The **BEPS** Monitoring Group

# TAX CONSEQUENCES OF THE DIGITALISED ECONOMY – ISSUES OF RELEVANCE FOR DEVELOPING COUNTRIES

This submission to the UN Committee of Experts on International Cooperation in Tax Matters has been prepared by the BEPS Monitoring Group (BMG). The BMG is a network of experts on various aspects of international tax, set up by a number of civil society organizations which research and campaign for tax justice including the Global Alliance for Tax Justice, Red de Justicia Fiscal de America Latina y el Caribe, Tax Justice Network, Christian Aid, Action Aid, Oxfam, and Tax Research UK. This report has not been approved in advance by these organizations, which do not necessarily accept every detail or specific point made here, but they support the work of the BMG and endorse its general perspectives. It is based on our previous reports, and has been drafted by Sol Picciotto, with contributions and comments from Jeffery Kadet, Tatiana Falcao, Abdul Muheet Chowdhary, and Mustapha Ndajiwo.

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## SUMMARY

We welcome the decision of the UN Committee to examine the tax consequences of digitalisation independently, while giving due consideration to work in other fora, and taking account of the limitations of its resources. Regrettably, the G20/OECD project on base erosion and profit shifting (BEPS) has produced little to benefit developing countries, and even the current negotiations in the Inclusive Framework for BEPS continue to be dominated by OECD countries, and to favour residence-based taxation.

Taxing income where activities take place means giving priority to source taxation, which has always been the concern of developing countries, as reflected in the UN model convention. They long ago pointed out the defects of a purely physical definition of a 'permanent establishment', particularly with the dematerialisation of economic activity, reflected in the shift from goods to services, now exacerbated by digitalisation. This enables extensive cross-border involvement in the society and economy, through close and continuous relations with customers, through a retainer, licence or subscription, rather than discrete one-off transactions. Digitalisation now also enables systematic collection of valuable data, and contributions of content by users, sometimes involving the appropriation of national heritage for profit, often through business-to-business relationships.

We support the proposal that the Committee should give priority to developing a new definition of taxable nexus for automated digital services. To cover services more generally, it should also consider reviewing article 5 of the UN model, particularly 5.3.b, which allows taxation of income from services delivered through the presence of personnel. A report on this issue should also examine the related aspects of attribution of profits to PEs, particularly the force of attraction principle in article 7.1, and the provision for fractional apportionment in article 7.4.

## 1. The Importance and Relevance of the Developing Country Perspective

We welcome the decision of the UN Committee to examine the tax consequences of digitalisation independently of similar work being pursued in other fora, while giving due consideration to such work. We also support the guiding principles for the work of the Committee of avoiding both double taxation and double non-taxation, preferring taxation of income on a net basis where practicable, and seeking simplicity and administrability. Although the Committee is hampered by its meagre resources, and the short time remaining under its current composition, the pressing needs of developing countries call for urgent action.

It is now clear that a radical rethinking is needed of international tax rules. In our view, this can only take place by giving due weight to the perspective of developing countries, and by the UN Committee playing a strong and independent role.

Addressing the tax implications of digitalisation poses a challenge, but also provides an opportunity. The reports produced for the G20/OECD project on base erosion and profit shifting (BEPS), now under the Inclusive Framework for BEPS, have made it clear that digitalisation has only exacerbated existing problems in international tax rules. Indeed, these problems are due to flaws in the development (mainly by OECD countries) of the two basic principles of international taxation: (i) taxable nexus based on the permanent establishment (PE) concept and (ii) allocation of income of multinational enterprises (MNEs).

On both these principles developing countries have long expressed divergent views from the developed countries of the OECD. These divergences have been reflected in differences in key provisions of the OECD and UN model conventions, and the UN model is now particularly relevant in dealing with the impact of digitalisation. The development of tax treaty rules was long dominated by capital-exporting countries, so they were designed to restrict taxation at source and prioritise investors' countries of residence. These rules became increasingly ineffective as large multinational enterprises (MNEs) exploited the concept of residence to design complex tax avoidance structures, while the MNEs' home countries weakened and have effectively dismantled their rules on controlled foreign corporations.

It should now be clear to all that income or profits from business must be taxed at source, where activities take place. Developing countries have long pointed to the defects of the physical presence requirement for a PE due to the dematerialisation of transactions, reflected in the economic shift from goods to services. That has been the case for decades, since well before the advent of digitalisation, which has taken dematerialisation to a new level. This is not simply a matter of making sales in a country. The delivery of digitalised goods and services more generally entails a close link with the customer, usually on a long-term basis and often on a retainer, by licensing or by subscription, rather than discrete one-off transactions. Digitalisation now also enables systematic collection of valuable data, as well as contributions of content by users. This can also involve the appropriation of elements of national culture or heritage for profit, for example for advertising, which concerns primarily business-to-business relationships. These activities can also now occur remotely, with little or no need for physical presence by the seller or service provider, while the lack of transparency of such MNEs makes it hard for policymakers to infer tax consequences. This significant and systematic involvement in the source country's society and economy justifies taxation of the profits it generates.

This also poses more sharply the key question of how to allocate MNE profits in line with their real activities, i.e. how to define the 'source'. Economic activity and profitability involve both production and consumption. The closer interaction with customers shows that consumption is not a passive one-way relationship, it has important social and cultural elements. The ability to sell and provide services to customers around the world promotes concentration and generates economies of scale, monopoly power and synergies, which are the major sources of the super-profits of MNEs. An outstanding innovation, whether a physical product, an intangible product or a service, will generate profits only by being tested, developed and refined, usually on a continuous basis, with its users and customers. Hence, the profits of a business depend not only on the skills of its workforce and investments in plant and equipment but also its access to and involvement with customers and users.

Due to its historic defence of the source principle, the UN treaty model is more suited to address these issues. As regards taxable nexus, the UN model's article 5 differs in significant respects from that of the OECD. In particular, it includes the 'services PE' provision, allowing taxation of income from delivery of services in a country through the presence of personnel, as well as the limited force of attraction rule. Secondly, developing countries have long pressed for an equitable and easily administrable method for allocation of income. The UN model still includes article 7(4) allowing an apportionment approach for allocation of profits to a PE.

Research conducted for the BMG shows that one-third of all bilateral treaties in force contain the services PE provision, and two thirds include article 7(4). These proportions are higher for treaties involving a developing country.[1]

The OECD countries have been slow to perceive the problems with international tax rules. Indeed, the 2010 revisions of the OECD model made matters worse, by eliminating article 7(4) and adopting the 'authorised OECD approach' (AOA) for attribution of profits to a PE, on an entirely supply-side basis, ignoring demand factors which are important for generation of profits especially in developing countries. These changes further facilitated tax avoidance strategies of MNEs, based on fragmenting their functions, attributing low-value 'routine' functions to affiliates in high-tax countries, and channelling the revenues to affiliates in low-tax jurisdictions. Such strategies are not new, but digitalisation has made it even easier to pursue them. Even during the first phase of the BEPS project only minor changes were made to the PE provisions in article 5, and the rules on allocation of income (transfer pricing) were made only more complex and difficult to administer. The later report on Attribution of Profits to PEs (2018) was based on the OECD Model's article 7, and hence on the AOA. However, at the insistence of African members of the Inclusive Framework, a footnote was included to make clear that it did not extend the AOA to countries that had not adopted it.

Only since January 2019 has the Inclusive Framework on BEPS begun to consider a new approach. This turnaround substantially resulted from a proposal submitted to the Inclusive Framework by the G24 group of developing countries. This argued for the adoption of a new

[1] Analysis of all bilateral tax treaties conducted as a TradeLab project at the Graduate Institute Geneva by Edgard Carneiro Vieria, Boris Ohanyan and Natalia Mouzoula, being prepared for publication, full data available on request.

taxable nexus based on significant economic presence, together with fractional apportionment of profits based on a balance of factors of production (employees, physical assets) and consumption (sales, users). This was one of the three proposals outlined in the discussion draft released in February 2019. Presumably to take account of this, the OECD Secretariat's Unified Approach of October 2019[2] for the first time proposed to begin from the global consolidated accounts of the MNE, and to adopt formulaic methods to allocate profits to the 'market' jurisdiction. While this advance was welcome we, along with many other commentators, pointed out the many defects of this unified approach.[3] We also outlined ways in which it could be refined, to establish a more comprehensive, fair, effective, and greatly simplified system of apportionment, building on the existing profit split method. The UN Tax Committee comments also expressed concerns, especially about the complexity of the proposals.

## 2. The Current Proposals for the Unified Approach

In January 2020 the Inclusive Framework issued a Statement on the Two-Pillar Approach.[4] It provided an outline of the Unified Approach, which is broadly similar to the Secretariat's proposal of October 2019. The Pillar One proposals envisage that MNEs could be taxed on three different components of their global income in countries where they derive sales revenues.

The first component, 'Amount A', consists of a percentage of the MNE's worldwide consolidated 'residual' (supra-normal) income. It seems to be envisaged that the 'residual' would be a large proportion, either 80% or 90% of the MNE's global profits before tax, but Amount A would be a small part of this, perhaps 20% of the residual.[5] This share of residual income would be apportioned among the countries in which the group has revenues from sales, based on the proportion of sales in each country. This would apply even to countries where the MNE has no physical presence, so Amount A is seen as creating a 'new taxing right' and its introduction would require changes to tax treaties.

Amount A would apply to companies involved in (i) 'automated digital services', and (ii) 'consumer-facing businesses' (OECD 2020, pp.10-11). The definition of 'consumer-facing' is now quite wide, and would exclude only business-to-business services, though there would also be sectoral exclusions, at least for financial services, extractive industries, and ships and aircraft. Also, it would apply only to taxpayers with global revenues above a specified threshold, still to be decided (but probably €750m). Existing transfer pricing rules would continue to apply for allocation of the remainder of the residual profit, as well as to all MNEs below the size threshold and those outside the scope.

Amount B would modify these rules, at least for some affiliates, by introducing a new method for a fixed return for 'baseline distribution and marketing activities'. Unlike Amount A, it would apply only where there is a PE, and would apply to all in-scope entities, regardless of size or sector. It would be a simplified, formulaic method, obviating the need for an individual facts-and-circumstances analysis, although there would need to be a determination of whether the entity is within scope, including whether its functions and local intangibles exceeded the defined baseline activities. The Statement asserts that this method

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[2] Available here.
[3] BMG (2019) *Comments on the OECD Secretariat Proposal for a 'Unified Approach' on Pillar 1*, available here. The other submissions, including those by the G24 and the UN Tax Committee, are available here.
[4] OECD (2020) *Statement by the OECD/G20 Inclusive Framework on BEPS on the Two-Pillar Approach to Address the Tax Challenges Arising from the Digitalisation of the Economy*, available here.
[5] See the OECD Secretariat's impact assessment presentation of 13 February 2020 (slide 12): https://www.oecd.org/tax/beps/presentation-economic-analysis-impact-assessment-webcast-february-2020.pdf.

could be introduced without the need for tax treaty changes, because it would apply when there is a taxable nexus under current rules, and would be designed to ensure only a 'routine' return, in line with the OECD's interpretation of the arm's length principle (ALP).

The Pillar 1 proposal also designates as Amount C any profits earned in a country additional to the baseline activities on which Amount B is calculated (OECD 2020, 8). Although Amount C is considered 'critical', it is left unclear. It seems that any of the 'residual' income in addition to Amounts A or B that may be claimed by a 'market' or source jurisdiction would be within Amount C. The effect is to create a presumption that the large part of the residual left after deduction of Amount A would be attributed to the country of residence of the MNE's parent, unless a country can justify a claim to Amount C under current transfer pricing rules.

A key element of the unified approach would be enhanced dispute prevention and resolution mechanisms, particularly for adjustments that claim an Amount C. An innovative approach would be needed, especially for Amount A, as the allocation would involve several, in some cases many, countries. The statement suggests the establishment of 'representative panels which would carry on a review function and provide tax certainty' (OECD 2020, para. 71), as well as a role for the tax administration of the ultimate parent entity (ibid. para. 73). What seems to be envisaged is a system in which the tax administration of the ultimate parent would audit the MNE and determine or verify the allocation, in conjunction with a 'representative panel'. The procedure would need to be 'effective and binding'.

The statement also refers to the need for 'new enhanced dispute resolution mechanisms' to deal with the 'other transfer pricing and permanent establishment disputes that will continue to arise' (ibid. para. 78). Although it accepts that some countries may have domestic obstacles to adopting mandatory binding arbitration, it seems clear that the alternative mechanisms being explored are also intended to be mandatory and binding. It seems that these would apply to Amounts A, B and C. Indeed, Amount C is likely to be particularly controversial, as it would concern any claim by a state other than the home state of the MNE to any of the large proportion of the 'residual' profit not allocated as Amount A, and would be decided under existing transfer pricing rules.

The Pillar Two proposals for an anti-base-erosion tax in principle could be independent of Pillar One.[6] Indeed, unlike the work on Pillar One, it is not necessary to reach consensus on this. This type of measure could even be adopted unilaterally, as the US has done with its GILTI tax, and other countries such as the UK with its diverted profits tax, or Australia's multinational anti-avoidance tax. Nevertheless, it is desirable to coordinate such measures as far as possible, but this creates two dangers. First, the measure could be watered down by some MNE home countries, and also to accommodate the views of low-tax jurisdictions which would be negatively affected, even though they would be unlikely to adopt it. Secondly, instead of providing a template that countries could adapt to their circumstances and improve if they wish, it could be formulated as a commitment from which participating states should not deviate.

Finally, it should be noted that the COVID-19 crisis has inevitably affected the negotiations. The meeting of the Inclusive Framework in July 2020 will not take place as planned, although there may be a virtual meeting to take some interim decisions. The intention now seems to be to aim for agreement in the first part of October (prior to the G20 Finance Ministers), but on a slightly reduced package. This is likely to focus on a solution targeted at highly digitalised companies, which might substitute for the digital services taxes (DSTs)

[6] The public consultation document of November 2019 (OECD 2019) is available here.

introduced by many countries, to avoid tax conflicts escalating into a trade war.[7] This might take the form of a 'safe harbour', as proposed by the US in a letter to the OECD of December 2019, which would allow MNEs an alternative to a DST.

## 3. Comments on the Unified Approach

Here we will only summarise briefly the problems and limitations of the Unified Approach.[8] Overall, it is undesirably and unnecessarily complex, because it is based on the residual profit split method. This would need a split of the supposed 'routine' from 'non-routine' profits, and a further division to determine the proportion of the non-routine (or 'residual') profits to be apportioned to 'market' countries. These would both be determined by fixed percentages, perhaps with some industry and regional variations in determining the 'routine' percentage. Since the percentages would be decided politically, it would be the powerful countries that settle the matter. While a formulaic method would be used for Amount A, the aim seems to be to allocate only a small amount to the 'market' jurisdiction. This misunderstands and underestimates the importance of the close interactions of the providers of goods and services, especially when digitalised, with their customers and users.

The current unsuitable and ineffective transfer pricing rules would continue to apply to all business not in scope. Furthermore, they would continue to be used for the allocation of not only the routine profits but also for the calculation of Amount C. This is clearly a key element, since residual income would be the major part of most MNE groups' profits (likely to be over 70% of the total, even after allocation of Amount A).

The assumption seems to be that the residual would normally be taxable in the residence country of the MNE's ultimate parent, while activities in other countries, including R&D, manufacturing and services, would be allocated only 'routine' levels of profit, applying current transfer pricing rules. Yet, activities outside the home country can often be substantial. For example, highly digitalised MNEs now employ software engineers in many countries, their teams are not always physically based in the MNE's home location. It would be inappropriate to attribute all, or even the bulk, of residual income to that location only because the activities are ultimately 'directed' from there. This will inevitably generate a large number of conflicts and disputes, both between MNEs and tax authorities and between countries. Conflicts between tax authorities, especially concerning Amount A, will be multilateral, often involving many countries. Resolving these conflicts will require mandatory and binding methods, probably with a key role to be played by the tax authority of the ultimate parent of the MNE, and 'representative panels'.

The Amount B proposal involves an overdue but modest reform of the 'one-sided' transfer pricing rules, particularly the transactional net margin method (TNMM). It would be limited to distribution and marketing affiliates, although supposedly 'stripped risk' structures are also used by MNEs to minimise tax payable by affiliates engaged in manufacturing, R&D and even some services activities. It is intended to apply whenever there is a taxable presence, and to be designed to be compatible with the ALP. This would nevertheless require considerable rewriting of the OECD Transfer Pricing Guidelines, which repeatedly (no less than 118 times) emphasise the need for an individual 'facts and circumstances' analysis. Alternatively, it might be introduced as a 'safe harbour', which would simply give each MNE

[7] In 2019 the US Trade Representative investigated France's digital services tax, and found it to be discriminatory, unreasonable and an unfair trading practice (see here). It approved retaliatory tariffs, which were suspended pending resolution of the tax issue in 2020. On 2 June 2020 a similar investigation was initiated against another ten countries, see here.

[8] For more details see our analysis in *OECD Secretariat Proposals for a New Taxing Right* (November 2019, available here.

a choice of the method to be applied. As recently as 2019 the OECD found Brazil's fixed percentage methodology contrary to the ALP. Compliance with the OECD's interpretation of the ALP also means that it would attribute only a 'routine' level of profits.

The Amount B proposal might be designed so that it could make small but significant improvements to the TNMM. In particular, it should apply to net profits before tax, defining the affiliate's taxable income after payment of interest, instead of 'operating income' as specified for the TNMM in the Guidelines. A major concern is that setting a fixed margin to reward only routine activities would operate as a cap, as it would be hard for tax authorities, especially in developing countries, to show that the affiliate is performing functions beyond the baseline.[9] One solution could be to fix the percentage on a sliding scale depending on the rate of profit, to allow distributors to share in the returns from economies of scale, as suggested in the proposal by Procter & Gamble.

However, evaluating the usefulness of such fixed margin methods and safe harbours should draw on the experience of developing countries which have tried them, such as Brazil, India, Mexico, and the Dominican Republic.[10] The OECD countries have invested so much in developing and applying inappropriate income allocation methods that they appear incapable of rethinking their approach.

The Pillar 2 proposal could potentially provide a powerful method for combatting beggar-thy-neighbour tax competition. The primary target should be the preferential tax regimes offered, mainly by OECD members, competing to be residence or conduit locations for services, funds, or property provided to operating companies in source states. These are a major source of BEPS, as they reduce the taxable profits of operating companies, while the payments are often not taxable by the source state and subject to low or no taxation in the either the home country of the MNE or the country of residence of the conduit. Hence, priority should be given to the undertaxed payments rule, followed by the subject to tax rule, rather than the income inclusion rule. This rule order is crucial to protect the source tax base, and should be non-negotiable for developing countries. Unfortunately, the indications are that the proposal will adopt the reverse approach. We have proposed a holistic approach based on a formulaic substance rule, which would be much easier to administer, and dispense with the need for priority rules.[11]

In our view, it is important to permit at most only jurisdictional blending, which would allow incentives to encourage investments in disadvantaged areas without discriminating against domestic companies. This is an important concern for developing countries, which need to increase their capital stock through investment. The adoption of worldwide blending would effectively emasculate Pillar 2, and allow MNEs to continue with most of their profit-shifting structures. Finally, it is important to ensure that the minimum effective tax rate applied should be close to the average corporate tax rate, which would place it at around 25%. However, it seems likely that the rate selected would be 12.5%, which is around half of the average rate for OECD countries, and under 40% of the average for developing countries.[12] Again, adoption of such a low rate would make the measure largely ineffective. A further concern is that the US is likely to insist that its GILTI should be 'grandfathered', although the evidence shows that the GILTI rules have not been particularly effective.

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[9] Countries considering a methodology such as Amount B should establish annual disclosures of locally conducted activities to verify whether they do not exceed the baseline.

[10] See our submission on *The UN Tax Committee's Work on Transfer Pricing* of September 2018, available here.

[11] Our analysis and comments on Pillar Two, including an explanation of our alternative approach, is available here.

[12] For details of corporate tax rates around the world see Tax Foundation data here.

Some parts of these proposals could improve international tax rules, particularly Pillar Two and Amount B, but this would depend on whether they are well designed. Unfortunately, this seems unlikely, due to the disagreements and conflicts between OECD countries, and the continuing adherence of most of them to outdated and ineffective approaches based on residence taxation and income allocation based on the ALP.

The main danger, however, is that the outcome would be a package to which participating states would be expected to make a commitment, and that would block more effective reforms. The adoption of a fixed return method, as envisaged for Amount B, and of measures against base erosion, as in Pillar 2, could be possible unilaterally, or by willing groups of states. It is clearly undesirable to tie them into a package that would include ineffective and unsuitable measures. This could block states from adopting measures they consider suitable to their own circumstances, as well as any further reform of international tax rules. A package deal should be designed as a comprehensive, effective and sustainable reform, not a short-term opportunistic assemblage of patch-up measures.

## 4. The Work of the UN Committee

In this context, it seems clear to us that the UN Committee has considerable scope for independent work. This could focus on the two key issues on which developing countries have always had divergent perspectives from the OECD, which are also embodied in the UN treaty model: (i) the PE concept and (ii) the allocation of MNE income. Hence, such work would be squarely within the mandate of the Committee, and would not prejudice any work that might continue in other fora such as the OECD.

As regards taxable presence, it seems clear that priority should be given to a revision of the PE provisions in the UN model, to extend to significant economic presence. This could be based on the concept of 'automated digital services', as proposed by Mr Bansal in his Note, included in the report of the Subcommittee on Tax Consequences of the Digitalised Economy. It also seems appropriate, as he suggests, to formulate it so that it could be a free-standing multilateral convention, to facilitate adoption by willing states without the need for bilateral negotiations. Since all states are members of the UN, this should be done by the UN Committee of Experts on the matter.

We also agree with Mr Bansal that there is no need for this to extend to 'consumer facing' business, as currently proposed in the unified approach, which would add unnecessary and undesirable complications. In any case, the limitation to 'consumer facing' business would not include important sectors, particularly business-to-business services. Hence, it seems important for the UN Committee now to reconsider its own article 5. Considerable work was done by the previous Committee, which developed the new article 12A on taxation of fees for technical services. However, it is clearly now important to examine the basis for taxation of net profits, as a possible alternative to withholding taxes on gross payments. While withholding taxes, including digital services taxes, are relatively easy to administer and can be useful, they have significant limitations. They do not fall on profits hence they are insensitive to profitability. The evidence is that MNEs pass them on to their customers, which increases the costs of popular mobile money or cloud services. Countries have resorted to such taxes largely because of limitations of the rules on PEs and allocation of profits.

We suggest that the Committee should also examine the scope for taxation of all services, including by digitalised means, particularly in article 5.3.b of the UN model. There have been sharp disagreements in the past about the interpretation of article 5.3.b, which are indicated in the Commentary of the UN Model (para. 10, p. 157). It may be easier to resolve these disagreements, now that there is wider acceptance of the need for taxation of services where substantial activities take place, regardless of physical presence. In any case, it seems important to clarify the application of this provision, as some countries have already begun to apply it to digitalised services (e.g. Argentina, and Saudi Arabia). This could be done by revising the Commentary, or it might need a revision of the article itself.

The important parallel issue is allocation of income, especially to PEs under article 7. Here the UN model has two main significant differences from the OECD model, that are very relevant today. The first is the force of attraction rule especially in (c) of article 7.1, which allows taxation of income from activities of the same or similar kind as those effected through a PE. Although digitalisation allows some activities to take place with little or no physical presence, perhaps a bigger problem is the way in which MNEs fragment their functions, so that substantial revenues can be attributed to non-resident entities, while resident affiliates or local PEs carry out functions to which only 'routine' profits are attributed. These activities are usually closely related, so the application of the force of attraction rule is entirely appropriate. What seems lacking is guidance on how the aggregated income derived from such related activities should be taxed.

The other distinctive provision in the UN model is paragraph 4 of article 7, which allows the use of apportionment methods of allocation of income, along the lines of the G24 proposal. Now that there has been a general move towards developing formulaic methods, it seems important to clarify when and how this provision could be applied. At present, the Commentary to the UN model only reproduces a section of the Commentary to the 2008 OECD model, which contained this provision. Since then of course the paragraph has been omitted from the OECD model. Indeed, the provision has a very long history, dating back to the work on allocation of income done under the League of Nations. Hence, it is both appropriate and necessary for the UN Committee now to develop its own guidance on the application of this provision.

Given the limitations of resources, and of time, priority could be given to developing the new PE provision. The Committee could also initiate intensive work on the other issues, to produce at least a report, which could help developing countries clarify and formulate policy options.