalised" (i.e. digital native businesses).

The two pillars of work that will be examined on a "without prejudice" basis by the Inclusive Framework throughout 2019 will address:

1. Base Erosion and Profit Shifting (BEPS) risks that are exacerbated by digitalisation, focusing on a minimum tax proposal that would limit tax deductions for outbound payments and include income in investors' profits where the profits were not otherwise subject to sufficient levels of tax; and
2. The broader challenges to the tax system that are associated with digitalisation, focusing on the allocation of taxing rights among countries through one or more of three separate proposals - significant economic presence, market based intangibles, and active user participation.

More detail for these proposals is expected on or around 11th or 12th February 2019, with a three week written public consultation period. A public consultation meeting will be held on 13th and 14th March in Paris, following which the OECD will present a work-plan to the IF in May, and then to the G20 in June. When approved, this work-plan will take the OECD project through to final recommendations to the G20 in 2020.

In detail

Background

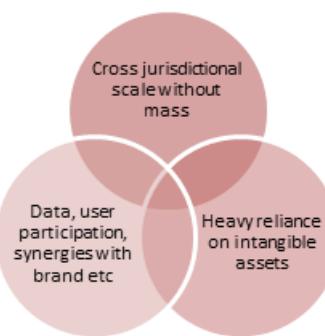
In its final report on Addressing the Tax Challenges of the Digital Economy in 2015, the OECD recognised that the digitalisation of the economy poses broader tax challenges than simply exacerbating the base erosion and profit shifting (BEPS) challenges that the OECD was seeking to address at the time. The OECD committed to keep monitoring the impact of digitalisation on the international tax framework and report back to the G20 in 2020. The OECD Inclusive Framework on BEPS (of 113 countries at that time, now 127, working together on consensus recommendations) was unable at that time to recommend that countries not implement unilateral measures to address their own concerns, so long as they respected their treaty obligations while doing so.

By summer 2017, several countries had introduced unilateral measures, and others - including the European Union - were considering doing so. Against this backdrop, the G20 renewed the mandate of the OECD's Task Force on the Digital Economy and asked them to prepare an interim report on their progress by April 2018.

As the OECD's work continued, several individual countries and the European Commission have - while noting their preference for global rule changes - stated that they are unwilling to wait indefinitely for such global agreement, and countries have begun gearing up to introduce localised measures to address their concerns in lieu of such an agreement.

The OECD Interim Report was released in March 2018. This detailed report examined a range of issues, particularly noting that the structure of businesses and the process of value

creation has significantly evolved through the digitalisation of the economy, especially for some enterprises. Three salient characteristics were noted to be impacting the process of value creation, and they will become common features of an even wider number of businesses as digitalisation continues:



The Report concluded that there were three viewpoints held by Inclusive Framework members at that time:

- One group believed that key features (particularly reliance on data and user participation) leads to (non-BEPS) misalignments on allocation of value creation. They did not wish to see change to the broad principles of international taxation.
- A second group of countries took the view that the ongoing digital transformation of the economy, and more generally trends associated with globalisation, present challenges to the continued effectiveness of the existing international tax framework for business profits. Importantly, for this group of countries, these challenges were not exclusive or specific to highly digitalised business models.

Finally, a third group of countries believed that the BEPS package

largely addressed the concerns of double non-taxation, were generally satisfied with the existing tax system, and did not see the need for any significant reform of the international tax rules at that time.

For more detail on the OECD's interim report, the interaction with the European Union's work, and a number of unilateral measures that were emerging at that time, see our [Tax Policy Bulletin of April 2018](#).

Since April, the number of unilateral measures observed has increased further still, with a number of European countries in particular noting a desire to introduce domestic Digital Services Taxes (turnover taxes) following the breakdown of pan-European agreement on a broadly scoped turnover tax.

On 29 January, the OECD released a [policy note](#), approved by the 127 members of the Inclusive Framework regarding options that it will examine for its project to address the tax challenges of the digitalisation of the economy. The OECD also hosted a webcast that provided further detail. The policy note is only two and a half pages long, but includes sufficient detail to identify the four key proposals under consideration in advance of more detailed papers that will be released on or around 11th or 12th February 2019.

Observation: The three groups of countries identified in March 2018 have come together to work "without prejudice" on a range of potential options under two pillars - additional BEPS rules alongside broader changes to the allocation of taxing rights. While the differences in views on the required breadth of solutions can still be seen in the detail of the four options being considered, previously hesitant countries seem to have been convinced of the need to

consider significant changes to the international tax system.

Two pillars

The OECD webcast confirmed that since March 2018, members brought forward concrete proposals under two pillars:

- Pillar one, dealing with nexus and profit allocation (three proposals); and
- Pillar two, relating to remaining BEPS issues (one proposal).

Both pillars will be examined "without prejudice" by all Inclusive Framework member countries.

Observation: The two pillars implies that any agreement will include two elements, which may not be interdependent. Given there is only one proposal under pillar two, and the OECD has revealed that it would include a combination of rules similar to German royalty deduction limitations and the US global intangible low-taxed income (GILTI) provisions, it is apparent this pillar has a much broader focus than "highly digitalised" businesses, but could garner support from several large countries.

Pillar one contains a more diverse range of options that could be taken forward individually or merged into a hybrid solution with elements of each.

Pillar one: nexus and allocation

"Under the first pillar, focused on the allocation of taxing rights including nexus issues, several proposals have been made that would 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."

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While little detail is given in the policy note regarding the solutions being discussed, the webcast provided a little more detail:

1. *User contribution:* revisions to existing rules on nexus and attribution based on "active user participation", which would apply only to highly digitalised businesses providing platforms or operating in the gig economy.
2. *Marketing intangibles:* revisions to existing rules on attribution based on "marketing intangibles" or possibly more broadly, market-related intangibles (distinct from other intangibles). This could be achieved through allocation of marketing/market-related intangibles to market jurisdictions, together with a share of income. This proposal includes changes to the nexus concept which could go beyond the requirement of physical presence. This new system could apply to more businesses than just those that are highly digitalised.
3. *Significant Economic Presence (SEP):* revisions to existing rules on nexus and attribution based on "SEP", looking to identify where businesses have an important economic relationship with a market but attributing taxing rights in a simpler way that would be more easily administered.

For the first two solutions, the OECD noted that a residual profit split approach would be considered together with other formulaic approaches.

The policy note clarifies that treaty changes may also be required. It is noted that in all proposals, the solutions would go beyond any current conception of the arm's length principle and limiting taxing rights to physical presence.

Observation: The first solution appears similar to the UK's proposals in its Discussion Documents of [November 2017](#) and [March 2018](#). The second, attributed to the US, is unlike any proposals or law put forward publicly to date. Both proposals imply a requirement for businesses to allocate greater profits to where they interact with markets in a broader range of ways (e.g. sales, "users"), regardless of whether there is a permanent establishment in the market jurisdiction. The third solution was put forward by a group of countries including India, which is in the process of implementing its own domestic rules based around one concept of SEP.

The commitment from the policy note to examine nexus and allocation simultaneously is welcome; BEPS Action 7 addressed these two areas separately which led to a delay in final guidance on profit attribution to permanent establishments and potentially also to the reluctance of some jurisdictions to accept the revised permanent establishment threshold agreed under Action 7.

Pillar two: BEPS 2.0

"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."

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In addition to the policy note, the webcast noted that the proposal would include three elements:

1. Income inclusion rule to encompass profits as income in the hands of related party investors

2. Denial of deductions for source countries for "base eroding payments"
3. Coordination rules to avoid double taxation.

Observation: The proposal appears to combine elements of the German royalty deduction limitation rules and the US GILTI provisions, and the OECD said it was introduced by France and Germany. Challenges will need to be addressed particularly in developing coordination rules that combine these two approaches coherently to ensure that double taxation (or higher) does not arise.

Double taxation and dispute resolution

Both the policy note and the webcast were clear that members of the Inclusive Framework are committed to ensuring that new rules should not result in taxation when there is no economic profit, nor double taxation.

This was stressed through recognizing the need for effective dispute prevention and dispute resolution tools.

Also, mindful of compliance and administrative burdens, the OECD

stated that the proposals will be designed to be as simple as possible, with simplification measures considered as part of the overall project.

Observation: The OECD has listened to businesses' concerns raised throughout the process and has committed to ensuring mechanisms to relieve double taxation and manage disputes will be included at the outset. However, as noted above these will be very challenging and will require a great deal of international cooperation - and an agreement in 2020 - if they are to be comprehensive.

Next steps

The OECD will publish more detail on the four options on or around 11th or 12th February 2019. This will commence a three week written consultation. A public consultation will then take place on 13th and 14th March 2019, which will influence the scoping and work plan that will be presented to the full IF and the G20 Finance Ministers in May and June 2020 respectively.

The OECD technical work will then continue throughout 2019, led by its Task Force on the Digital Economy.

Observation: The OECD timetable is very tight, with little time available for public comment (three weeks from the release of the more detailed papers).

The takeaway

Change is coming to the way international businesses are taxed, potentially including businesses that operate in few countries, yet export goods and services to many. Already we are observing a broad range of unilateral measures as countries seek to address the challenges that they see with the tax system in the digital age. Some are targeted only at so-called "highly digitalised" businesses, but others are broader and are likely to affect all international businesses.

The alternative to a number of uncoordinated unilateral measures is an aligned international solution. The four options on the table will have a significant impact for all businesses, especially as globalisation and digitalisation change operating models further. The consultation in February and March 2019 is a key opportunity for businesses to contribute to this debate - and the four options on the table - before the OECD commences work on technical solutions that could garner this global agreement.

Let's talk

For a deeper discussion of how these issues might affect your business, please call your usual PwC contact. If you don't have one or would otherwise prefer to speak to one of our global specialists, please contact one of the people below:

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