Industry Reactions on OECD's Unified Approach - An Insight.....

Dec 04, 2019

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Much has been debated about the discord between the existing international tax principles and fair tax allocation amongst jurisdictions for the digital economy transactions. This is because business through digital medium can be conducted from beyond the sovereign boundaries of nations. Just to recap, in respect of the digital economy, the Inclusive Framework on BEPS, working through the Task Force, as mandated by the G20 Finance Ministers in March, 2017, submitted a report titled Tax Challenges Arising from Digitalisation - Interim Report which captured the challenges in digital economy in a single phrase: Digitalisation, business model and value creation. The Inclusive Framework had received several proposals for reaching long term solutions to the tax challenges. These proposals are divided under two pillars, where the first pillar is about allocation of taxing rights which involves review of the nexus and profit allocation rules, and the second pillar is about introducing rules to counter BEPS. The main principle underlying the Programme of Work under Pillar One in respect of Digital Economy is that the user/ market jurisdiction must be able to tax the profit that can be reasonably attributed to the income arising in the user/market jurisdiction.

The Organisation of Economic Cooperation & Development (**OECD**) Secretariat placed a public discussion document with the proposal for a Unified Approach under Pillar One, on 9 October 2019 (**Proposal**). It is heartening to see many comments (running into 1000+ pages) received by them. Almost all the comments have recognised the need to arrive at a mechanism to give fair share of taxation to market / user jurisdictions from where the multinational enterprises (**MNEs**) earn their revenue, without creating sufficient business presence. The market jurisdictions cannot tax such MNEs under the traditional permanent establishment (**PE**) rule as they have no business presence there. The PE rule was established somewhere in 1922 when the seamless globalisation and business by MNEs without any physical presence was not even conceived! While the need for such taxation right is recognised, it is herculean task to arrive at an acceptable consensus on several aspects for this taxing right to be achieved. Some of them (not exhaustive by any means) are: (i) How to determine nexus, (ii) which businesses should be covered - should they be digital businesses or technology enabled businesses or both? (iii) determination of the income of the MNE which can be attributed to the market jurisdiction (iv) computation mechanism for such income (v) elimination of double taxation (vi) how this mechanism should not replace or overlap the existing principles of income allocation under transfer pricing rules as well as source rules - such as taxation on gross basis of interest, royalty, fees for technical services as well as net business income under PE. (vii) robust dispute resolution mechanism between jurisdictions (viii) which entity to be taxed (ix) how the tax should be collected - whether

withholding tax is possible (x) filing of tax returns (xi) deletion of unilateral measures put in place by several jurisdictions to levy tax on digital economy, e.g. equalisation levy in India, etc.

Unified Approach under Pillar One

Before, proceeding to analyse the proposals and comments from the stakeholders including e-commerce companies, it is opportune to recap the Proposal in summary form.

I. Scope

The Proposal suggests to cover the highly digitalised businesses which have large consumer -facing focus. The definitive aspects such as meaning of consumer facing business, the sectors which should be carved out from the scope, limitation of the scope on the basis of size, and definition of the MNE group et al are yet to be clarified.

II. New Nexus for the taxpayers in the Scope

The proposal suggests a New Nexus rule wherein the nexus will not be dependent on the physical presence but will be ascertained through the 'sustained and significant involvement in the economy of a market jurisdiction'. This will be determined based on the revenue threshold, which in turn will be based on the size of the market. This new rule is proposed to be a standalone rule separate from and in addition to the conventional PE rule. The Proposal specifies that the threshold would factor the economic conditions of the developing countries and small economies. The approach recognises the difficulties of smaller economies and smaller market sizes.

III. Increased Tax Certainty via Three Tier Mechanism under revised profit allocation

In order to provide tax certainty, the Proposal envisages the idea of a three tier profit allocation mechanism which is discussed below:

Amount A: This is the amount over which new taxing right will be applicable. This will be a portion of deemed residual profit of the MNE group which is allocated to the concerned market jurisdiction using formulaic approach, i.e. new taxing right. The residual profit is what remains after allocating 'deemed routine profit' on activities to the countries where the activities are performed under all the traditional allocation rules. The idea is not to overrule the existing international taxing principles, but arrive at an amount which is earned by the MNE and can be given taxing right to the market jurisdiction, after the usual allocations are made. This could also be in addition to what that jurisdiction earns through the application of other principles of international taxation.

Amount B: This is the fixed amount aimed at reducing transfer pricing disputes in relation to distribution functions where such tensions are likely to exist. As there are multiple disputes in relation to distribution functions, the Proposal contemplates fixed remuneration for baseline marketing and distribution functions that take place in market jurisdiction. It is proposed to clarify the scope of the activities which will be covered for fixed returns and the quantum of return.

Amount C: If there are more functions performed in a market jurisdiction than those covered under Amount B, then the market jurisdiction will have the right to tax the additional profits for such functions as per the existing transfer pricing rules.

Comments from the stakeholders

I. Re Scope under Pillar One

Interestingly, various e-commerce companies and stakeholders have suggested to eliminate any reference to consumer-facing business as the key principle for application of this Proposal. They have suggested that rather than focusing on defining the 'consumer' or 'user', it would be more beneficial to focus on any transaction involving products or services aimed at distribution on the market. Concerns have also been raised to suggest that the focus on the 'user' or 'consumer' could lead to only the end user or customer being considered within this ambit, however the Unified Approach should apply to both

B2B and B2C transactions, so that the distortion to the neutrality of the international tax system can be avoided.

Few industry specific associations have sought to seek exemption from being included within the ambit of the New Nexus rule. On the other hand, others have commented that there should not be any industry carve-out from the scope of the New Nexus rule as it would result in 'reversed ring- fencing' mechanism which should be avoided. Furthermore, it has also been suggested that the application should be channel neutral and cover all interaction with customers/users or important features of digitalisation.

It is considered sensible that no industry or channel specific exemption carve out is there, as such exemption would likely result in leakage and erosion of tax base. However one would need to wait to see the details under the Unified Approach post the discussion on the comments to see how this comment is incorporated.

II. Re New Nexus

Many stakeholders have raised a concern that having a defined sales thresholds could result in further distortion of tax base in developing countries, as they may not benefit as much as larger economies or developed countries. While it can be acknowledged that the calibration of measures to reflect the interests of smaller economies will be challenging, it is critical that these concerns are ironed out in the course of further deliberation on the Unified Approach. One possible solution could be to fix revenue thresholds per country in relation to the size of the economy, such as based on the GDP of the economy. It would need to be done in a manner that it does not need to be revised each year.

Another vital aspect in this respect has been the clarification for delinking any indirect taxes with the thresholds under the New Nexus Rule. It should be clarified that the rule is purely for the purposes of corporation/income tax and the market allocation or the revenue threshold does not create nexus for VAT or indirect tax purposes or any other non-tax or regulatory purposes.

III. Re Three-tier Profit allocation

While the industry has been supportive of the introduction of Amount A as the new taxing right, the adoption of a formulaic approach for computing the excluded routine profits to determine the quantum of attributable profits to market jurisdictions does not seem to have incited favourable response from some e-commerce companies. It is perceived that liberty to each country to set its own percentages of deemed routine and non-routine amounts of profits may disregard the actual functions performed, assets used and risks assumed which permit taxation of profits where value creation activities take place.

In this respect, it is also suggested that it would be vital to reconcile the country-by country reporting under Action 13, since the objective to align the value creation with the commensurate and fair share of taxes is inherent under the country-by country reporting. Furthermore, one should bear in mind that the idea of the Unified Approach is not to distort the conventional international tax system but to aid in fairly taxing digital transactions based on the nexus with respect to territories based on the users and revenues. Another concern raised in this respect is the identification of Amount A based on segments, one suggested approach is for the Unified Approach be applied to a group's consolidated financials as a whole, not on a segmental basis such that the administrative burden to comply with the Unified Approach is reduced.

With respect to Amount B, stakeholders have rightly raised the concern in relation to the ability to determine losses and carry such losses forward to offset future taxable income. While this aspect should ideally be taken care by the respective domestic laws of the source state, such ability would also depend on the modality of the implementation of the Unified Approach.

Another aspect in relation to Amount B, is the guidance on what constitutes base line activities. There could be significant complexities in determining this and what comprises routine marketing and distribution activities, hence a detailed guidance on this has been cautioned to be framed in ascertaining a better suited regime for taxing digital transactions. Some have raised a concern as to what the 'fixed return' in respect of Amount B would be on - sales or costs.

IV. Re Withholding Tax

Almost all comments with regard to withholding tax are negative. This is understandable, since there may not even be a payment coming out from the market jurisdiction from where withholding can take place, if all the types of economic transactions which render themselves to New Nexus are to be considered. Also, the administrative burden may be practically unmanageable, especially where the retail consumer is required to withhold tax. Since Amount A can only be determined after the year has closed, it is important to ensure that the taxes payable to the market jurisdiction would be post facto and not as the transactions take place or based on the accounts of the previous year and not the year of payments. A proposal for self-assessment tax has been made by one of the stake holders, which seems worth considering. However, this may be done on a quarterly basis like for advance tax.

Challenges and the Road Ahead

While the Proposal seems to be comprehensive, it would be interesting to see the details on all the elements listed earlier in this article so as to have consensus on the New Nexus rule. It is also important to ensure that these rules tie-in with the DTAA network and multi-lateral instrument (**MLI**). Multilateral measure such as the MLI for implementing such paradigm shift for New Nexus would be good as it would help reconcile with the existing PE concept and obviate any overlap.

Inspired from OECD Action Plan 1, India has introduced the concept of significant economic presence in its domestic law under its source rules. While its DTAA network has remained unchanged, it is interesting to note that as soon as the New Nexus approach is made part of international taxation through MLI or any other multilateral instrument, the domestic law will also support it. The recommendations would need to be aided by detailed prescriptive suggestions and rules to implement them.

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The authors would like to acknowledge the assistance provided by Jayesh Karnawat, 4th Year, B.B.A. LL.B, National Law University, Jodhpur in preparing this article.