

Future of digital tax: OECD's Pillar One (2/8/20)

Picking up where we left off in last week's article "Unified approach to addressing tax challenges in digital economy," this article explores recent proposals for international taxation rules within Pillar One of the OECD's Work Programme.

OECD proposals

Today's digitalised world sees many services supplied remotely and online, without needing any physical presence at all. This leads to a taxation problem as the traditional corporate taxes are linked to a physical presence such as a branch or a permanent establishment, which no longer reflects the reality of the digitalised world. Pillar One summarises key solutions that tackle the uneven profit distribution within the digital business:

- Scope – digitised businesses interacting with users;
- New rules for a nexus that does not depend on a physical presence but is largely based on sales;
- New profit allocation rules that go beyond the arm's length principle;
- Increased tax certainty delivered by a three-tier profit allocation – amounts A, B, and C.

Scope

The new tax aims to cover large businesses interacting with end users that can be divided into two segments: highly digitalised services (online marketing, streaming, social platforms, cloud computing etc) and consumer-facing business (PCs, automobiles, consumer brands etc). Pillar One focuses on companies that remotely interact with users and for which data processing and marketing are important business elements.

Exceptions are the extractive industry, the commodity trading industry, the regulated financial sector, and the operations of ships and aircraft in international traffic. The OECD plans to introduce a threshold similar to country-by-country reporting to ensure that Pillar One covers only groups with gross revenue exceeding EUR 750 million.

The new nexus and profit allocation rules

The traditional income allocation rules would allocate a zero profit to any nexus that is not based on a physical presence. To tackle this problem, the OECD introduces an additional concept of "significant economic presence" that does not require a company's physical presence in a particular country but is linked to revenues derived from the market (clients/users). The OECD is still working on the definition of the new nexus and reviewing various parameters, such as user count, market share, and revenue.

The three tiers

If a group is found to have a significant economic presence in a particular country under the new nexus rules, the next question is which profit do we tax? The OECD has come up with a profit allocation mechanism that achieves both goals: reconciliation with the existing rules and creation of additional taxing rights on excess profits of the digitalised business. This approach divides a company's profits into three amounts: B and C are profits attributed to the company under the arm's length principle, while amount A is the additional taxing right within the new system of Pillar One. Amounts B and C remain taxable under the

existing rules linked to a physical presence, while amount A creates additional taxing rights even for countries where the group has no physical presence but has users/clients.

++A %



Amount A – new taxing rights

This creates new taxing rights for countries where a group is already present and for countries where the group has no physical presence. The calculation of amount A will be based on the group's consolidated accounts by deducting a deemed routine return on activities from the group's profit. The "deemed residual" profit will then be reallocated to countries with a significant economic presence based on sales. The OECD intends to make amount A effectively applicable to losses as well as profits.

+Y %



Amount C – extra functions (dispute prevention and resolution)

This is introduced for preventing and resolving disputes if there is an excess over the compensation under amount B or if the group or company carries out some other business activities in the country unrelated to marketing and distribution.

X %



Amount B – fixed return for defined baseline distribution and marketing activities

This is defined as applicable to "baseline marketing and distribution activities" for distributors that buy products from related parties for resale, i.e. a fixed return.

Conclusion

All proposals under Pillar One have a common overarching objective – to recognise, from different perspectives, the value created by a business's activity or participation in user/market jurisdictions that is not recognised within the current framework for allocating profits. In broad terms, Pillar One is about redistributing excess profits of the digitalised business according to the new nexus rules. And the idea of the three-tier profit allocation is to grant countries where products are sold, or where users reside, taxing rights on a larger share of the group's profit.

(to be continued)