E/C.18/2019/CRP.12

Distr.: General
5 April 2019

Original: English

Eighteenth session

Summary

This paper was prepared by the Subcommittee on Tax Challenges Related to Digitalization of the Economy for discussion by the Committee at its 18th Session. It proposes a general workplan for the subcommittee work, proposes some guiding principles, and seeks Committee view on four questions that have arisen in the subcommittee work and where views of the committee will help focus the work going forward.

The Subcommittee is mandated by the Committee as follows:

“The Subcommittee is mandated to draw upon its own experience as a body widely representative of affected stakeholders and engage with other relevant bodies and interested parties with a view to:

Analyzing technical, economic and other relevant issues;
Describing difficulties and opportunities especially of interest to the various affected agencies of developing countries;
Monitoring international developments;
Describing possible ways forward; and
Suggesting measures and drafting provisions related to the digitalization of the economy, regarding
- Income taxes;
- Double tax treaties, and
- VAT as well as other indirect taxes.”

I. INTRODUCTION

1. The Committee of Experts on International Cooperation in Tax Matters as constituted in 2017 formed a Subcommittee on Tax Challenges Related to the Digitalization of the Economy (the "UN Subcommittee") to address the tax challenges of the digitalization of the economy. The Subcommittee is mandated to draw upon its own experience as a body widely representative of affected stakeholders and engage with other relevant bodies and interested parties with a view to analyzing technical, economic and other relevant issues; describing difficulties and opportunities especially of interest to the various affected agencies of developing countries; monitoring international developments; describing possible ways forward and suggesting measures and drafting provisions related to the digitalization of the economy, with regard to income taxes, double tax treaties and VAT as well as other indirect taxes.
2. The Committee and the Subcommittee discussed these matters in the 15th and 16th Sessions of the Committee and in the Subcommittee Meetings held on the sidelines of the 16th and 17th Sessions. After the 17th Session of the Committee, the Subcommittee had a meeting from 16-t (c)4 (o)-10 ((s)-1 (i)-2 (de)4 (r)3 how,)2 (t)-2 (9)-10 (t)-2 (a)4 k(e)-6

consideration by the Subcommittee. In preparing the Paper, the following guiding principles were to be followed:

- Avoiding both double taxation and non-taxation;
- Preferring taxation of income on a net basis where practicable; and
- Seeking simplicity and administrability.

5. An important decision was for the Subcommittee to adopt an approach independent of similar work being pursued in other fora, while giving due consideration to developments which will inform its work. The Subcommittee also was of the view that

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countries as falling into three groups, which ranged from countries that considered that there was a need to change the existing profit allocation and nexus rules to varying degrees (i.e., first and second groups) to countries that considered that no action was needed beyond addressing BEPS issues (i.e., third group).

10. Since the delivery of the Interim Report, the IF and the TFDE continued their work including on addressing broader tax challenges. In this regard, the IF/TFDE has been mainly considering two proposals focusing on the allocation of taxing rights (the "broader tax challenges"

the Final Report on Action 1 of BEPS, for addressing the tax challenges of the digital economy. Under this proposal, a taxable presence in a country would be created when a non-resident enterprise has a significant economic presence on the basis of factors that are evidence of purposeful and sustained interaction with the economy of that country via technology and other automated means. For establishing the nexus in terms of significant economic presence, some factors, which were also referred to in the Action 1 Final Report, are suggested to be taken into account. These are revenue generated on a sustained basis from a jurisdiction, the user base and the associated data input, the volume of digital content collected through a digital platform from users and customers habitually resident in that country and other factors such as billing and collection in the local currency, a website in the local language, delivery of goods to customers being the responsibility of the enterprise or the enterprise providing other support services, such as after-sales service or repairs and maintenance or sustained marketing and sales promotion activities, either online or otherwise, to attract customers to the digital enterprise. The developing countrotia(u)-4 (s) (i)-2 e devoping countn[-.n01 -12

Model and the pre-2010 OECD Model Tax Convention both provide for attribution of profit to a permanent establishment based either on the direct accounting method or on the apportionment method, where books of account are not maintained for the PE. For fractional apportionment purposes, one would need determine: (a) the definition of the tax base to be divided; (b) the determination of the factors based on which that tax base is to be divided; and (c) the weight of these factors. According to the proponents of the SEP approach, the tax base can be determined by applying the global profit rate to the revenues (sales)eiess. Ac8OEC pr -0.00J 0 Tw 7.34

excises – to tax consumption. There are sound economic reasons for using different taxes to address different elements of the economy. Some countries may be wary about further increasing taxes on consumption. Further, incorporation of an explicit demand element into corporate income tax implies that market countries would gain the right to tax a portion of the profit associated with bare exports to that country of a range of products from oil, minerals and agricultural products to textiles and machinery. While this may benefit countries with large domestic markets such as large emerging market

Question A to the Committee on Paragraphs 17 & 18 and the principles governing the allocation of taxing rights

Within the Drafting Group, a question arose about the principles that should govern the attribution of taxing rights.

One view is that, if after deliberation, the Committee concludes that the market is to be rewarded, it might open the discussion regarding the allocation of taxing rights for other (i.e. traditional) business models. That should also raise the question of whether this paradigm shift is broadly in the interest of developing countries. According to this view, many smaller developing countries (with small domestic markets) reliant on export earnings could be detrimentally affected by a shift toward incorporatio demand/destination elements. For example, analysis in a draft IMF report on "Corporate Taxation in the Global Economy" with respect to various weighting factors unc formulary apportionment shows that while large emerging market economies (e. BRICs) would tend to benefit from the weighting of sales/market, this would not be the case for many lower income developing countries, which tend to benefit more when allocation is based on where MNEs engage staff (employment).

The counter-view is that rewarding the market does not mean that allocation of taxing rights is solely on the basis of market or sales but a combination of factors including sales, users, digital presence etc are to be seen. Thus, the change being discussed is about tax challenges posed by digitalization of economies only and any solution, if reached, should be confined to digital businesses only.

According to this counter-view, the discussion in paragraph 17 is about the validity of the "value creation" principle as a basis of taxing rights, especially from the developing countries' or market economies' point of view, since it seems to ignore demar factors and focuses on supply side aspects only. Further, according to this view, it is not being argued in paragraph 17 that the value creation is only due to the demand side factors without the o t Td ((n)]TJ 0 Tc 0 Tw 5.q 86.64 109.32 436.199 660.1 0 .88 Tm (“)Tj -0.004 Tc 0

19. Further, discussion on value creation could involve consideration of "location savings", a concept of value creation that is accepted by many developing countries, including emerging countries. It includes factors such as the lower costs of labour and real estate in most developing countries, which are seen as contributing an often unrecognized value to the multinational that arguably should be accounted for in transfer pricing analysis. Many proponents of the "value creation" approach based on corporate activities would argue, however, that because such savings are not created by the multinational, but merely captured, they should not be considered in the taxation calculus.

20. The fact that several factors may be relevant to value creation inevitably means that "each nation has an incentive to establish and encourage 'value creation' meanings that will favor that nation". One risk of the current emphasis on "value creation" as the foundation stone is that if there is no consensus on what it means, then any consensus based on the term will be seen through different lenses, with the consequent possibilities of an uncertain investment environment and double taxation or even double non-taxation. This suggests that if the term is used, it is important to be specific about which meaning is intended. Also, some would argue that the emphasis on "value creation" as the basis for taxing digitalized economy does not match with the widely followed policy and practice of many developed and developing countries for taxing passive income (i.e., dividends, interest, royalties, etc.) in the source country. On the other hand, there

IV. POSSIBLE FRAMEWORK FOR CHANGES TO THE UN MODEL CONVENTION TO ADDRESS TAX CHALLENGES OF DIGITALIZATION FROM DEVELOPING COUNTRIES' POINT OF VIEW

21. Under the current tax treaty models including the UN Model, many highly digitalized businesses conducted by MNEs do not pay income taxes or corporate taxes in market countries, including developing countries, despite deriving significant revenues from remote operations carried on there. Taking cognizance of this, relevant work was conducted under the BEPS Project, and has intensified with the more recent discussions under the Inclusive Framework and its Task Force on the Digital Economy. Still, countries have varying positions and no consensus has been reached so far in these fora on the so-called broader tax challenges of digitalization. Another matter of concern is countries proceeding with interim measures unilaterally.

22. From a developing countries' point of view, the solution to the issue on taxing profits of digitalized businesses derived from the market economy may be to take into account that the value of digital goods or services out of which the profits are generated is contributed to by several factors that could be deemed to create nexus in the country hosting these markets, which country, for certain digital business models, would thereby have a right to tax them. At the same time, the solution should be simple to administer by tax administrations and easy to comply with by taxpayers. If the approach adopted is complex, it may lead to disputes and potential double taxation. Developing countries often neither have the capacity to administer complex solutions nor are they equipped to handle costly international dispute settlement processes.

23. The UN Committee has an important role to play here by developing, after the examination of options, a provision in the UN Model on a new nexus rule and a related profit allocation methodology to address the peculiarities of digital business models, and which takes into account the perspective of developing countries in particular. This work should take into account the work done in other fora, particularly the Inclusive Framework, including whether such approaches as are developed there are suitable for developing countries or could be modified. The work done here and in other fora for a relatively long time has shown that the design of a nexus rule and a mechanism to allocate profits that are easily administrable, given the complexity of the matter, may involve trade offs in terms of accuracy as to measuring, allocating various shares of income, and delineating the scope of the rules, i.e. identifying the business to which they would apply. There should be an openness to consider compromise solutions, which would satisfy the legitimate aspirations of market countries, including those that are developing countries, and yet are not unfair to the jurisdictions in which the MNEs are resident. In this regard, the following points may be relevant for consideration of the Committee:

(i) Based on the interaction of supply and demand, rather than the mere "supply side" approach that is often meant when reference is made to "value creation", changes to the UN Model would be suitable as an option for developing countries. The Committee may consider whether to modify the permanent establishment

definition (Article 5) to include remote activities that

more prepared to experiment with formulaic approaches to allocation in a constrained area, at least initially. These approaches, however, seem to require a considerable level of information exchange. To the extent that all countries will be trying to compute the same amounts (to determine the "pie" to be allocated), smaller countries may be able to rely to some extent on the efforts of others. These and many other issues, however, remain to be worked out. In the context of the proposal on Significant Economic Presence, the Inclusive Framework is also planning to examine an alternative approach based on a broad formulary apportionment, that could also be considered. "Modified deemed profit" methods are also contemplated in the BEPS Action 1 Report of 2015 in the context of the Significant Economic Presence concept (paragraphs 289 to 291) and could similarly be explored. These presumptive tax schemes envisage taxation on a net basis though they compromise accuracy in favor of simplicity. It needs to be noted in the same context that even the conventional approach based on transfer pricing is not completely accurate in that a range of prices can often be justified in any given situation. Achieving certainty and administrability may well require sacrificing accuracy to some extent, especially in the context of digitalized business taxation, where complete accuracy seems to be an unattainable target.

<u>Question D</u> to the Committee on subparagraph (ii) of paragraph 23:

1) Complexity of the approaches examined by the Inclusive Framework.

Within the Drafting Group, the question came up whether the approaches examined by the Inclusive Framework, based on routine vs. non-routine profits, are unreasonably complex.

One view is that it is premature to conclude that those approaches are unreasonably complex (given work is ongoing and one of the objectives is to explore simplicity). Further, the alternative approach, i.e. Formulary Apportionment, is simple in theory but can be significantly complex in practice. It would require all the countries hosting the operations of a given MNE to agree on the definition of a common tax base, the allocation factors and their weights, and to jointly audit and jointly agree on the taxable profit of the entire MNE group and the allocation to each country. This would require exchange of information, coordinated tax administration and multi-party dispute resolution on an unprecedented scale.

Another view is that the description of the method for calculating routine and non-routine profits in the Marketing Intangibles approach itself shows how complex it is. In essence, the approach requires first the determination of marketing intangibles, then their contribution to profits, which would need to be determined using two sets of assumptions and then take their difference, i.e. the "marketing intangible adjustment". The calculation of contribution through two sets of assumptions would require, on one hand, allocating marketing intangibles as per current Transfer Pricing Guidelines and on the

VI. GUIDANCE ON ISSUES RELATED TO VAT AND OTHER INDIRECT TAXES

25. The OECD has already released post BEPS guidance in this area, in the form of