

Base Erosion and Profit Shifting Project

Public Consultation Document

ADDRESSING THE TAX CHALLENGES OF THE DIGITALISATION OF THE ECONOMY

13 February – 6 March 2019



OECD/G20 Base Erosion and Profit Shifting Project

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Following a mandate by G20 Finance Ministers in March 2017, the Inclusive Framework on BEPS, working through its Task Force on the Digital Economy (TFDE), delivered an Interim Report in March 2018, *Tax Challenges Arising from Digitalisation – Interim Report 2018*. One of the important conclusions of this report is that members agreed to review the impact of digitalisation on nexus and profit allocation rules and committed to continue working together towards a final report in 2020 aimed at providing a consensus-based long-term solution, with an update in 2019.

Since the delivery of the Interim Report, the Inclusive Framework further intensified its work and several proposals emerged that could form part of a long-term solution to the broader challenges arising from the digitalisation of the economy and the remaining BEPS issues. The work on these proposals is being conducted on a “without prejudice” basis; their examination does not represent a commitment of any member of the Inclusive Framework beyond exploring these proposals. In this context, the Inclusive Framework agreed to hold a public consultation on possible solutions to the tax challenges arising from the digitalisation of the economy on 13 and 14 March 2019 at the OECD Conference Centre in Paris, France. The objective is to provide external stakeholders an opportunity to provide input early in the process and to benefit from that input.

As part of this public consultation, this consultation document describes the proposals discussed by the Inclusive Framework at a high level and seeks comments from the public on a number of policy issues and technical aspects. The comments provided will assist members of the Inclusive Framework in the development of a solution for its final report to the G20 in 2020.

Interested parties are invited to send their comments on this consultation document. Comments should be sent by **6 March 2019** at the latest by e-mail to TFDE@oecd.org in Word format (in order to facilitate their distribution to government officials). They should be addressed to the Tax Policy and Statistics Division, Centre for Tax Policy and Administration.

Please note that all comments on this discussion draft will be made publicly available. Comments submitted in the name of a collective “grouping” or “coalition”, or by any person submitting comments on behalf of another person or group of persons, should identify all enterprises or individuals who are members of that collective group, or the person(s) on whose behalf the commentator(s) are acting. Speakers and other participants at the upcoming public consultation in Paris will be selected from among those providing timely written comments on this consultation document. Registration details for the public consultation will be published on the OECD website in March.

The proposals included in this consultation document do not represent the consensus views of the Inclusive Framework, the Committee on Fiscal Affairs (CFA) or their subsidiary bodies. Instead, they intend to provide stakeholders with substantive proposals for analysis and comment.

Table of contents

1. Introduction	5
1.1. The Interim Report.....	5
1.2. The new phase of work.....	7
2. Revised profit allocation and nexus rules.....	8
2.1. Illustration of the challenge to the profit allocation and nexus rules	8
2.2. Overview and background.....	9
2.2.1. The “user participation” proposal.....	9
2.2.2. The “marketing intangibles” proposal.....	11
2.2.3. The “significant economic presence” proposal	16
2.2.4. Comparing the proposals.....	17
2.3. Potential design considerations.....	19
2.3.1. Scope and potential limitations	20
2.3.2. Business line segmentation	20
2.3.3. Profit determination.....	20
2.3.4. Profit allocation	21
2.3.5. Elimination of double taxation.....	21
2.3.6. Nexus and treaty considerations.....	22
2.3.7. Administration.....	22
2.4. Questions for public comments	23
3. Global anti-base erosion proposal.....	24
3.1. Overview and background	24
3.2. Mechanics	25
3.3. Income inclusion rule.....	25
3.4. Tax on base eroding payments.....	27
3.4.1. Undertaxed payments rule.....	27
3.4.2. Subject to tax rule.....	28
3.5. Rule co-ordination	29
3.6. Questions for public comments	29

1. Introduction

1. The tax challenges arising from the digitalisation of the economy were identified as one of the main areas of focus of the Base Erosion and Profit Shifting (BEPS) Action Plan, leading to the 2015 BEPS Action 1 Report on *Addressing the Tax Challenges of the Digital Economy* (the Action 1 Report).¹ The Action 1 Report recognised that digitalisation and some of the business models that it facilitates present important challenges for international taxation. The report also acknowledged that it would be difficult, if not impossible, to ‘ring-fence’ the digital economy from the rest of the economy for tax purposes because of the increasingly pervasive nature of digitalisation. It highlighted the ways in which digitalisation had exacerbated BEPS issues, but also noted that the measures proposed under the other BEPS Actions were likely to have a significant impact in this regard. In addition, the Action 1 Report observed that beyond BEPS, digitalisation raised a series of broader direct tax challenges, which it identified as data, nexus and characterisation. These challenges chiefly relate to the question of how taxing rights on income generated from cross-border activities in the digital age should be allocated among countries. While identifying a number of proposals to address these concerns, none were ultimately recommended. After the release of the OECD/G20 BEPS package, countries agreed to renew the mandate of the Task Force on the Digital Economy (TFDE) and continue to monitor developments in respect of digitalisation.

1.1. The Interim Report

2. In March 2017, the G20 Finance Ministers mandated the TFDE, through the Inclusive Framework on BEPS, to deliver an interim report on the implications of digitalisation for taxation by April 2018 and a final report in 2020. The interim report, *Tax Challenges Arising from Digitalisation – Interim Report 2018* (the Interim Report)² was agreed by all members of the Inclusive Framework and delivered to the G20 in March 2018. Building on the Action 1 Report, the Interim Report reflects among other things the progress made by the TFDE and the Inclusive Framework since 2015 in considering the two previously identified direct tax issues, namely the exacerbated BEPS issues and the broader tax challenges.

3. On the former issue, related to the impact of digitalisation on BEPS issues, the Interim Report took stock of progress made in the implementation of the BEPS package, and its impact on the various challenges raised by digitalisation. The Interim Report noted that despite the fact that only a small number of BEPS measures were minimum standards and that many of the BEPS measures have only recently been introduced, there was evidence that countries already had gone a long way in achieving a widespread implementation of the various BEPS measures, and that this was already having an impact. In reaction to BEPS Actions 8-10, for example, some multinational enterprises (MNE groups) have realigned their tax arrangements with real economic activity by reconsidering

¹ OECD (2015), *Addressing the Tax Challenges of the Digital Economy*, Action 1 - 2015 Final Report, OECD/G20 Base Erosion and Profit Shifting Project, OECD Publishing, Paris.

² OECD (2018), *Tax Challenges Arising from Digitalisation – Interim Report 2018*, Inclusive Framework on BEPS, OECD/G20 Base Erosion and Profit Shifting Project, OECD Publishing, Paris.

their transfer pricing positions and by relocating and on-shoring valuable intangible assets. In addition, several highly digitalised MNE groups have also changed their distribution models, which were based on remote sales, to local “buy-sell” distributors in response to the work on BEPS Action 7. In connection with the remaining BEPS challenges, some countries highlighted the risks that even after such a restructuring digitalised MNE groups would be able to use local limited risk distributors to justify only minimal tax in the market jurisdiction, while being able to shift a disproportionately high amount of profit to a small number of affiliates in remote locations provided there is a correlation with a certain level of physical activity (e.g. functions that control risks and functions relating to the development, enhancement, maintenance, protection and exploitation of intangibles (DEMPE)). These countries were concerned that while the BEPS project had significantly contributed to realigning income from intangibles with value creation, notably by putting greater emphasis on real economic activities (e.g. Action 5, Actions 8-10), and by taking a more holistic approach to the review of cross-border transactions (e.g. Action 13), risks remain for highly mobile intangible income-producing factors which can be shifted into low-tax environments based on contractual allocations accompanied by a relatively modest level of decision-making capacity. These risks can arise for highly digitalised MNE groups as well as for MNE groups with more traditional business models.

4. As regards the broader tax challenges relating to the allocation of taxing rights, the Interim Report first provided an in-depth analysis of new and changing business models in the context of digitalisation. This enabled the identification of three characteristics that are frequently observed in certain highly digitalised business models, and the discussion of their implications for the existing profit allocation and nexus rules. *Scale without mass* impacts the distribution of taxing rights over time by reducing the number of jurisdictions where a taxing right can be asserted over a business’s profits. *A heavy reliance on intangible assets* strains the rules for allocating income from intangible assets among different parts of an MNE group, creating uncertainties and opportunities for locating income in low or no tax entities. *Data and user participation* poses challenges to the existing nexus and profit allocation rules, especially in situations where the highly digitalised business that exploits the data and user-generated content has little or no taxable presence in the jurisdiction where the users are located. It was noted, however, that countries had different views on the scale and nature of these challenges, and in particular on the question of whether, and to what extent, these challenges should result in changes to the international tax rules. The Interim Report described these countries as falling into three groups, which ranged from countries that considered that there was a need to change existing profit allocation and nexus rules (i.e. first and second group) to countries that considered that no action was needed beyond addressing BEPS issues (i.e. third group).³

³ The first group considered that the reliance on data and user participation may lead to misalignments between the location in which profits are taxed and the location in which value is created. This first group saw the challenge as confined to certain business models, and did not see the case for wide-ranging changes that would alter the principles underpinning the existing tax system. A second group of countries took the view that the ongoing digital transformation of the economy, and more generally trends associated with globalisation, presented challenges to the continued effectiveness of the existing profit allocation and nexus rules. Importantly, for this group of countries, these challenges were not exclusive or specific to highly digitalised business models. Finally, there was a third group of countries which was supportive of the existing the international tax system and did not see the need for any significant reform of the profit allocation and nexus rules. These countries considered that the BEPS package had largely addressed the concerns of

5. In this context, the members of the Inclusive Framework committed to continue working together towards a consensus-based solution with the goal of producing a final report in 2020, with an update to the G20 in 2019. The work would therefore need to focus on the two outstanding issues posed by a rapidly digitalising economy: ongoing work on remaining BEPS challenges as well as a coherent and concurrent review of the nexus and profit allocation rules, including an exploration of the feasibility of different technical solutions that are consistent with the principle of aligning profits with underlying economic activities and value creation.

1.2. The new phase of work

6. Conscious of the G20 time frame and the significance of the issue, the Inclusive Framework and the TFDE further intensified their work since the delivery of the Interim Report. The TFDE met in July 2018, and at that meeting some members made suggestions on how the work could be taken forward to achieve progress towards a consensus-based solution. These proposals were conceived in light of the two interrelated challenges identified in the Action 1 Report and the Interim Report. Some proposals focused on the allocation of taxing rights (the “broader tax challenges”) by suggesting modifications to the rules on profit allocation and nexus based on the concept of user contribution or marketing intangibles. Another proposal focused more on unresolved BEPS issues.

7. Following the July meeting, the Inclusive Framework agreed to continue developing these proposals on a “without prejudice” basis, and to consider how the gaps between the different positions identified in the Interim Report could be bridged, taking into consideration the overlaps that exist between the BEPS issues exacerbated by digitalisation and the broader tax challenges. The result of this effort is presented in this consultation document, which sets out a number of proposals which could form part of a long term solution to the broader challenges arising from the digitalisation of the economy and the remaining BEPS issues. The proposals are at the policy design phase and, therefore, their description has been kept at a high level.

8. While the two issues of the ongoing work on remaining BEPS challenges and a concurrent review of the profit allocation and nexus rules are distinct, they intersect and a solution that seeks to address them both could have a mutually reinforcing effect. Therefore both issues should be discussed and explored in parallel.

9. Section 2 of this note describes proposals related to the “broader tax challenges” to the existing profit allocation and nexus rules. It discusses policy proposals that would modify those rules based on the concepts of user participation, marketing intangibles and/or the concept of significant economic presence. It sets out their policy rationale and “mechanics”, i.e. the basic design features of a possible set of rules. Section 3 describes proposals related to remaining BEPS concerns and explores two sets of interlocking rules designed to give jurisdictions a remedy in cases where income is subject to no or only very low taxation. These rules would effectively give jurisdictions the right to “tax back” profits that are taxed only at low effective tax rates.

double non-taxation, but acknowledged that it was still too early to fully assess the impact of all the BEPS measures (see Interim Report, par. 388-394).

2. Revised profit allocation and nexus rules

10. This part first sets forth an illustration of the challenges that members have identified with the existing profit allocation and nexus rules. It then discusses three proposals being examined by the Inclusive Framework to address such challenges. These proposals would require fundamental changes to both the profit allocation and nexus rules and expand the taxing rights of user and market jurisdictions. These proposals have important differences, including the justifications put forward for the reallocation of taxing rights, and the businesses for which that change in profit allocation would be relevant.

11. However, these proposals have the same over-arching objective, which is to recognise, from different perspectives, value created by a business's activity or participation in user/market jurisdictions that is not recognised in the current framework for allocating profits. Some of these proposals share important structural commonalities to achieve the aforementioned objective, such as a mechanism based on residual profit allocation for the proposals based on the concepts of "user participation" and "marketing intangibles". Hence, while all the proposals are being explored on their individual merits, the Inclusive Framework is also considering some common design issues and how some of those proposals could be framed in a more aligned manner.

2.1. Illustration of the challenge to the profit allocation and nexus rules

12. The three characteristics identified in the Interim Report – scale without mass, a heavy reliance on intangible assets, and the role of data and user participation – work together to enable highly digitalised businesses to create value by activities closely linked with a jurisdiction without needing to establish a physical presence. For example, some highly digitalised business models may solicit substantial contributions to, and active utilisation of, a web-based platform by a jurisdiction's residents, generating substantial value for a business but, under the current tax rules, that jurisdiction may not have a taxing right over any of that business's income. Some of these business models may facilitate large numbers of transactions between persons within the same country, similarly generating value for the business without creating any taxing right for the user or market jurisdiction – notwithstanding the highly localised impact of the utilisation of the platform. This "remote" participation in the domestic economy enabled by digital means but without a taxable physical presence is often seen as the key issue in the digital tax debate.

13. However, any solution that seeks to address nexus must also address the closely-related issue of profit allocation, or it is bound to fail – with likely increases in uncertainty and controversy without a meaningful increase in income allocation. This can easily be demonstrated by developments already taking place on the ground: in response to the BEPS package (including Action 7), some MNE groups with highly digitalised business models were able to establish local affiliates in market jurisdictions, especially in those jurisdictions constituting the businesses' larger markets. However, the local affiliates are commonly structured to have no ownership interest in intangible assets, not to perform DEMPE functions, and not to assume any risks related to such assets. Accordingly, only a modest return may be allocated to these "limited risk distributors," or LRDs. Thus, without effective changes to profit allocation rules, an MNE group may seek to sidestep the nexus issue by establishing local affiliates that are not entitled to an appropriate share of the group's profit.

14. Finally, if “remote” participation in the absence of a taxable physical presence, or in the absence of one that attracts substantial taxable profits, is considered to be a concern in relation to certain highly digitalised businesses, there is an important question as to whether this concern is not relevant to a broader set of businesses – for example, businesses that, due to digitalisation and changes in the global economy, can build their brand, develop an engaged customer base and create value in the absence of local activities or in the absence of local activities that attract a significant share of taxable profits. In other words, to the extent the current rules are seen as under-allocating income to particular jurisdictions due to the ability of highly digitalised businesses to remotely and non-physically participate in those jurisdictions, horizontal equity, design coherence and a level playing field suggest that consideration should be given to whether that policy concern (and reforms to address that concern) are relevant also to more traditional businesses.

15. Against this background, some members of the Inclusive Framework have made proposals, further discussed below, that focus on value creation in the user/market jurisdiction that is not recognised in the current framework for allocating taxing rights and taxable profits.

2.2. Overview and background

16. The Inclusive Framework is currently examining three proposals for revising the profit allocation and nexus rules in response to these challenges posed by digitalisation. These three proposals, which seek to expand the taxing rights of the user or market jurisdiction, are discussed in further detail below. To date, the discussion has focused primarily on two of these proposals, the user participation proposal and the marketing intangible proposal, where a number of commonalities emerged. A detailed discussion of the concept of significant economic presence is also taking place, but this concept was revisited more recently.

2.2.1. The “user participation” proposal

17. One proposal currently discussed focuses on the value created by certain highly digitalised businesses through developing an active and engaged user base, and soliciting data and content contributions from them.

Policy rationale

18. This proposal is premised on the idea that soliciting the sustained engagement and active participation of users is a critical component of value creation for certain highly digitalised businesses. The activities and participation of these users contribute to the creation of the brand, the generation of valuable data, and the development of a critical mass of users which helps to establish market power.

19. This proposal contemplates that this source of value is most significant, on an absolute basis and relative to more traditional drivers of business value, for the following business models:

- a. **Social media platforms:** These platforms are populated by user-generated content, with the volume and quality of that content a key factor in their ability to generate revenue from those users or from paid-for advertising targeted at those users. Social media platforms also benefit from the role users play in building a wider network of platform users, through their role in fostering connections and encouraging others to use the platform. A core business strategy will be to cultivate an active

user base and encourage them to proactively contribute content and spend time on the platform.

- b. **Search engines:** In a similar way to a social media platform, much of the content of a search engine is delivered, directly or indirectly, by users of that platform. The intensive monitoring of user data also allows the platform to tailor experiences to individual users, to indirectly improve platform performance for other users, and to earn revenue by selling advertising targeted at users based on their demonstrated interests.
 - c. **Online marketplaces:** The success of an online marketplace is dependent on the size of the user network on either side of the platform, and the quality and diversity of goods/services those users are offering. A key business strategy will be to build, and encourage users to build, that network. Businesses will also enable and rely on users to play a role in regulating the quality of goods and services provided on the platform, such as by offering public reviews or providing feedback directly to the platform.
20. This value generated by user participation is not captured in user jurisdictions under the existing international tax framework, which focuses on the physical activities of a business itself in determining where profits should be allocated and the extent of the taxing rights of user jurisdictions. This results in businesses being able to generate significant value from a jurisdiction with a significant and engaged user base (user jurisdiction) without the profits they derive from that value being subject to local tax.
21. To better align profit allocation outcomes with value creation, the proposal seeks to revise profit allocation rules to accommodate the value creating activities of an active and engaged user base. In addition, the nexus rules would be revised so that the user jurisdictions would have the right to tax the additional profit allocable to them. However, this change in the rules would be limited to those business models which benefit from this type of user base. For businesses that have more traditional relationships with customers, there would be no change in the profit allocation or nexus rules.

Mechanics

22. The proposal would modify current profit allocation rules to require that, for certain businesses, an amount of profit be allocated to jurisdictions in which those businesses' active and participatory user bases are located, irrespective of whether those businesses have a local physical presence.
23. The proposal acknowledges the difficulties in using traditional transfer pricing methods for determining the amount of profit that should be allocated to a user jurisdiction. For example, it dismisses the idea that the value created by user activities can somehow be determined through the application of the arm's length principle, e.g. through hypothesising the user base as a separate enterprise and asking what return it would receive at arm's length in its dealings with other group entities.
24. It is instead proposed that the profit allocated to a user jurisdiction, in respect of the activities/participation of users, be calculated through a non-routine or residual profit split approach. This approach would, at a basic level, involve:
1. Calculating the residual or non-routine profit of a business, i.e. the profits that remain after routine activities have been allocated an arm's length return;

2. Attributing a proportion of those profits to the value created by the activities of users, which could be determined through quantitative/qualitative information, or through a simple pre-agreed percentage;
 3. Allocating those profits between the jurisdictions in which the business has users, based on an agreed allocation metric (e.g. revenues); and
 4. Giving those jurisdictions a right to tax that profit, irrespective of whether the business has a taxable presence in their jurisdictions that meets the current nexus threshold.
25. Under this approach, the profit attributed to the routine activities of an MNE group would continue to be determined in accordance with current rules. The only effect of the proposal would be to reallocate a proportion of the non-routine profit of the business, from the entities that are currently realising that profit, to the jurisdictions in which users are located.
26. Significant challenges exist in calculating non-routine profit across an MNE group, and there would be additional difficulties in trying to calculate non-routine profit at the level of an individual business line, e.g. where user participation is considered a material driver of value for one business line within a multi-business line group.
27. To streamline its implementation, the proposal could rely on formulas that would approximate the value of users, and the users of each country, to a business. However, it is acknowledged that this would be a pragmatic approach for allocating profit to a novel driver of value, and one that helps to avoid disputes between countries based on their subjective view of value generated by user participation. The proposal could also be combined with a strong dispute resolution component to minimise additional controversy and double taxation.
28. It is proposed that this approach would be targeted at highly digitalised businesses for which user participation is seen to represent a significant contribution to value creation. That would include, and perhaps be limited to, social media businesses, search engines and online marketplaces. The proposal could also incorporate a range of additional restrictions based on the size of the business to further reduce the administrative burden for tax administrations and taxpayers.

2.2.2. The “marketing intangibles” proposal

29. Another proposal under discussion is based on the concept of marketing intangibles.⁴ Like the user participation proposal, it would change the profit allocation and nexus rules. But unlike the user participation proposal, it would not be intended to apply only to a subset of highly digitalised businesses. Instead, it would have a wider scope in an effort to respond to the broader impact of the digitalisation on the economy.

⁴ The term “marketing intangibles” as used in this paper has the same meaning as is set forth in the OECD Transfer Pricing Guidelines: “an intangible . . . that relates to marketing activities, aids in the commercial exploitation of a product or service and/or has an important promotional value for the product concerned. Depending on the context, marketing intangibles may include, for example, trademarks, trade names, customer lists, customer relationships, and proprietary market and customer data that is used or aids in marketing and selling goods or services to customers.” (OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations 2017 (OECD TPG), p. 27).

Policy rationale

30. The marketing intangible proposal addresses a situation where an MNE group can essentially “reach into” a jurisdiction, either remotely or through a limited local presence (such as an LRD), to develop a user/customer base and other marketing intangibles. It sees an intrinsic functional link between marketing intangibles and the market jurisdiction.

31. This intrinsic functional link is seen as manifested in two different ways. First, some marketing intangibles, such as brand and trade name, are reflected in the favourable attitudes in the minds of customers and so can be seen to have been created in the market jurisdiction. Second, other marketing intangibles, such as customer data, customer relationships and customer lists are derived from activities targeted at customers and users in the market jurisdiction, supporting the treatment of such intangibles as being created in the market jurisdiction.

32. Taking into account this link between marketing intangibles and the market jurisdiction, the proposal would modify current transfer pricing and treaty rules to require marketing intangibles and risks associated with such intangibles to be allocated to the market jurisdiction. The proposal considers that the market jurisdiction would be entitled to tax some or all of the non-routine income properly associated with such intangibles and their attendant risks, while all other income would be allocated among members of the group based on existing transfer pricing principles.⁵ One consequence of this proposal is that market jurisdictions would be given a right to tax highly digitalised businesses – even in the absence of a taxable presence – given the importance of marketing intangibles for such business models.

33. The proposal is intended to be consistent with the principle of allocating profit based on the value creation by firms in that this positive attitude in the minds of customers is created by, and the customer information and data is acquired through, the active intervention of the firm in the market. It is thus different from favourable demand conditions in the market jurisdiction that exist independent of the actions of the firm – such as the existence of a stable population benefitting from a successful economy that provides them with the financial means to be able to buy the relevant product. While these aspects of demand obviously have economic relevance, they are not relevant for the allocation of a firm’s profits under the general tax framework, which is based on a determination of how different activities by the firm contribute to its profits.

34. Unlike marketing intangibles, trade intangibles are seen as not similarly possessing an intrinsic functional link with market jurisdictions. A patent used to build an efficient car engine will allow it to achieve the same mileage in one country as it does in another, and does so regardless of who made it or who bought it.

35. The marketing intangible proposal would also help mitigate BEPS concerns. Although BEPS Actions 8-10 achieved significant progress, the shifting of income attributable to marketing intangibles may still be accomplished through the exercise of only a relatively modest degree of decision-making capacity outside the market jurisdiction. Where a local distribution affiliate is needed for business purposes, it may be structured as an LRD and attract only a modest amount of profit. The marketing intangibles that the LRD

⁵ The marketing intangible concept could be designed to specially allocate to market jurisdictions only a portion of the non-routine income attributable to marketing intangibles, instead of all of it.

uses in its distribution activities may be owned and controlled remotely, and accordingly all the profits attributable to those intangibles may be shifted out of the market jurisdiction.

36. Importantly also, the proposal maintains that the implications of BEPS Actions 8-10 are different for marketing and trade intangibles. The proposal is premised on the view that MNE groups now have less ability to shift profits attributable to trade intangibles, which generally arise from substantial, observable activities arising in a specific location. In contrast, the proposal contemplates that the situation is significantly more challenging with respect to marketing intangibles, where the link between specific and substantial activities and the return is less readily apparent. Similar considerations also influenced the decision in the context of BEPS Action 5 to permit certain incentive regimes for trade intangibles but not for marketing intangibles.

37. While MNE groups for a long time have had the ability to capture marketing intangible profits outside the market jurisdiction in low tax jurisdictions, recent developments have enhanced their ability to do so which in turn justifies taking a fresh look at this point in time.

38. As discussed and agreed in the Interim Report, digitalisation is transforming the way our economy functions. The impact of digitalisation and the wider changes to business models and value chains, including lower communication and transportation costs, have increased the opportunities for a modern enterprise to reach and interact with customers in a given market either remotely or through a limited physical presence that does not attract substantial taxing rights in the market jurisdiction. For instance, online retailers with no or only a small physical presence in one country may develop a large user and customer base in that country and know more about these users' and customers' shopping preference than a local book shop around the corner. The same is increasingly true for many branded consumer goods companies either because they are directly and digitally engaged with their customers or because they do so via the intermediation of highly digitalised businesses, or both.

39. With consumers increasingly online, consumer-facing businesses need to be online, which in turn reduces the need for a physical presence or changes the nature of the physical presence in a way that reduces the market jurisdiction's taxing rights. Formerly, for a consumer business to invest successfully into a foreign market, develop a broad customer base, and create value would have typically required some physical proximity and a local presence involved in the sales and marketing effort; but this is no longer the case. Sales and marketing can be handled remotely with only shipment and fulfilment – limited risk distribution – still requiring a presence and even that may depend on the nature of the business, including applicable regulatory requirements. The more data on consumers that can be collected, analysed and exploited remotely through the use of digital technology, the easier it is to avoid exercising any of the DEMPE and related risk management functions in the market jurisdiction that under today's rules govern the allocation of income from marketing intangibles.

Application to key fact patterns

40. One way to understand the marketing intangible proposal is to consider its impact on three key fact patterns. The first is where a highly digitalised business derives revenue from sales and marketing activities targeting a particular market jurisdiction in which it does not have a taxable presence. In these situations, the proposal would allocate non-routine profit attributable to the use of marketing intangibles related to the market jurisdiction to that jurisdiction, even in the absence of a taxable presence under existing

rules. In the context of highly-digitalised businesses, such marketing intangibles may include, for example, marketing intangibles generated by the operation of a free search service, free email, free digital storage and the like.⁶ The proposal would also change the nexus rules to grant the market jurisdiction the right to tax this marketing intangible profit, even if the entity earning the profit would not have a taxable presence under existing nexus rules. Thus, despite a different conceptual starting point it would get to a result similar to that which would be achieved using the user participation proposal.

41. The second key fact pattern is where the same highly digitalised business has a local presence but operates it as an LRD. The marketing intangible proposal would provide that some or all of the non-routine profit allocable to marketing intangibles associated with the market jurisdiction would be taxable by that market jurisdiction. Further, it would ensure that the nexus rules allow the market jurisdiction to exercise a taxing right over this marketing intangible profit. This proposal would address the issue discussed above and frequently seen in the post-BEPS environment, in which a highly digitalised business establishes an LRD but the resulting profit allocable to the market jurisdiction is considered inappropriately small. Here again, the marketing intangible proposal should achieve a tax outcome broadly similar to that which would be achieved under the user participation proposal.

42. The final key fact pattern is a consumer product business not traditionally thought of as a highly-digitalised business, operating either remotely or through an LRD structure. Consistent with the broadly relevant motivation for the proposal, and to foster equity, coherence, and a level playing field, the proposal contemplates that changes to the profit allocation and nexus rules for situations involving highly digitalised businesses would need to apply equally to similarly-situated structures utilised by traditional consumer businesses. It is in this fact pattern that there remains a gap between the outcomes under the user participation and the marketing intangibles proposals.

Mechanics

43. The proposal would modify current profit allocation and nexus rules to require that the non-routine or residual income of the MNE group attributable to marketing intangibles and their attendant risks be allocated to the market jurisdiction. All other income, such as income attributable to technology-related intangibles generated by research and development and income attributable to routine functions, including routine marketing and distribution functions, would continue to be allocated based on existing profit allocation principles. This is because the latter is perceived to continue to produce results that are consistent with the objective of aligning taxable profits with value creation when applied to such businesses activities.

⁶ The definition of marketing intangibles in the OECD TPG includes: “customer lists, customer relationships, and proprietary market and customer data that is used or aids in marketing and selling goods or services to customers.” Highly digitalised businesses have revolutionised the availability and depth of usable micro data on customers, potential customers, including their interests and preferences. Such consumer data is typically acquired in exchange for free services, such as free search functions, free emails etc. The marketing intangible proposal would conceptualise the acquisition of such data as an investment in marketing intangibles (i.e. customer lists and the like) which is then monetised either via the sale or other provision of such data to third parties as part of an advertising business model or used to enhance the sales of own goods and services. In addition, these consumer facing digitalised businesses will often have invested in community and wider brand positioning so as to enhance their subjective appreciation by their users.

44. The special allocation of some or all non-routine returns from marketing intangibles, and the related expansion of the market country's taxation rights, would apply regardless of which entity in the MNE group owns legal title to the marketing intangibles, regardless of which entities in the group factually perform or control DEMPE functions related to those intangibles (though as noted above, routine marketing functions would receive a routine return in the location where carried out), regardless of how risks related to the marketing intangibles would be allocated under existing transfer pricing rules, and regardless of how those rules would ordinarily allocate income related to the marketing intangibles and their associated risks. The proposal assumes that in many instances the type of MNE group to which this special allocation rule applies will already have a taxable presence in the market jurisdiction, but accepts that there will be instances where a taxing right would be assigned to the market jurisdiction in cases where no such right exists under the international tax rules as they stand, taking compliance and administrative cost considerations into account.

45. The allocation of non-routine or residual income between marketing intangibles and other income producing factors could be determined through different methods. One approach would be to apply normal transactional transfer pricing principles. Conceptually, the approach would be quite straightforward. First, marketing intangibles would need to be determined and then their contribution to profit would need to be determined under two sets of assumptions: (i) an assumption that the marketing intangibles (and their attendant risks) are allocated under the current rules; and (ii) an assumption that the marketing intangibles (and their attendant risks) are allocated to the market jurisdiction. This calculation could create a marketing intangible adjustment which would be the difference between those two numbers.

46. The income allocation would be dependent entirely on the facts of each case and the economic contribution to profits provided by the marketing intangibles. This would retain the existing rules requiring an identification of the specific marketing intangibles and a calculation of their contribution to profit.

47. Alternatively, the allocation could be done under a revised residual profit split analysis that uses more mechanical approximations. As with any residual profit split this would require a number of steps including the determination of relevant profit, the determination of routine functions and their compensation, the deduction of routine profit from total profit and finally the division of the remaining or "residual" profit. In this regard, there are different ways in which routine profit could be determined for purposes of computing the amount of non-routine income to be subject to the profit split, ranging from a full transfer pricing facts and circumstances analysis to a more mechanical approach (e.g. a mark-up on costs or on tangible assets). Second, and once the amount of routine profit is determined and subtracted from total profit, there are different ways of determining the portion of non-routine or residual profit attributable to marketing intangibles, ranging from, e.g., cost based methods (e.g. costs incurred to develop marketing intangibles versus costs incurred for R&D and trade intangibles) to more formulaic approaches (e.g. using fixed contribution percentages, which may differ by business model).

48. Once the amount of income attributable to marketing intangibles is determined it would be allocated to each market jurisdiction based on an agreed metric, such as sales or revenues. In this context revenue of MNE groups active in the advertising industry, as many digital businesses are, would be sourced not by reference to the residence of the payer but by reference to the customers that are targeted by the advertisement – e.g., in the online platform context, generally the users of the platform.

49. To address concerns that the implementation of the proposal would result in significant controversy and double taxation for business, the proposal should offer taxpayers the possibility of early certainty on the taxation under this approach and come with a strong dispute resolution component.

2.2.3. The “significant economic presence” proposal

50. The Inclusive Framework will also explore a proposal based on the concept of “significant economic presence” described in Section 7.6 of the Action 1 Report (“Developing options to address the broader direct tax challenges of the digital economy”). This proposal is motivated by the view that the digitalisation of the economy and other technological advances have enabled business enterprises to be heavily involved in the economic life of a jurisdiction without a significant physical presence. According to this view, these technological advances have rendered the existing nexus and profit allocation rules ineffective.

51. Under this proposal, a taxable presence in a jurisdiction would arise when a non-resident enterprise has a significant economic presence on the basis of factors that evidence a purposeful and sustained interaction with the jurisdiction via digital technology and other automated means. Revenue generated on a sustained basis is the basic factor, but such revenue would not be sufficient in isolation to establish nexus. Only when combined with other factors would revenue potentially be used to establish nexus in the form of a significant economic presence in the country concerned. In this context, one or more of the following factors may be considered relevant for constituting the kind of purposeful and sustained interaction with a jurisdiction via digital technology and other automated means that would be sufficient to create a significant economic presence: (1) the existence of a user base and the associated data input; (2) the volume of digital content derived from the jurisdiction; (3) billing and collection in local currency or with a local form of payment; (4) the maintenance of a website in a local language; (5) responsibility for the final delivery of goods to customers or the provision by the enterprise of other support services such as after-sales service or repairs and maintenance; or (6) sustained marketing and sales promotion activities, either online or otherwise, to attract customers. As noted in the Action 1 Report, a link would have to be established between the revenue-generating activity of the non-resident enterprise and its significant economic presence. Additional issues to address in respect of revenue as a factor would include the definition of the types of transactions that are to be covered and appropriate thresholds.

52. The proposal contemplates that the allocation of profit to a significant economic presence could be based on a fractional apportionment method, as discussed in Section 7.6.2.2 of the Action 1 Report. A fractional apportionment method would require the performance of three successive steps:

1. the definition of the tax base to be divided,
2. the determination of the allocation keys to divide that tax base, and
3. the weighting of these allocation keys.

53. The tax base could be determined by applying the global profit rate of the MNE group to the revenue (sales) generated in a particular jurisdiction. The tax base would be apportioned by taking into account factors such as sales, assets and employees. In addition, this proposal contemplates that for those businesses for which users meaningfully contribute to the value creation process, users would also be taken into account in apportioning income.

54. Other simplified methods for allocating profit will also be considered, such as the modified deemed profits methods described in section 7.6.2.3 of the Action 1 Report.

55. Equally, in line with the Action 1 Report, the proposal also contemplates the possible imposition of a withholding tax as a collection mechanism and enforcement tool. In this context, consideration could be given to a gross-basis withholding tax at a low rate on payments to an enterprise with a significant economic presence, with the enterprise having the right to file an income tax return and seek a refund if the withheld amount exceeded the enterprise's income tax liability.

2.2.4. Comparing the proposals

Overview

56. The three proposals would require changes to nexus and profit allocation rules. On nexus they all argue for a re-thinking of the traditional nexus concept and, within their different parameters, they go beyond the limitations on taxing rights determined by reference to a physical presence. On profit allocation, the significant economic presence proposal contemplates the use of a fractional apportionment approach with the possibility of using a withholding mechanism for collection while the user contribution and marketing intangible proposals would use a residual profit split approach. All three proposals apply a global approach to determination of profit.

57. While the user contribution and marketing intangible proposals proceed from different conceptual origins and scope they can be conceptualised in a similar way as discussed in further detail below. Furthermore they both use a residual profit split methodology for allocating profit. Accordingly, the remainder of this section focuses on the commonalities and design challenges of these two proposals, while recognising that other commonalities may exist between these proposals and the proposal based on the concept of significant economic presence, including their possible use of a withholding tax as a collection mechanism or enforcement rule, to the extent that this does not result in double taxation.

Commonalities between the user contribution and marketing intangibles proposals

58. The user participation and marketing intangible proposals share important features. Both proposals are based on the principle that business profits should be taxed in the countries in which value is created, and argue that the profit allocation and nexus rules should be amended to better reflect that principle. Both proposals would have the effect of increasing the share of business profit allocated to countries in which users or customers are located, implemented via a changed nexus standard and a residual profit split method, and both proposals would require changes to the existing nexus and profit allocation rules.

59. Despite these commonalities the proposals have different conceptual origins and resulting differences in scope. The user participation proposal emphasizes the value that digital businesses generate from the engagement, interaction and contributions of users, including content, data and powerful network effects. Its premise is that this justifies the reallocation of profits of relevant businesses to countries in which users are located. In contrast, the marketing intangible proposal emphasizes the intrinsic factual link between a market jurisdiction and marketing intangibles related to that jurisdiction, while suggesting that loyalty of an active and engaged user itself could be considered a type of marketing intangible. Its premise is that this intrinsic link justifies the reallocation of profits of

relevant businesses to countries in which customers are located, or rather being awarded taxing rights over some portion of profits attributable to marketing intangibles. The marketing intangible proposal is also intended to help mitigate BEPS concerns, where the income attributable to marketing intangibles may be allocated outside the market jurisdiction through the exercise of only a relatively modest degree of decision-making capacity outside the market jurisdiction.

60. These differences in emphasis inform the different scopes of the two proposals. The user participation proposal could apply only to social media platforms, search engines, and online marketplaces while the marketing intangibles proposal instead potentially could apply to a much broader range of businesses that have significant marketing intangibles.

61. There are questions and challenges that could be raised with both the user participation and marketing intangibles proposals:

- Under the user participation proposal, it could be argued that the value created by the contribution and engagement of users does not constitute value created by the business, and instead constitutes value created by third-parties, that are more akin to suppliers than employees, and are remunerated at arm's length through the provision of a free service. Furthermore, if one accepts the conceptual motivation behind the user participation proposal, there is a question as to whether it has relevance beyond the digital-centric businesses identified above, and whether the narrow scope proposed will prove sustainable over time as digitalisation impacts on more traditional businesses.
- Under the marketing intangibles proposal, the intrinsic link between marketing intangibles and a market jurisdiction could be questioned, particularly where marketing activities are undertaken outside of that jurisdiction and not significantly tailored to local customer habits and preferences. There is also a question as to whether the justification is of equal relevance to companies that sell business-to-business, such as industrial goods and professional services companies, that may have substantial marketing expenditure and valuable trademarks, brands, or goodwill but may not leverage digital technology and customer data in delivering highly targeted/personalised marketing in the same way as consumer-facing businesses.

62. While the proponents would dispute these challenges, in recognition of the larger goal of identifying a potential basis for international consensus, there is reason to explore the possibility of a unifying rationale that addresses the points raised above and bridges the conceptual and scoping differences between the two proposals.

63. Although the proposals have different conceptual origins, a sharpened focus on the proposals' shared foundation in value creation by businesses could facilitate the development of a unified approach. Within the existing value creation framework, the user participation and marketing intangible proposals could be thought to challenge assumptions underlying the existing profit allocation principles about what it means to have an active presence or participation in a jurisdiction and undertake activities there.

64. The existing paradigm generally allocates profits based on the jurisdiction in which physical activities are performed or, in the case of allocating income that represents a return on capital or risk, based on the residence of the entity that legally owns the capital together with the location of the individuals who make relevant decisions regarding the deployment of that capital. Unless an enterprise is physically present in a user or customer's jurisdiction, including through a dependent agent, it generally will not be subject to tax there. In contrast,

the user participation and marketing intangible proposals could be said to embody a different conceptualisation of presence. Both proposals could be said to argue that, even where the physical situs of a business is substantially outside of a market jurisdiction, it is possible for that business to have an active presence or participation in that jurisdiction and generate value through customer/user facing activities that can be said to take place in that jurisdiction.

65. That is, both proposals could be said to take the common position that by failing to acknowledge the reality that businesses can today have an active presence or participation in market countries without a physical presence, or one that would justify a substantial allocation of income to that jurisdiction, the existing international tax rules fail to properly allocate income to the locations in which an enterprise is understood to create value in today's increasingly digitalised world.

66. If the user participation and marketing intangible proposals are viewed from this common perspective – i.e. as re-conceptualisations of assumptions underlying the existing framework about the location at which an enterprise acts – the central question that would need to be resolved to develop a unified approach becomes more readily evident. That central question would be, in what situations can it be said that a business, with a physical situs outside of a market jurisdiction, has an active presence or participation in that jurisdiction and generates value in that jurisdiction through its user or customer related activities?

67. Both proposals share the position that, under a value creation principle, the cross-border sale of goods and services to customers in a jurisdiction should not alone lead a business to have an active presence or participation in that jurisdiction, irrespective of the volume of those sales. Both proposals instead interpret active presence or participation to be a function of a business's active outreach to and interaction with users or customers, including the use of digital technologies to cultivate, interact with and leverage a local customer or user base in a way that creates meaningful value for the enterprise. The question then is whether this is relevant:

- only in situations in which digital-centric businesses engage, interact with and leverage contributions from a participatory user base on a digital platform, as per the user participation proposal;
- in a broader range of situations in which, for example, consumer facing businesses use digital technologies to develop a customer base, collect customer data or deliver highly targeted marketing and personalization of products; or
- in all situations in which businesses have significant marketing intangibles that can be attributed to customers of a jurisdiction, as per the marketing intangibles proposal.

68. In exploring this question, it will be important to consider how digitalisation has impacted different businesses/sectors, and allowed them to participate actively in remote user or customer markets in a way, or to a degree, that was not possible before the rapid technological advances that have taken place in recent decades.

2.3. Potential design considerations

69. Given the commonalities identified above, the marketing intangibles and the user participation proposals raise similar technical issues which justify considering together their key design features. The details of the proposal based on the concept of significant

economic presence were still emerging at the time of drafting this consultation document. Therefore, the policy designs described in this section 2.3 are, for the most part, relevant to the marketing intangible and the user participation proposals.

70. A number of technical options are briefly discussed below, including important policy trade-offs between the search for precision – e.g. through the use of detailed and factual determinations – and the need for certainty and predictability – e.g. through the use of simplified methods. Further technical work on each of these design considerations would be required as the proposals are further developed, including analysing the pros and cons of these proposals, taking into consideration different levels of development and the capacity of tax administrations, the need to ensure a level playing field between small and large jurisdictions, as well as the potential effect of the various options on revenue and taxpayer behaviours.

2.3.1. Scope and potential limitations

71. Despite the different starting points, both proposals contemplate some express scope limitations to align the proposals with the policy objectives outlined above and limit compliance and administration concerns. These limitations could be structured in different ways, but the proposals would need to be limited to businesses in which the contribution of marketing intangibles and/or user participation to the production of income is substantial. This could be determined, for example, through the use of some materiality thresholds (e.g. cost ratios, size of customer and user base, or other metrics) and exclusions (e.g. *de minimis* rules, exemptions of certain industry sectors, exclusion of commodities). Additional limitations, related for instance to the size or profitability of the taxpayer, could also be used to further focus the scope and reduce associated compliance costs, though differentiation also raises issues of fairness.

2.3.2. Business line segmentation

72. Many aspects of the proposals suggest that they could be applied more appropriately at the business line level rather than at the level of the MNE group. A business line approach would however raise significant data availability and administration issues which could increase complexity and uncertainty.

2.3.3. Profit determination

73. The amount of profit (or loss) to be re-allocated would likely not be determined by using existing transactional transfer pricing methods. Instead, a new type of residual profit split method could be mandated, relying on more simplified conventions for determining such profit and approximate results consistent with an application of the arm's length principle. Apart from this special treatment of profit attributable to user participation, marketing intangibles, or some alternative formulation, the existing profit allocation rules would continue to apply.

74. This proposal would involve the following steps:

1. the determination of the total or combined profits to be split;
2. the identification of the residual (i.e. non-routine) portion of this total or combined profits by subtracting the returns allocable to routine functions; and
3. the determination of the portion of the residual profit to be re-allocated.

75. While this proposal would retain many similarities to the existing profit split method, it may apply to a broader aggregate – combined profit of multiple entities – and introduce simplifying conventions that are intended to make the calculations easier. This is because the more the above steps are based on detailed and factual determinations (e.g. conventional transfer pricing analysis), the greater is the risk of disputes and uncertainty in the outcome produced by the proposal. Reducing complexity in the implementation of the various above steps, while at the same time making sure that any approximation is principle-based, will thus be a key policy consideration. The various implications of any simplified method would also need to be assessed as the proposals are further developed, including an examination of their effect on revenue and taxpayer behaviour. In some businesses such as those which are highly digitalised, the separation of non-routine returns attributed to trade intangibles relative to those attributed to user participation or marketing intangibles, with which they are often interconnected, will be important in terms of results and also potentially challenging.

76. Importantly, the application of these methods would not necessarily produce a positive amount of non-routine or residual profit, i.e. where the sum of routine profits is greater than the actual total profit of the MNE group or business line. One possible approach would be to apply the proposals similarly to non-routine losses, in which case the portion of these negative amounts attributable to marketing intangibles or user contribution should also be re-allocated.

2.3.4. Profit allocation

77. The profit (or loss) to be re-allocated to the relevant user or market jurisdictions must be apportioned based on an agreed allocation metric. This metric would need to be a reasonable proxy for the relative value created in each jurisdiction, and be administrable by taxpayers and tax authorities alike.

78. The most straight-forward approach may be to allocate this profit to user or market jurisdictions based on sales or revenues, though other approaches involving users, expenditures in particular jurisdictions, etc., might also be considered. The method used for allocating profit to the relevant user or market jurisdiction should be informed by the method used to determine the relevant amount of non-routine or residual profit. Implementation issues and potential avoidance opportunities will need to be identified and taken into consideration (e.g. manipulation of the location of sales). Adjustments or variations of the metric may also be required in the case of advertising revenue to ensure that profit is allocated to the jurisdiction of the targets of the advertising, as opposed to the jurisdiction of the purchaser of the advertising.

79. In parallel, to the extent that the proposals would not fully supplant the existing profit allocation rules, additional rules will be required to reconcile the outcome of the proposals with the results produced by existing profit allocation rules and prevent double taxation (e.g. constraining the application of the existing rules in certain areas, intra-group adjustments).

2.3.5. Elimination of double taxation

80. Because the new profit allocation proposals envisage a reallocation of the MNE group residual profits to user or market jurisdictions, some changes to existing treaty provisions to address the elimination of double taxation seem necessary. Adjustments to the amount of profits allocated to MNE group members under the proposals should be designed so as to prevent double taxation among associated enterprises.

81. In addition, the new proposals may need to incorporate strong dispute prevention and resolution components to prevent their implementation from resulting in double taxation for businesses.

2.3.6. Nexus and treaty considerations

82. New nexus requirements would be required to implement the profit allocation proposals. The essential task would be to provide user or market jurisdictions with the right to tax the additional income, even if the entity earning that income would have no taxable presence under existing treaty principles. This could conceivably be achieved by amending or supplementing the Article 5 definition of “permanent establishment”, allied with changes to the distributive rules in Articles 7 and 9. However, those existing provisions look at transactions between enterprises or parts of an enterprise, whereas the new proposals look at the combined profit of multiple entities within an MNE group. Therefore, an alternative approach might be to introduce the new nexus through a new standalone rule allocating taxing rights over the additional income. In all cases, the proposals recognise the need for a new nexus which would be based on an alternative threshold. There are similarities between this and nexus rules based on a concept of significant economic presence described in section 2.2.3 which should be further explored. Of course countries may also need to amend their domestic laws, such that any new article can become operational and there may be benefits in coordinating the development of any such domestic rules.

2.3.7. Administration

83. The taxation of the reallocated income in the user or market jurisdiction would require the determination of the identity of the taxpayer who bears the tax liability and filing obligations. To the extent that the proposal may result in reallocating income earned by multiple entities in an MNE group (which may be resident in the taxing jurisdiction or in another jurisdiction), further work would be required to identify and assess the different options available to allocate the tax liability, taking into consideration administrative burdens and risks of non-compliance.

84. To address concerns that the implementation of the proposals would result in additional controversy and double taxation for businesses, the proposals would need to incorporate strong dispute prevention and resolution components, and focus on simplicity. For example, early certainty features could range from improved multilateral risk assessment procedures, drawing on the current International Compliance Assurance Programme (ICAP) pilot, to multilateral advance pricing agreement programmes, and joint audit programmes, all following co-ordinated or unified procedures to reduce controversy in the application of the rules and to minimise the risk of double taxation. The objective of any potential dispute prevention and resolution features would be to ensure a consistent application of the proposals across tax administrations in multiple participating jurisdictions.

85. The effective application of the proposals would also require a number of data points to be available to tax administrations (e.g. total profit, business line) which could be derived from tax accounting or financial accounting data. Any additional data needs could potentially be added to an already agreed filing and exchange of information mechanism such as that in place under BEPS Action 13 (country-by-country reporting).

86. To improve compliance, the use of principle-based administrative simplifications and collection mechanisms, which could include new or existing withholding mechanisms

as an enforcement rule supporting the application of the proposals could also be explored, provided this mechanism does not result in double taxation.

2.4. Questions for public comments

87. Commentators' views are requested on the policy, technical and administrability issues raised by each of the three proposals described above. In particular, comments are specifically requested on the following questions:

1. What is your general view on those proposals? In answering this question please consider the objectives, policy rationale, and economic and behavioural implications.
2. To what extent do you think that businesses are able, as a result of the digitalisation of the economy, to have an active presence or participation in that jurisdiction that is not recognised by the current profit allocation and nexus rules? In answering this question, please consider:
 - i. To what types of businesses do you think this is applicable, and how might that assessment change over time?
 - ii. What are the merits of using a residual profit split method, a fractional apportionment method, or other method to allocate income in respect of such activities?
3. What would be the most important design considerations in developing new profit allocation and nexus rules consistent with the proposals described above, including with respect to scope, thresholds, the treatment of losses, and the factors to be used in connection with profit allocation methods?
4. What could be the best approaches to reduce complexity, ensure early tax certainty and to avoid or resolve multi-jurisdictional disputes?

3. Global anti-base erosion proposal

88. This part of the paper sets out proposals 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: an income inclusion rule and a tax on base eroding payments. The rationale and mechanics for these rules are set out below together with a discussion of the key questions for consultation.

3.1. Overview and background

89. While the measures set out in the BEPS package have further aligned taxation with value creation and closed gaps in the international tax architecture that allowed for double non-taxation, certain members of the Inclusive Framework consider that these measures do not yet provide a comprehensive solution to the risks that continue to arise from structures that shift profit to entities subject to no or very low taxation. This risk is particularly acute in connection with profits relating to intangibles, prevalent in the digital economy, but also in a broader context; for instance group entities that are financed with equity capital and generate profits, from intra-group financing or similar activities, that are subject to no or low taxes in the jurisdictions where those entities are established.

90. The global anti-base erosion proposal is made against this background. It is intended to respect the sovereign right of each jurisdiction to set its own tax rates, but reinforces tax sovereignty of all countries to “tax back” profits where other countries have not sufficiently exercised their primary taxing rights. The proposal recognises that in the absence of multilateral action there is a risk of un-coordinated, unilateral action, both to attract more tax base and to protect existing tax base, with adverse consequences for all countries, large and small, developed and developing. It posits that global action is needed to stop a harmful race to the bottom, which otherwise risks shifting taxes to fund public goods onto less mobile bases including labour and consumption, effectively undermining the tax sovereignty of nations and their elected legislators. Unilateral measures taken in response can lead to double taxation and may even result in new forms of protectionism. Developing countries, often with smaller markets, may also lose in such a race and become even more dependent on natural resource taxation to finance their public needs, while multiplying tax free zones and other incentives to attract foreign direct investment. The proposal therefore seeks to advance a multilateral framework to achieve a balanced outcome which makes business location decisions less sensitive to tax considerations, limit compliance and administration costs and avoid double taxation.

91. Recognising, as stated in the Action 1 Report, that it would be difficult, if not impossible, to ring-fence the digital economy from the rest of the economy for tax purposes, the scope of the anti-base erosion proposal is not limited to highly digitalised businesses. However, by focusing on the remaining BEPS challenges, it proposes a systematic solution designed to ensure that all internationally operating businesses pay a minimum level of tax. It does not tolerate that a modest level of substance can result in an allocation of a substantial amount of intangible and risk related returns to group entities that pay no or very little tax. In so doing, it addresses the remaining BEPS challenges linked to the digitalising economy, where the relative importance of intangible assets as profit drivers makes highly digitalised business ideally placed to avail themselves of such planning structures, but it goes even further and addresses these challenges more broadly.

3.2. Mechanics

92. The proposal seeks to address the remaining BEPS challenges through the development of two inter-related rules:

1. an **income inclusion rule** that would tax the income of a foreign branch or a controlled entity if that income was subject to a low effective tax rate in the jurisdiction of establishment or residence; and
2. a **tax on base eroding payments** that would deny a deduction or treaty relief for certain payments unless that payment was subject to an effective tax rate at or above a minimum rate.

93. These rules would be implemented by way of changes to domestic law and double tax treaties and would incorporate a co-ordination or ordering rule to avoid the risk of economic double taxation that might otherwise arise where more than one jurisdiction sought to apply these rules to the same structure or arrangements.

94. As part of the global anti-base erosion proposal, further consideration could also be given to whether any additional specific rules are required to deal with issues raised by thickly capitalised entities.

95. Some of the broader questions that may need to be addressed as part of this proposal include:

- further work to clarify the kinds of entities, arrangements and behaviours that are within the intended scope of the global anti-base erosion proposal, supported by practical examples;
- analysing the intended operation of the rule in light of anticipated changes in the behaviour of both firms and jurisdictions in response to the proposal;
- further considering the role of substance in the application of the proposal (including the substance criteria developed under BEPS Action 5), particularly in light of its intention to not impact on structuring and location decisions made for economic or business reasons;
- considering safe harbours and thresholds that would reduce complexity in the application of the rule; and
- co-ordinating outcomes and the possibility of incorporating dispute prevention and resolution components in order to reduce controversy in the application of the rules and minimise the risk of double taxation.

3.3. Income inclusion rule

96. The income inclusion rule would operate as a minimum tax by requiring a shareholder in a corporation to bring into account a proportionate share of the income of that corporation if that income was not subject to tax at a minimum rate. The rule would apply to any shareholder with a significant (e.g. 25%) direct or indirect ownership interest in that company and would be applied on a per jurisdiction basis. The amount of income to be included would be calculated under domestic law rules and shareholders would be entitled to claim a credit for any underlying tax paid on the attributed income, with such credits also being calculated on a jurisdiction-by-jurisdiction basis. This rule would supplement rather than replace a jurisdiction's CFC rules.

97. In the case of exempt foreign branches the income inclusion rule would operate by way of switch-over rule that would turn off the benefit of an exemption for income of a branch and replace it with the credit method where that income was subject to a low effective rate of tax in the foreign jurisdiction.

98. The income inclusion rule would build on the Action 3 recommendations and draw on aspects of the US regime for taxing Global Intangible Low-Taxed Income (“GILTI”).⁷ The rule would be designed in such a way that Member States of the European Union could apply it to both domestic and foreign subsidiaries and Member States could choose to adopt this rule through an EU directive.

99. The income inclusion rule would ensure that the income of the MNE group is subject to tax at a minimum rate thereby reducing the incentive to allocate returns for tax reasons to low taxed entities. The income inclusion rule would have the effect of protecting the tax base of the parent jurisdiction as well as other countries where the group operates by reducing the incentive to put in place intra-group financing, such as thick capitalisation, or other planning structures that strip profit from high to low tax entities within the same group. It is not intended to affect structuring and location decisions made for economic or business reasons.

100. In addition to discussing how the minimum rate itself should be determined and applied, there are a number of further technical issues that would need to be considered in the design of the rule, drawing on the experience from countries with similar rules, including:

- the types of entity covered and definition of the minimum level of ownership or control required in order to apply the income inclusion rule, and in particular the ability of minority shareholders to access the information required in order to determine and calculate their tax liability;
- the mechanism for determining whether a corporation has been subject to tax at the minimum rate (i.e. the design of the effective tax rate test);
- the design of any thresholds or safe harbours to facilitate administration and compliance with the rule;
- the rules for attribution of income to shareholders based on their control or economic ownership including mechanisms to prevent taxpayers structuring around the rules;
- whether the included income should be taxed at the minimum rate or the full domestic rate;
- mechanisms for avoiding double taxation including rules governing the use of foreign tax credits and corresponding adjustments to the scope of any related exemptions; and
- the compatibility of the design of the income inclusion rule with international, and where applicable EU law, obligations.

⁷ Public Law No. 115-97, 22 December 2017, Section 14201 (a) introducing sec. 951A in Subpart F of part III of subchapter N of chapter 1 of the Internal Revenue Code of 1986 (US Congress, 2017).

3.4. Tax on base eroding payments

101. The second key element of the proposal is a tax on base eroding payments that complements the income inclusion rule by allowing a source jurisdiction to protect itself from the risk of base eroding payments. More specifically, this element of the proposal would include:

- an *undertaxed payments rule* that would deny a deduction for a payment to a related party if that payment was not subject to tax at a minimum rate; and
- a *subject to tax* rule in tax treaties that would only grant certain treaty benefits if the item of income is sufficiently taxed in the other state.

102. These two measures ensure that the proposal will provide a comprehensive solution to profit shifting risks by ensuring the payer jurisdiction remains protected from base-eroding payments even where that payment is not brought within the charge to taxation in the hands of the underlying owners under the income inclusion rule.

3.4.1. Undertaxed payments rule

103. The undertaxed payments rule would deny a deduction for certain defined categories of payments made to a related party unless those payments were subject to a minimum effective rate of tax. The effective tax rate test would take into account any withholding tax imposed on the payment (including as a result of the denial of treaty benefits under the subject to tax rule described below). The test for whether a payment was to a related party could be based on a 25% common ownership test, similar to that used for the application of the income inclusion rule and in the BEPS Action 2 (hybrids).

104. The rule should apply to a broad range of payments and should cover “conduit” or “imported” arrangements, where the effect of an undertaxed payment is “imported” into the payer jurisdiction through a payment that is otherwise outside the scope of the rule. The benefit of a broad scope is seen in the fact that it avoids design issues that can arise in defining particular categories of payments and would prevent MNE groups from being able to structure transactions that fall outside the scope of these definitions.

105. In addition to considering how the minimum rate should be determined and applied, and the relevance, if any, of any substance in the entity receiving the payment such as substance concepts developed in connection with BEPS Action 5, the key technical issues that would need to be considered in the design of the undertaxed payments rule, drawing on the experience from countries with similar rules, will include:

- the scope of payments covered by the rule and, in particular, the need for a workable scope that addresses the full range of profit shifting risks while minimising the administration and compliance burdens and limiting the potential for economic double taxation or over-taxation;
- the threshold for related party status and, in particular, the degree of common control and the information that parties are likely to need in order to be able to comply with, and to avoid any unintended tax consequences under, the undertaxed payments rule;
- the mechanics of this effective tax rate test including whether it should be applied on an entity by entity or transaction by transaction basis and the development of

robust and workable tests for calculating the effective tax rate on each type of payment;

- the compatibility of the undertaxed payments rule with international obligations; and
- whether the rule should deny deductibility in full or only on a graduated basis reflecting the level of taxation in the jurisdiction of the recipient.

3.4.2. *Subject to tax rule*

106. To complement the undertaxed payments rule, the anti-base erosion proposal would also include a subject to tax rule that would apply to undertaxed payments that would otherwise be eligible for relief under a double tax treaty. This rule would apply to deny tax treaty benefits provided by the following Articles (using the numbering of the OECD Model Convention):

- **Article 7 (Business profits).** In this case the subject to tax rule could allow a contracting state to tax the business profits of a non-resident enterprise regardless of its obligation under Article 7 to only tax profits which are attributable to a permanent establishment, if those profits are not subject to tax at a minimum rate in the residence state.
- **Article 9 (Associated enterprises).** The subject to tax rule could make corresponding adjustments in one contracting state dependent on effective taxation by the state making the primary adjustment under Article 9, requiring that state to specify the effective taxation on the adjustment.
- **Article 10 (Dividends).** The subject to tax rule could deny treaty benefits in the source state if the residence state does not tax the dividend at a minimum effective rate of tax. Because the rule could defeat the objective of participation exemption regimes to avoid economic double taxation, an alternative rule could include a general carve-out for such regimes or introduce a special effective tax rate test that could take account differences in tax relief systems between the residence and source state.
- **Article 11 - 13 (Interest, Royalties and Capital Gains).** The subject to tax rule could deny treaty benefits in the source state if the residence state does not tax the interest, royalties or gains at a minimum effective rate of tax.
- **Article 21 (Other income).** Similarly, where Article 21 allocates exclusive taxing rights to the residence state on other income, a subject to tax rule could deny treaty benefits in the source state if the residence state does not tax the income at a minimum effective rate of tax.

107. The subject to tax rule could be limited to payments between related parties, but a broader scope could be explored in Articles 11 to 13. Consideration could be given to thresholds and safe harbours to facilitate administration and compliance with the rule. A delegation of authority to operate the subject to tax rule and mechanisms for resolving disputes could also be considered in order to ensure that the tax on base eroding payments is effective, co-ordinated and limits the risk of double taxation.

108. In addition to technical issues that would need to be considered in the design of the undertaxed payment rule (which equally applies to a subject to tax rule), the following key technical issues would also need to be considered:

- impact on tax exemptions accorded to dividend distributions in order to mitigate double taxation of such dividends that should probably not be affected by a subject to tax rule;
- information that a payee would be required to provide to payers and withholding agents in order to support a treaty benefits; and
- impact on certain categories of taxpayers (e.g. individuals, pension funds, charitable organisations).

3.5. Rule co-ordination

109. Because the various elements of the anti-base erosion proposal are intended to tackle the same structures there is the possibility that these rules will overlap to a certain extent. Given the potential for overlap an ordering rule would be necessary. There are at least two design options for such an ordering rule: a rule that could be applied on a payment by payment basis or a more systemic approach that would switch off the application of one rule if an MNE was based in a jurisdiction that had introduced the other rule. Further technical work would need to explore these overall approaches and then also establish the order in which they would be applied.

3.6. Questions for public comments

110. Commentators views are requested on the policy, technical and administrability issues raised by the proposals described above, including those raised in paragraphs 100 and 105. In particular, comments are specifically requested on the questions set forth below:

1. What is your general view on this proposal? In answering this question please consider the objectives, policy rationales, and economic and behavioural implications of the proposal.
2. What would be the most important design considerations in developing an inclusion rule and a tax on base eroding payments? In your response please comment separately on the undertaxed payments and subject to tax proposals and also cover practical, administrative and compliance issues.
3. What, if any, scope limitations should be considered in connection with the proposal set out above?
4. How would you suggest that the rules should best be co-ordinated?
5. What could be the best approaches to reduce complexity, ensure early tax certainty and to avoid or resolve multi-jurisdictional disputes?

111. In their responses commentators are invited to draw on experiences from the operation and design of existing rules that they consider would be helpful for this discussion.

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