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ECOSOC Special Meeting on International Cooperation in Tax Matters

ECOSOC Chamber, Monday 29 April 2019, 10:30 am – 12:00 pm

Session 1: Taxation and the digitalization of the economy

Purpose of the session

The rapid digitalization of the economy has created significant difficulties for the application of corporate taxes to cross-border transactions. Corporate taxes, on which developing countries typically rely more than developed countries,[1] are key to mobilizing domestic resources. Over the last few years, these issues have been intensely debated at the national and international levels and a number of proposals for short-term and long-term solutions have been made. This session will address how these proposals may impact in particular the tax revenues of different countries, with special attention to the least developed and other countries in special situations and to the overall quality and effectiveness of tax rules.

Background

Under the rules incorporated in the domestic tax laws of most countries and in the vast network of bilateral tax treaties currently in force, a country is generally prevented from taxing the business profits of a foreign company unless these profits are derived from some form of physical presence that the company has in the country (generally referred to as "nexus").

Once a foreign company has nexus in a country, the existing rules also provide that its taxable profits will be determined on the basis of the "separate entity arm's length principle". This means that each company (or taxable presence that a company has in a country) that is part of a multinational group is taxed separately from the other members of that group. Further, to prevent transfer mispricing, the company's profits are determined as if it were dealing at arm's length with the other members of the group.

The digitalization of business models has put a lot of stress on these existing rules. A multinational group that provides goods or services through the internet can have a significant economic impact in a country, without any of the companies that are members of the group having the required nexus to be taxable in that country. Also, the practical application of the arm's length principle in the case of transfers of intangibles, which is the main type of assets used by digital business models, has proven extremely problematic.

To a large extent, the digitalization of business models has accentuated the fundamental difficulty of determining where business profits originate and should therefore be taxed. This stems in part from the difficulty of defining and measuring the location and the respective contribution of different profit-generating factors, especially where significant profits derive from intangible assets used in a large number of countries.

The digitalization of the economy therefore exacerbates tax avoidance risks that arise from the basic features of the existing corporate tax rules. The importance of these risks is shown by the proliferation of corporate structures that shift profits to entities that escape taxation or are taxed at only very low rates, which is referred to as the problem of "base erosion and profit shifting" (BEPS).

[1] Recent statistics show that African and Latin American countries derive on average 15% of their tax revenues from corporate taxes, whereas these taxes represent only 9% of tax revenues in OECD countries.

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"…non-OECD countries lose about $200 billion in revenue per year, or about 1.3 percent of GDP, due to companies shifting profits to low-tax locations"

– Christine Lagarde, Managing Director of the International Monetary Fund

Where are these issues being debated?

Each country is responsible for designing its own corporate tax and must therefore address these issues. Some countries have adopted[2] or proposed [3] unilateral measures to address corporate tax issues related to the digitalization of the economy. Yet, the risks of double taxation and double non-taxation that would result from the use of fundamentally different rules for allocating and taxing business profits have led countries to seek multilateral solutions to these problems.

As part of their BEPS project, the Group of 20 and OECD have mandated the OECD Task Force on the Digital Economy to work on these issues and try to reach a consensual solution that could be endorsed by 2020 by the 129 countries and jurisdictions that are members of the BEPS Inclusive Framework. The Task Force is currently examining proposals related to a "two-pillar" approach: one pillar focuses on nexus and allocation of profit rules; a second pillar focuses on remaining tax avoidance risks resulting from structures that shift profits to entities that do not pay tax or are taxed at only very low rates.

The European Commission made two legislative proposals to address the corporate tax challenges arising from the digitalization of the economy. The first proposal sought to change existing nexus rules, through the addition of a new concept of digital presence that would consider factors such as revenues, number of users and number of business contracts for digital services with business users. The second proposal, intended to be an interim measure, would have applied a 3% withholding tax on gross income of certain large companies carrying activities in which users play an important value-creation role. There is currently no consensus among EU States on these proposals made by the European Commission in 2018.

The UN Committee of Experts on International Cooperation in Tax Matters, through its Subcommittee on Tax Challenges Related to the Digitalization of the Economy, has outlined its own work programme on these issues (see note E/C.18/2019/CRP.12). The objective of that work is to find solutions that would avoid both double taxation and non-taxation, give preference where practicable to taxation of profits rather than turnover, and be simple and easy to administer. This objective is in line with the recent acknowledgment, at the 2019 ECOSOC Financing for Development Forum, that "any consideration of tax measures in response to the digitalization of the economy should include a thorough analysis of the implications for developing countries, with a special focus on their unique needs and capacities."

[2] For example, in 2016, India enacted its "equalisation levy", which is a 6% withholding tax payable when Indian merchants advertise on foreign websites.

[3] In a recent example, France, announced its intention to introduce in 2019 a digital service tax similar to the proposal, described below, that was made by the European Commission in 2018.

What are the main proposals currently being discussed?

Recent discussions have focussed on proposals made in the context of the work of the Task Force on the Digital Economy.[4] These include three proposals related to the "first pillar" (i.e. changes to nexus and allocation of profit rules).

One proposal would be to allow a country to tax the business profits that foreign enterprises derive from value generated by user participation in that country even if the enterprise has no physical presence in the country. This proposal would typically apply to social media platforms, search engines and online marketplaces. Under that proposal, the relevant taxable income would be determined on the basis of formulae that would seek to approximate the value of users.

The second proposal would be to allow the taxation of non-routine income derived from "marketing intangibles" used in a market country, even if the enterprise that derive these profits has no physical presence in that country. For that purpose, "marketing intangibles" would include intangible assets such as trademarks and customer data.

The third proposal, which was made by the G-24, would be to extend existing nexus rules to cover cases where a foreign enterprise has a "significant economic presence" in a country, even if it does not have any physical presence therein. An enterprise would be considered to have a "significant economic presence" in a country if it had a purposeful and sustained interaction with the economy of that country, which could be assessed based on revenues, user base, data generation, digital content creation or other factors.

The other proposal being examined by the Task Force on the Digital Economy relates to the "second pillar" (i.e. changes to address tax avoidance risks resulting from structures that shift profits to entities that do not pay tax or are taxed at only very low rates). That proposal, referred to as "global anti-base-erosion" (GLOBE), would focus on situations of untaxed or low-taxed profits. It would allow countries to tax income derived from payments received from a foreign enterprise or made to a foreign enterprise when the country to which taxing rights are allocated with respect to these payments does not exercise these taxing rights. The proposal would act as a form of a minimum tax.

Additional proposals for a more fundamental reform of corporate tax have been examined in a recent IMF publication entitled "Corporate Taxation in the Global Economy."[5] These include a proposal, originally made by academics, to move to a destination-based allocation of taxing rights, which would mean that the countries where goods and services are ultimately sold would have the right to tax the profits from these sales.

Another proposal, often suggested by members of civil society,[6] would be to replace the current profit allocation rules based on the "separate entity arm's length principle" with a formulary apportionment approach: this would involve apportioning among countries the global consolidated profits of all the members of a multinational group according to a formula based on factors such as payroll, sales, assets, number of employees or a combination thereof.

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[4] See the recent report of the Inter-agency Task Force on Financing for Development, *Financing for Sustainable Development Report 2019*, section 5.4 "Digitalisation of the Economy and Taxation".

[5] *IMF, Corporate Taxation in the Global Economy*, released on 10 March 2019, available at https://www.imf.org/en/Publications/Policy-Papers/Issues/2019/03/08/Corporate-Taxation-in-the-Global-Economy-46650.

[6] See, for example, Independent Commission for the Reform of International Corporate Taxation, "*A Roadmap to Improve Rules for Taxing Multinationals – A Fairer Future For Global Taxation*", available at https://static1.squarespace.com/static/5a0c602bf43b5594845abb81/t/5a78e6909140b73efc08eab6/1517872798080/ICRICT+Unitary+Taxation+Eng+Feb2018.pdf.

How can countries' tax systems benefit from the digitalization of the economy?

The adoption of tax systems that are better adapted to the digitalized economy would not only result in additional tax revenues. Greater access to information and enhanced digital systems and processing capabilities would open new options to combat tax avoidance and evasion. Also, access to broader information can also drive better tax policies and offer opportunities to reduce inequalities, through a fairer allocation of the tax burden among citizens.

Suggested questions for discussion
▪ *What would be the impact on the revenues of different countries, under the new allocation of taxing rights resulting from proposals to address the tax issues related to the digitalization of the economy?* ▪ *How can we ensure that the situation and interests of all countries are duly taken into account in revising international tax rules to address such issues?* ▪ How can we ensure the overall quality and ultimate effectiveness of these rules?