Grant Thornton
An instinct for growth™

Tax

Navigating

Digital

Cloudy with a chance of complacency

Scaled back digital tax plans leave local jurisdictions to fill in the gaps

The Organisation for Economic Co-operation and Development's (OECD'S) latest proposals on taxing digital business pull back from the radical roadmap put forward in May to something much closer to the January policy note by proposing a modified residual profit split with benchmarking of routine profits.[1] The G20 finance ministers subsequently welcomed progress and reaffirmed their commitment to seeking a consensus-based solution by the end of 2020.[2]

Key developments include narrowing the scope to large enterprises carrying out business-to-consumer (B2C) transactions. It also looks like the arm's length principle is back from the brink, having appeared doomed under the earlier proposals, though this is only a partial reprieve.

But the sighs of relief among mid-size multinational enterprises (MNEs) are likely to be tempered by continuing uncertainty over the type of commerce covered and size of affected businesses. Moreover, anything the OECD eventually agrees will only be a recommendation, leaving governments to frame their own measures and hence heightening the risk of double taxation and dispute.

What then do the latest OECD proposals say, what do they leave open and what are the risks that need to be addressed?

1 Secretariat Proposal for a 'Unified Approach' under Pillar One – Public consultation document, www.oecd.org – 9 October 2019.
OECD/G20 Base Erosion and Profit Shifting Project 'Programme of Work to Develop a Consensus Solution to the Tax Challenges Arising from the Digitalisation of the Economy', www.oecd.org – 31 May 2019.
Addressing the Tax Challenges of the Digitalisation of the Economy – Policy Note, www.oecd.org – 23 January 2019.

2 G20 press release on international taxation – 18 October 2019

Taxing digital business is proving to be challenging. 'Old economy' conventions require a physical presence in the market to be liable to pay corporate tax there. But times have changed. As a result of digitisation, a huge amount of transactions take place in markets where a business has no 'bricks and mortar' presence. How can taxation be brought into line with the realities of modern commerce by bringing these virtual transactions into the net?

Taxing digital business is also contentious. Governments are under intense political pressure to up the tax take from Big Tech firms that are seen by many of their voters, rightly or wrongly, as underpaying. The other big source of contention is the tension between 1) jurisdictions where a lot of digital businesses are based and hence do well from a tax perspective under current rules and 2) giant consumer markets that feel they are losing out on taxable income right now.

What’s been proposed?

On 9 October 2019, the Organisation for Economic Co-operation and Development (OECD) launched its latest attempt to find a workable solution for these vexed digital taxation issues. After floating a radical overhaul in May, which would have caught pretty much every business in its net, the new Pillar 1 (allocation of profit and new nexus rules) proposals appear to be limited to large enterprises that deal with consumers. An online marketplace would be a fairly obvious candidate. But there are lots of overlaps between business-to-consumer (B2C) and business-to-business (B2B) commerce that create uncertainty around scope and application. What about a large smartphone manufacturer that sells through mobile network providers, for example?

The OECD has made an effort to take most small business out of the scope. This includes a combined group turnover threshold – mentioned as €750 million in line with country-by-country (CbC) reporting, but this is only a suggestion for consideration. If €750 million does emerge as the rule of thumb, a good many mid-size MNEs would be covered, rather than just the Big Tech giants. Moreover, like CbC, the door is open to individual markets to lower this, which leaves considerable concern for businesses that do not have a large tax department able to respond to the additional demands.

The thresholds also include minimum levels of sales in a particular market. Again, this isn’t clear cut and could leave many mid-size and even smaller MNEs within the scope. In particular, some small jurisdictions might set the threshold at just a few million dollars or even less to ensure they don’t miss out. This very real possibility leaves considerable uncertainty over where else you might need to register for tax (nexus rule).

The OECD has also sought to retain some elements of the arm’s length principle, with a supplement for enterprises that are in scope. The suggested approach consists of a blend of residual profit and a formulaic allocation for each consumer market based on levels of sales. This could be calculated by using consolidated financial statements. The revised proposals recognise that a simultaneous implementation and an effective dispute resolution mechanism are needed to make this viable. Both in turn require a high level of agreement between jurisdictions that could have different and even competing priorities and different formulas.

The consultation paper proposes the development of nexus thresholds based on changes to local tax legislation and a new self-standing treaty provision to make sure the arrangements are workable. Certain activities won’t be in scope, including extractive industries, financial services, commodities and likely some B2B scenarios. This again opens up uncertainty – for example, is a FinTech business that supplies a bank or insurer with technology used in consumer interactions liable under the rules?

“Anything the OECD eventually agrees will only be a recommendation, leaving governments to frame their own measures…”

What's coming up?

Consultations are ongoing until 12 November 2019. This will be followed by a consultative meeting in Paris on 21 and 22 November. The OECD continues to target a political agreement leading to the basic tax policy architecture to be released in early 2020. This would pave the way for detailed technical work to be carried out during the year.

It's hoped that some of the grey areas in the OECD proposals can be clarified as part of the consultations and subsequent review of responses. Open items on the OECD agenda include:

- determining what a consumer facing business is and its application to indirect sales
- defining a new nexus rule for local taxation including threshold for application
- calculating group profits (by business unit, consolidated financial statements)
- determining residual profits and allocation issues
- defining activities that are subject to a fixed return
- determining application to business unit or the enterprise as a whole
- determining how to handle losses
- determining application to tax treaties.

Also coming up later in the year is the OECD's latest recommendations on minimum taxation (Pillar 2 global anti-base erosion or 'GLoBE'). The imposition of a minimum tax seeks to compensate for diversion of taxable income from high to low tax jurisdictions. Models already in use include the minimum tax on global intangible low-taxed income (GILTI) in the US. Will the OECD follow a similar approach? What floor will they propose?

"It's hoped that some of the grey areas in the OECD proposals can be clarified as part of the consultations and subsequent review of responses."

Where could we end up?

Yet even with clarifications, the OECD sees its latest proposals as an opportunity to share its views to help countries move forward in their own approach.[3] It doesn't bind any countries into an agreement.

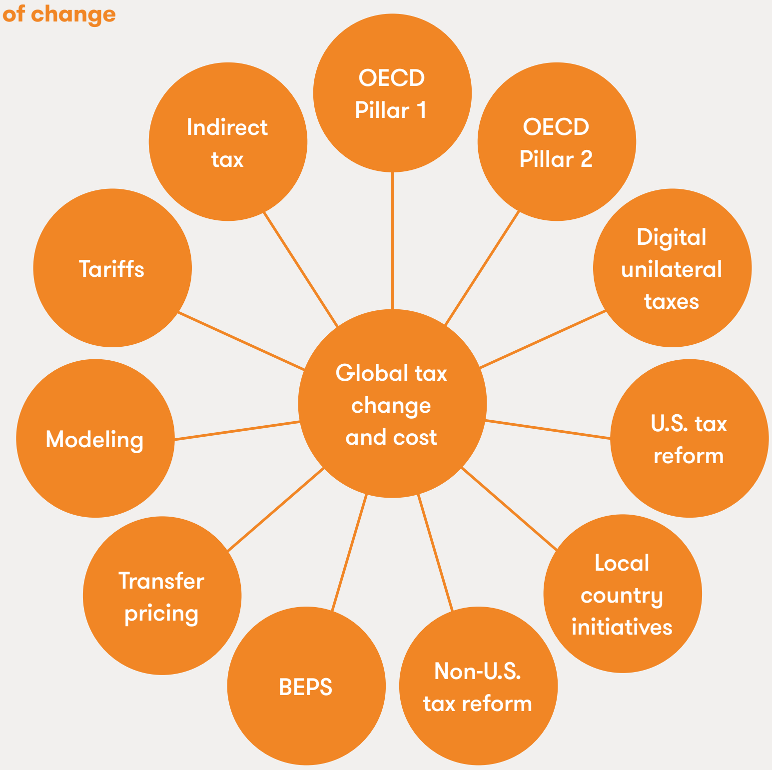
Countries could therefore go their own way. A growing number already have or plan to. For example, the French government has introduced a 3% levy on sales generated in the country by large digitally-focused groups (turnover globally of over €750 million and sales in France of €25 million plus).[4] This met with opposition from the US, where many of the targeted businesses are based, highlighting the difficulties of securing an international consensus on this issue, though France subsequently agreed to repay tax that exceeds levels set under the finalised OECD plans.[5] Others including Italy, Spain and the UK have plans in the pipeline. Spain is especially notable by proposing a threshold of only €3 million taxable revenues in the country.[6]

What does this mean for your business?

The big shift between the OECD's May and October proposals turn this from an economy-wide shake-up to a business specific challenge. However, the grey areas within the latest recommendations (eg the uncertain line between B2C and B2B) and how any new rules might be applied on the ground (eg lower turnover thresholds) open up the danger of assuming that you are not in the scope when you are.

It's also important to view digital tax against the backdrop of the wider global tax changes in areas ranging from the shift to indirect taxation to tit-for-tat tariffs (see Figure 1). Many of the drivers are common across multiple markets – anger over perceived tax avoidance, for example. However, we're likely to see as much unilateral as agreed global action, with the risks of competing agendas, tax disputes and double taxation this entails.

Figure 1: The tax wheel of change



[3] OECD Tax Talks, www.oecd.org – 9 October 2019.
[4] France leads the way on taxing tech more fairly, Financial Times – 11 July 2019.
[5] Macron says France and U.S. reached digital tax deal, Reuters – 26 August 2019
[6] Digital services tax in Europe, grantthornton.global – 25 February 2019

What can your business do now to prepare?

If your business is in the cross hairs of these changes then you will need to spend a lot more time and money working out the impact and how to respond. This is challenging if you only have a small tax team, but we can help. Even if you aren't in the target group, you're still likely to face increasing pressure from local tax authorities and more formula-based allocations.

Three steps to get on the front foot:

1. Model impacts of upcoming developments, not just in terms of tax paid and where, but needs and costs of compliance. As part of this assessment, it's important to understand and plan for multiple eventualities.

2. Review organisational structure and supply chains to take account of digital tax and wider developments such as tariffs.

3. Reduce the growing risks of dispute by being data-ready (ie evidence-based justification rather than scrambling to respond to an investigation), beefing up documentation in areas such as transfer pricing and reducing uncertainty through steps such as advanced pricing agreements (APAs). While unilateral APAs have been less popular than bilateral or multilateral counterparts due to state aid issues or the BEPS outcome, they may come back into focus as a result of the unilateral developments in digital tax.

Danger of complacency

The latest OECD proposals are likely to be more palatable for mid-size MNEs, which had been likely to bear the brunt of the more far-reaching overhaul muted by the OECD despite not being the main target. Yet, there is no room for complacency as virtual as well as physical presence becomes the trigger for tax registration and payment. And, as is so often the case, it isn't certain who will be affected and how, so business-by-business evaluation and re-evaluation is critical.

Feel free to get in touch

We hope that you found this update useful. If you would like to discuss any of the issues in more detail or if you would like assistance modelling how the proposals may affect your business, please contact one of the following or speak to your local Grant Thornton office.

Canada
Pierre Bourgeois
E bourgeois.pierre@rcgt.com

Brad Rolph
E brad.rolph@ca.gt.com

China
Richard Bao
E richard.bao@cn.gt.com

France
Pascal Luquet
E pluquet@avocats-gt.com

Germany
Christoph Ludwig
E christoph.ludwig@wkgt.com

Italy
Paolo Besio
E paolo.besio@bernoni.it.gt.com

Spain
Juan Martinez
E juan.martinez@es.gt.com

United Kingdom
Wendy Nicholls
E wendy.nicholls@uk.gt.com

United States
Steven Wrappe
E steven.wrappe@us.gt.com

David Zaiken
E david.zaiken@us.gt.com

"It's also important to view digital tax against the backdrop of the wider global tax changes in areas ranging from the shift to indirect taxation to tit-for-tat tariffs."

Grant Thornton
An instinct for growth™

grantthornton.global