BritishAmericanBusiness

November 2019

Taxing the 21st Century Economy

Towards a Multilateral Approach

Digital Tax Position Paper

Taxing the 21st Century Economy

Towards a Multilateral Approach

Contents

Background

There is increasing consensus that the rules governing corporate taxation, established in the first half of the 20th century, are not fit for an age where physical presence in a specific location is no longer a prerequisite for conducting business there. The rapid speed of digitalization internationally has posed challenges for tax policies, particularly for companies which have found new ways to generate value through digital means.

Digitalization makes it increasingly possible for businesses to reach markets in which they may have relatively little physical presence and to create value for their products based on the participation of users in those jurisdictions. Under existing international tax rules, which allocate taxing rights on business profits on the basis of physical presence, it is possible for a company that is resident in one country to generate significant revenues in another country without paying a significant amount of corporation tax in the latter. This state of affairs is increasingly being challenged.

In short, the debate is about value creation and the division of tax rights among countries which consider that their citizens contribute to the profits made by some digitally focused companies, even if they do so via unconventional means.[1]

The issue of the value created from digital goods and services has been a discussion topic for G20 and OECD countries across the past decade. In June 2012, the G20 Leaders' Summit identified the need to prevent base erosion and profit shifting (BEPS) and the OECD took the lead in exploring this. It was followed by a BEPS Action Plan.[2]

In March 2018, the OECD released an interim report on the challenges of taxing digital services, which was endorsed by 113 countries and analyzed the characteristics of digitalized business models, including features such as remote presence, reliance on intangibles and data, and heavy user participation.[3]

Meanwhile, in 2018, the United Kingdom (UK) announced it would introduce a Digital Services Tax (DST) in parallel to its efforts to support the development of an OECD framework. The draft legislation was published as part of the Finance Bill 2019-2020 and would come into effect from 1 April 2020.[4] The government also published guidance alongside the legislation and both underwent a consultation process.[5]

With unilateral approaches underway, in October 2019, an OECD Secretariat Proposal for a "Unified Approach" under Pillar One was released for public consultation, combining features from three separate proposals – from the UK, the US, and the G20 – and aiming to achieve compromise. This lays the groundwork for a potential agreement in 2020, keeping with the planned schedule. In addition, a public consultation for a Pillar Two proposal was recently launched, which focuses on anti-base erosion measures.

Since the start of the debate on how to tax digital services, BritishAmerican Business (BAB) has been a supporter of a multilateral solution that provides the highest level of consistency across markets, reduces fragmentation, and increases regulatory alignment.

This paper was produced in consultation with BAB's members and finalized following a roundtable discussion organized in Washington D.C. on the 7th of November, 2019, in partnership with PwC, which brought together stakeholders from the OECD, governments, the private sector, and academia. It confirms BAB's initial assessment of the UK DST as the wrong solution to a genuine problem and emphasizes why the renewed momentum behind a global solution should be an added reason to refocus efforts behind the OECD initiative.

The UK Digital Services Tax – An Overview

The UK DST is a tax on gross revenues of 2% of specific business models, where revenues are linked to the participation of users based in the UK. The draft UK guidance mentions that "a user will be considered a UK user if they are normally resident in the UK and thus primarily located in the UK when participating with the relevant business activity." There is little clarity as to how this is to be determined; instead, the burden is placed on businesses to identify user location.

The scope of the tax includes search engines, social media platforms, and online marketplaces. A group will be liable to pay the DST when (a) it provides a relevant business activity, (b) the worldwide revenues attributable to relevant business activities exceed £500m, and (c) more than £25m of these revenues are attributable to UK users. There is also an allowance of £25m under which a group's first £25m of revenues derived from UK users will not be subject to the DST.

The UK proposal is that this tax is meant to be temporary and is subject to formal review in 2025.

While the motivation in the UK for such a tax is well understood, there are several issues that the transatlantic business community identified as worth considering:

- The UK DST was originally drawn up as the OECD progress on a unified approach had stalled. However, given the recent Secretariat Proposal submitted for Public Consultation and the renewed momentum behind a multilateral framework, the UK DST may come into effect at an uncomfortable time, raising uncertainty and sending the wrong signal to businesses: that the UK supports unilateral measures when global measures are possible.

- In the absence of a global framework, the UK tax covering cross-border digital activity is bound to raise the cost of businesses operating across markets, as they must ensure compliance with different regulatory regimes. The risk is compounded by the UK's departure from the EU and the government's expressed policy of pursuing a different regulatory framework in some sectors. In addition, the lack of alignment between national taxes will risk double taxation on companies.

- There is an additional risk that the DST, while presented as an interim measure, will become permanent. It could also encourage other individual states to pursue their own DST. Unilateral measures will distract from efforts towards a multilateral solution.

- The UK and the US have expressed their intention to pursue bilateral trade negotiations as soon as the UK is able to do so. The UK pursuing a unilateral DST may work against the momentum of any upcoming talks, as the US government has stood firmly against unilateral taxes. Trade volatility between the US and UK in the context of recent WTO rulings is an added risk factor.

- Finally, the UK DST fails to provide clarity for businesses on several key operational concepts, and instead places the burden on companies. For instance, the issue of a user's location is central to the UK DST, however the legislation does not provide clarity for situations where location is not actively tracked, where users move across borders often, or where users make use of rerouting tools such as Virtual Private Networks (VPN). As such, much more clarity and certainty in both the legislation and the guidelines on implementation would be needed.

Recommendations on the UK DST

1. Given the renewed momentum behind the OECD's "Programme of Work to Develop a Consensus Solution to the Tax Challenges Arising from the Digitalisation of the Economy," BAB recommends that the UK refocuses on supporting the development of a global, multilateral framework under the OECD umbrella.

2. The transatlantic business community calls for the consistency, stability, and certainty which a global framework developed by consensus through the OECD can provide and which will foster trade and investment in the transatlantic corridor. In contrast, unilateral tax rules based on multiple standards can affect competitiveness, create compliance problems, and raise the risk of double taxation, going against established taxation principles.

3. BAB rejects the revenue-based DST model, which goes against OECD guidance and can create unintended negative consequences. Businesses with losses or generating low profits will be affected disproportionately. We welcome steps taken by the UK to adjust and shield such businesses by introducing a safe harbor, but companies that are not 'giants' will still be affected.

4. BAB would also like to stress that the discussion around and plans for a UK unilateral DST come at an already uncertain time for the UK, given its imminent departure from the EU and the stress it puts on businesses. In addition, a DST may also distract from efforts towards a future bilateral trade agreement with the US, which sees it as a targeted measure aimed at US tech giants. This tumultuous political context makes it imperative that the UK reconsiders its approach.

5. At the same time, BAB believes that the threat of imposing punitive tariffs by the US on British products should the UK go ahead with its DST, is equally counterproductive and needs to be avoided. Instead, both the UK and the US should engage with the OECD process and with each other in meaningful and constructive dialogue, to avoid any friction and obstacles to transatlantic trade and investment.

6. Should the UK government decide, against business recommendations, to go forward with the legislation as it currently stands, BAB strongly urges that provisions be made for reimbursing companies once an international system is in place.

7. The UK should also define precisely when a multilateral solution fulfills the UK's criteria and thus the UK can transition to it.

The OECD's Secretariat Proposal – A Way Forward

The recent OECD proposal, published in October 2019, is not an agreed solution, but rather the Secretariat's own initiative to combine features of three separate proposals – the UK's, the US', and the G20's – with the aim of achieving consensus.

The proposal does not single out the digital economy, nor does it apply to all companies; instead, it focuses on consumer-facing businesses, with further work to be carried out on scope and carve-outs.

For businesses within the scope, it creates a new nexus, not based on physical presence but on sales. The new nexus could have thresholds including country specific sales thresholds calibrated to ensure that jurisdictions with smaller economies can also benefit. It would be designed as a new self-standing treaty provision.[6]

It creates a new profit allocation rule applicable to taxpayers within the scope, and irrespective of whether they have an in-country marketing or distribution presence (permanent establishment or separate subsidiary) or sell via unrelated distributors. The profit allocation is likely to be proportionate to the revenues generated in that market as a percentage of the whole. This is the most detailed aspect of the proposal.

At the same time, the approach largely retains the current transfer pricing rules based on the arm's length principle but complements them with formula-based solutions in areas where tensions in the current system are the highest. In this regard, the proposal includes new rules for fixed returns for baseline distribution activities, which is an area where there have been significant tax disputes.
The Secretariat recognizes that more effective means of dispute prevention and resolution will be essential for implementation.

Overall, the OECD intends to create certainty for taxpayers and tax administrations with this three-tier profit mechanism that combines new formula-based rules and traditional transfer pricing and provides new dispute resolution approaches.[7]

Recommendations for the OECD

1. BAB welcomes the OECD's proposals and recognizes that some issues do not have easy solutions and will require compromise between parties. The proposed attempt to balance the existing transfer pricing system with simplified and formula-based features is a possible way forward towards an agreement.

2. However, the OECD must also complement the work done under Pillar One with mechanisms to prevent and resolve double tax disputes.

3. BAB recommends that the OECD and participating countries provide clear rules regarding the scope of taxation and appropriate carve-outs for certain sectors which do not raise the concerns identified by the process.

4. Additionally, standards and monitoring implementation in various jurisdictions will be needed to ensure that, once there is an agreement, it is followed through by all participants in a consistent and coherent manner that reflects the agreed solutions.

5. BAB urges the OECD and participating countries to act with urgency and purpose in order to respect the agreed timeline and deliver a workable tax framework by the end of 2020.

6. BAB would like to underscore the value of the consultation document approach and encourages the OECD to continue to use it as the proposal is further fleshed out. This will provide stakeholders the opportunity to provide feedback on the detail and specifics.

7. At the same time, particular attention should be given to the interaction of the solutions to be agreed under Pillar One and Pillar Two, to avoid unnecessary duplication and the risk of double taxation.

8. BAB supports the OECD process because it represents a pathway to consistency, less fragmentation, more clarity and certainty for businesses operating globally. These features are essential for transatlantic businesses and will foster trade and investment in the transatlantic corridor.

Conclusion

With an active debate on how to tax the digital economy, new momentum is being built towards a multilateral solution at the OECD level. The Secretariat itself has acknowledged that the current framework will require significant work before being ready. The challenge of identifying and agreeing a formula for the taxable deemed profit in each market, when there will be winners and losers, is fiendishly difficult. Regardless, BAB welcomes the proposal which continues the work done under Pillar One and looks forward to the public consultation and debate around Pillar Two. It is a much-needed development for encouraging consensus and achieving a multilateral solution. The alternative is an increasingly fragmented landscape with different regulatory requirements for companies operating across markets and an increased risk of double taxation.

---

[1] **EY, New digital tax policies: What, when, where, how and by whom?**, August 2018, https://www.ey.com/Publication/vwLUAssets/EY-new-digital-tax-policies-what-when-where-how-and-by-whom/$FILE/EY-new-digital-tax-policies-what-when-where-how-and-by-whom.pdf
[2] **OECD, Action 1 Tax Challenges Arising from Digitalisation**, https://www.oecd.org/tax/beps/beps-actions/action1/
[3] **KPMG, Interim measures for taxing the digital economy allow time for global consensus**, July 2018, https://home.kpmg/xx/en/home/insights/2018/07/taxing-the-digital-economy.html
[4] **HM Treasury, Budget 2018 Digital Services Tax, 2018**, https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/816389/DST_response_document_web.pdf
[5] **HM Treasury, Digital Services Tax: response to the consultation**, July 2019, https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/816389/DST_response_document_web.pdf
[6] **Bloomberg Tax, Taxing the Digital Economy – As Simple as 'A,B,C'?**, 18 October 2019, https://news.bloombergtax.com/daily-tax-report/insight-taxing-the-digital-economy-as-simple-as-a-b-c
[7] **OECD, Public Consultation Document: Secretariat Proposal for a "Unified Approach" under Pillar One**, October 2018 https://www.oecd.org/tax/beps/public-consultation-document-secretariat-proposal-unified-approach-pillar-one.pdf

BritishAmericanBusiness

November 2019

BritishAmerican Business (BAB) is an exclusive members' organization; we create networking opportunities for our members, which often lead to business opportunities, through the events and programming that we run. As a policy and advocacy organization we are the voice of transatlantic business; we support policies and action that will protect and enhance the environment for trade and investment between the US and UK.

For more information, please visit www.babinc.org