# AIDC Briefing Paper 3:
# IFF, BEPS and the Digital Economy

The OECD has published very recently a draft policy document on the digital economy and for the implementation of digital service tax. Following its initial work that led to the publication of the BEPS Action and the progressive implementation of some of its proposals, the OECD had agreed to continue discussions on certain controversial areas where no consensus was found. One of those actions was Action 1 on the digital economy.

## What is special about the Digital Economy?

Transnational corporations (TNCs) in the digital economy creates the same problem that other TNCs do (difficult to effectively tax because of operations in countries all around the world) but the digital economy exacerbates the problem because of three characteristics:

- Scale without mass (possible to reach a huge number of customers without any or hardly any local presence – usually they will have a facade company that does not undertake any risky (hear profitable) activity but merely do only preparatory works and therefore register no profits);
- Reliance on intangibles, user data and contribution (eases the potential to shifting profits through transfer pricing. Moreover, it raises an interesting question, where is value created? Are users in fact local unpaid workers? Does this justify the existence of a local tax base?);
- Rheir ability to supply goods and services without any physical presence

This result is that TNCs in the digital economy pay almost no taxes.

## Why is it particularly important?

One main elements in the debate is that the digital transformation concerns much more economic sectors of the economy that simply Google, Apple, Facebook, Amazon and Microsoft (commonly referred to as GAFAM), Chinese tax giants Baidu, Alibaba, Tencent and Xiaomi (BATX) as well as Uber and Airbnb. Many major sectors of the economy are being impacted by increased digitalisation (automotive industry, manufacturing, tourism, etc.). This means **the impacts of any agreement on digital service tax is likely to impact the whole international tax system**.

Another main element is that since the mere nature of the digital economy makes it particularly difficult to tax (extremely movable tax bases), the **solutions promoted to tax fairly these activities will have to be radically different, meaning the international tax system could move away from the arm's-length principle** towards a unitary tax system.

The discussion paper put forward by the OECD has an extremely interesting proposal: the **creation of a minimum international tax rate for TNCs** (the global anti-base-erosion proposal).

## What was the game changer that made things move forward?

For a long time, discussions on how to properly tax e-giants were stuck: dominating countries (the US and China to a certain extent) were strictly opposing any ambitious reforms to protect their home-grown e-companies and the worldwide economic and financial dominance these companies have acquired.

However, the answer of several European countries in front of a divided European Union has been to take a unilateral position: the imposition of digital service taxes that focus not on the profits (easily shift-able) but on the sales/market share instead. The UK, Spain, France, Italy, and some Global South countries (Philippines, South Korea, Mexico and Argentina) are also in the process of implementing digital service taxes on sales/market share. This is what boosted the sudden surge of ground-breaking solutions (see below). Unfortunately, so far African countries (including South Africa) have been slow to move on this issue.

**What are the three different options on the table for the digital economy?**

The first two proposals in the OECD discussion paper put forward is an increase of taxing rights for market jurisdictions, but these do not suggest a completely sales-based allocation. The third proposal explicitly argues for a balance of operational factors (labour and capital) and sales.

**The first one is the *user participation* proposal**. It is a **very restrictive approach**: it basically wants to target only a few very digitized businesses that rely strongly on users (social media, search engines, etc.) and impose on these companies an extra tax based on the profits created locally by their user base.

It is problematic because a lot of conflicts/tax disputes will arise around this artificial division between highly digital businesses, and non-digital businesses, and to see if a user base is sizeable/significant enough to be considered as value creating. This proposal limits the scope of implementing a digital service tax, meaning it won't have much impact on the rest of the economy instead it adds another layer of complexity.

**The second one is the *marketing intangibles* proposal**. It basically wants to assimilate the users' contributions to business models as unpaid marketing intangibles that would be entitled to part of the profits made locally, meaning a greater share of profits made by multinational companies could be taxed in the country of operation.
As such it is more progressive because it allows to allocate more income to the market jurisdiction.

There are however big problems with this proposal:

- It differentiates between marketing and production intangibles whereas in reality, the contribution of users goes beyond the purely marketing side (targeted advertising);
- It promotes a two-step approach to apportion only residual profit (and not the whole profit) following an apportionment formula (more on this below - see risks)

**Lastly, the *significant economic presence* proposal is more interesting**. Basically instead of having a narrow idea of what a taxable presence is (one local establishment, the existence of management functions, etc.) the notion of Permanent Establishment would be replaced by the idea of significant economic presence defined not only on the basis of sales, but in combination with factors deemed to create a significant economic presence.

**This proposal is particularly ground-breaking because it offers the idea of a fractional apportionment formula (de facto moving away from the arm's-length principle).**

**<u>What are the risks of the current discussions?</u>**

The main risk of the current discussion is that these proposals are watered down and made useless.

One main way to do that would be to insist that any use of an apportionment formula must apply only on the share of the profit that is due to such digitalisation.
In other words, certain proposals want to separate routine profits from residual profits: that's what they call the two-step 'residual' profit split method.

The risk here is to add another major layer of complexity where the international tax system needs massive simplifications for it to work for all countries and not only those with greater capacity. This will mean even more opportunities for profit shifting.

In addition, by using such an approach, you limit the use of a simple apportionment formula to a tiny share of MNC's profits and would have the possibility to use it more widely.

**<u>What are the main demands of Tax Justice organizations / progressive unions?</u>**

The following groups made submissions: TJN, TJN Africa, TJN Israel, PSI and Oxfam. They all agree on the outcome they want: MNCs paying more taxes and a simpler tax system that allocates more taxing rights to low and middle income economies.

**Practically this means:**

1 – They want a **single enterprise principle** to be adopted, to replace the inappropriate fiction that affiliates of a multinational corporate group are independent of each other.

2 – The aim should be to allocate income and taxes according to the fundamental factors that generate profits: **labour, capital and sales**. This would provide a balance between operational factors (employees and physical assets) and sales to third-parties (without which profits cannot be realised).

3 – The development of detailed definitions of these broad factors and their quantification and appropriate weightings (to build well working apportionment formulas for each industry) according to a closer analysis of different industries/sectors and their commonly-used business models

4 – The quantification (i.e. the allocation keys – Labour, sales and assets) must be **objectively measurable and location-specific**, using only physical factors reflecting the actual assets, activities, and sales in the countries concerned.

Ultimately, the idea is to go **beyond the artificial distinction between residence country** (the country of residence can tax any income of its residents, even non-local one – often rich countries) and **source country** (country of the actual value creation) by using the unitary approach.

There are more differences on the way apportionment formulas should be developed: some groups argue that emphasis should be put on R&D inputs by employees (Israel), some say that emphasis should be put on the contribution of labour and employment to corporate profits, and less weight to intangible assets which are easily exploited for tax avoidance (PSI), while others prefer to leave the Assets/Capital part completely out of the formula (TJN) due to the massive differences in accounting methods of each country that could lead to artificial manipulations.

**<u>What is debated around the global anti-base-erosion proposal?</u>**

Here the idea is to deter tax planning/avoidance strategies. It is intended to respect the sovereign right of each jurisdiction to set its own tax rates, but reinforces the tax sovereignty of all countries to "tax back" profits where other countries have not sufficiently exercised their primary taxing rights.

In reality such proposal acts as an anti-tax race to the bottom measure that is inspired from the recently implemented "Global Intangible Low Tax Income (GILTI) in the US.

This targets specifically the allocation of a substantial amounts of intangible and risk related returns to group entities.

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

*(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)*

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 the minimum rate. *(this is more of a defensive rule)*

On this specific proposal, Tax Justice organizations are supportive given a strict framework is adopted: the minimum tax rate must be high enough (PSI says 25%), the topping-up tax imposed following one of the two rules must lead to a least 95% of the minimum tax rate to be fulfilled (not too much room for manoeuvre), and no exception if any should be acceptable (for certain kinds of tax breaks for instance)

In terms of implementation, they argue there is no need for a consensus as far as major economies agrees to it. They recommend allowing the allocation of income only to countries that impose a minimal effective tax rate and support both the proposed "income inclusion rule" and a "tax on base eroding payments."

**What does it mean for South Africa?**

Clearly some of these proposals have the scope, if they are not watered down, to be massive game changers, and South Africa should defend them.

That can mean creating a digital service tax (or at least announcing so) to make sure the pressure increases to find a solution.

The main risk for South Africa and its diplomatic allies (low income African countries) if this leads to the creation of the *two-step 'residual' profit split method* that would add complexity to the international tax system, further disempowering developing countries. It must therefore continuously push for the international tax system to be as simple as possible.