

REALLOCATION OF TAXING RIGHTS – SCOPE AND NEXUS



CONTENTS

Section 1: Background

Section 2: A deep-dive into scope and nexus

Section 3: Next steps

Section 1

Background

Setting the Context

Problem

- Address the tax challenges faced due to the use of highly mobile intangible income-producing factors by both digitalized and traditional MNEs

Solution

- Reallocate taxing rights in favour of the user/market jurisdiction
 - ❖ Devise a new nexus rule not dependent on physical presence
 - ❖ Attribute income to such jurisdiction

Timelines

- 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 Journey Thus Far

2015

- BEPS Action 1 Report

2018

- Tax Challenges Arising from Digitalization – Interim Report

2019

- Policy Note

2019

- Public Consultation Document

2019

- The Inclusive Framework adopted Programme of Work to develop a consensus solution

Status of Global Consensus (1 of 4)

Consensus in global opinion

The need for creating taxing rights to address the challenges imposed by digitalization

- Reallocate taxing rights in favour of the market jurisdiction
- New nexus rule not dependant on physical presence
- New profit allocation rules that go beyond the arm's length principle
- Reduce compliance costs and disputes
- Devise a mechanism that is simple, facilitates stability of the tax system, and increases tax certainty

Status of Global Consensus (2 of 4)

Divergence in global opinion

Method for establishing nexus and attributing income without physical presence

- **User Participation:**

- ❖ UK and other European nations
- ❖ Soliciting the sustained engagement and active participation of users is a critical component of value creation for highly digitalised businesses
- ❖ Identifies 3 highly digitalized business models where soliciting data and content contributions from an active and engaged user base creates value
 - a. Social media platforms
 - b. Search engines
 - c. Online marketplaces
- ❖ Allocation through a residual profit split approach

Status of Global Consensus (3 of 4)

Divergence in global opinion

- **Marketing Intangibles:**

- ❖ United States
- ❖ Marketing intangibles such as brand name and customer lists establish an intrinsic link with the market jurisdiction. The proposal suggests that marketing intangibles and risks associated with such intangibles be allocated to the market jurisdiction
- ❖ Applicable to a wider range of business models, and not just highly digitalised businesses
- ❖ Allocation through a revised residual profit split analysis that uses more mechanical approximations

Status of Global Consensus (4 of 4)

Divergence in global opinion

- **Significant Economic Presence ('SEP') :**
 - ❖ India, Ghana, Colombia and other G24 countries
 - ❖ An enterprise may create an SEP in a jurisdiction without establishing a physical presence
 - ❖ SEP is created based on factors that evidence purposeful and sustained interaction with the economy of the country via technology and other automated rules. These factors include revenue, user participation, volume of data collected etc.
 - ❖ Allocation of profit to an SEP could be based on a fractional apportionment method and collection through a withholding mechanism

Potential Challenges

User Participation

- The proposal's focus on only highly digitalized businesses may ring-fence the digital economy and may not be sustainable in the constantly evolving digital economy

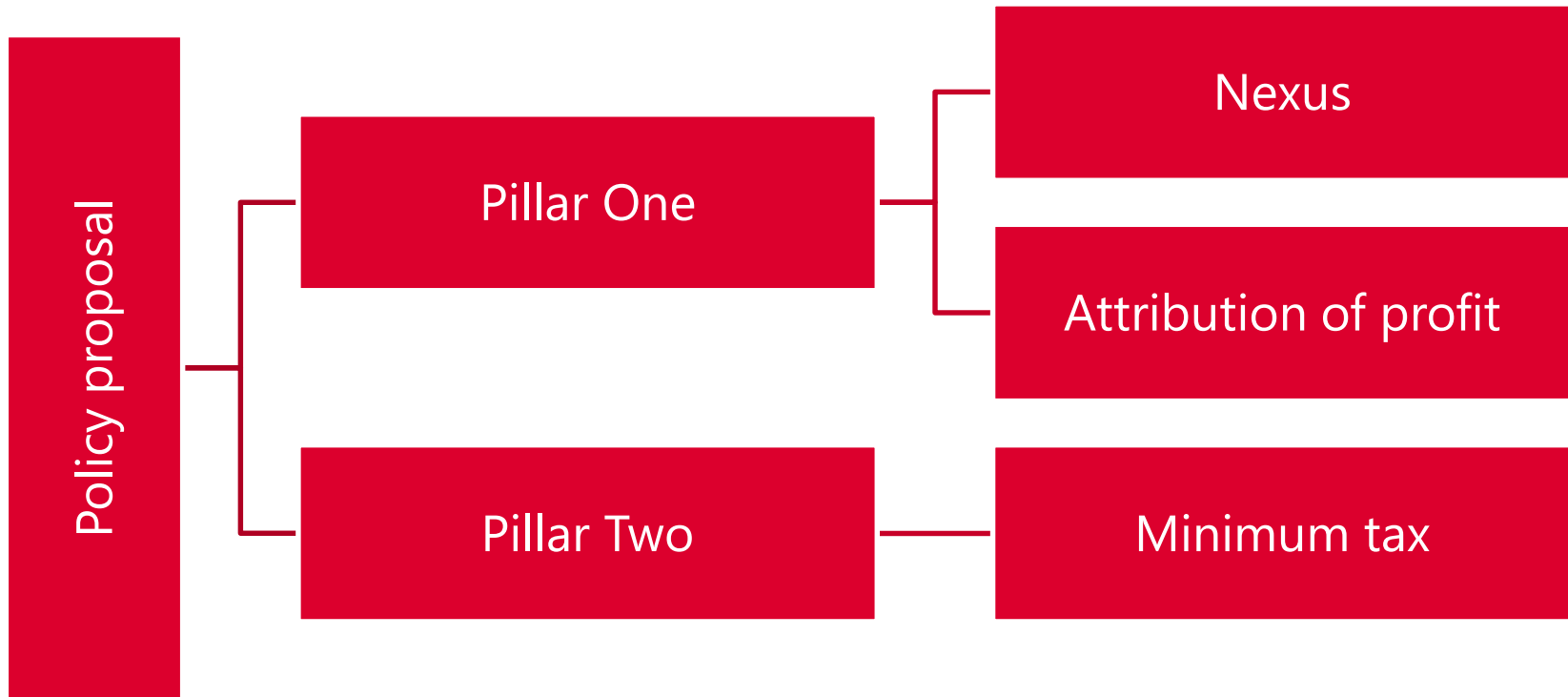
Marketing Intangibles

- Marketing activities undertaken outside a particular jurisdiction and not significantly tailored to local customer habits and preferences may also be unintentionally included within the scope of the approach

SEP

- The SEP approach may be very wide in its scope given that it proposes the establishment of a nexus even in cases where no revenue is earned but the enterprise has a certain number of users.

Where We Stand Today



The Secretariat's Proposal – An overview

Key Features of the 'Unified approach'

- **Scope:** Focusses on large consumer-facing businesses
- **Nexus:** Established when a business has a sustained and significant involvement in the economy of a market jurisdiction, such as through consumer interaction or engagement, irrespective of its level of physical presence in that jurisdiction
- **Profit allocation:** Seeks to complement ALP with a formulaic approach to allocate profit and relieve the tension between residence and source. Proposes the allocation of three amount:
 - ❖ Amount A: A share of the deemed residual profits
 - ❖ Amount B: An amount for baseline marketing or distribution activities
 - ❖ Amount C: An additional sum that may not be stipulated under Amount A and B, subject to binding and effective dispute prevention and resolution mechanism
- **Increased tax certainty:** Emphasis on simplicity, stabilisation of the tax system, and increased tax certainty in implementation

Section 2

A deep-dive into scope and nexus

The Secretariat's Proposal – Scope

Key features

- Focusses on large consumer-facing businesses
- Includes highly digitalized businesses
- Generally excludes businesses catering to other businesses
- Specifically includes certain businesses catering to other businesses
- Contemplates other specific carve-outs
- Envisages size limitation such as the € 750 Million consolidates group revenue for country-by-country reporting

Carve-outs

Sector-based

- Extractive industries and commodities
- Financial services


Market based

- B2B models
- Except:
 - Intermediaries
 - Supply of component products
 - Use of franchise agreements

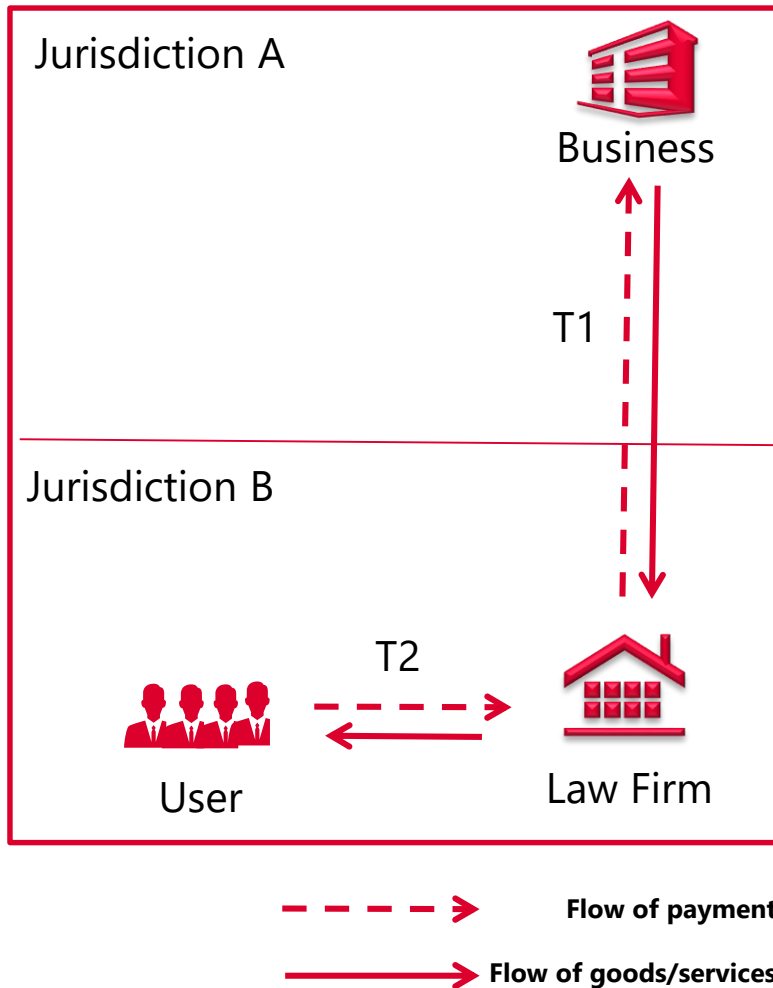
The Secretariat's Proposal – Nexus

Key features

- **Policy rationale:** Not based on physical presence, based largely on sales
- **Threshold:** Country specific sales threshold
- **Primary determinant:** Sales demonstrating a sustained and significant involvement in the economy of the market jurisdiction
- **Operating mechanism:** Define a revenue threshold as the primary indication of a nexus

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- 'Sale' typically requires an element of reciprocity between the supplier and the user.
 - The proposal envisages the concept of a 'non-paying user' towards whom an activity may be directed, but the revenue may flow from elsewhere.

Case Study (1 of 4) – Cloud computing model



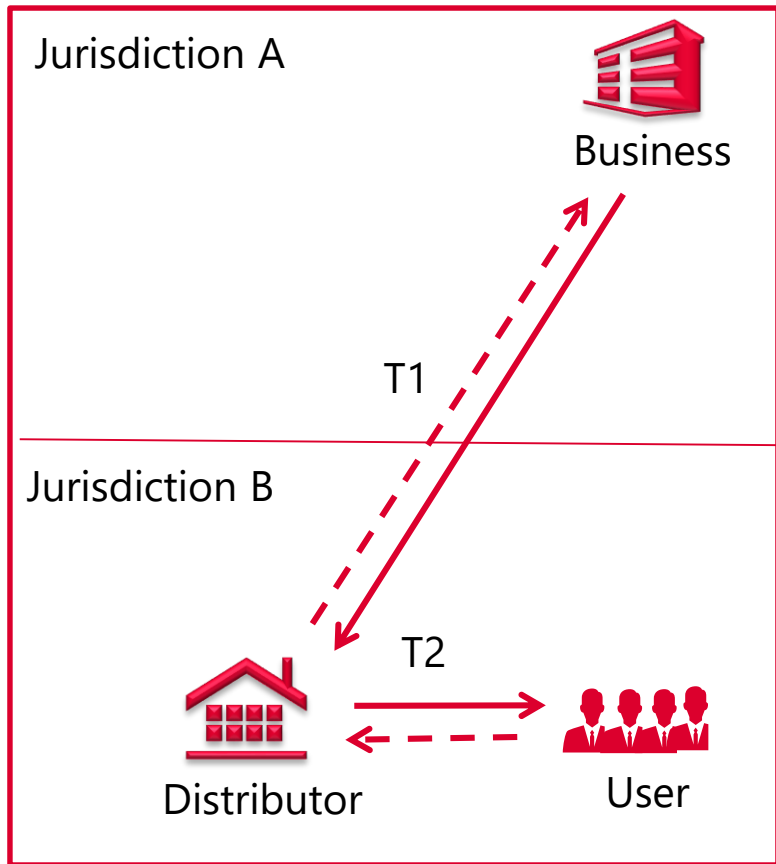
Business Model

- T1: Business in Jurisdiction A provides cloud computing services to Law firm in Jurisdiction B for payment.
- T2: The Law firm subsequently provides legal services to users in Jurisdiction B

Challenges

- T1 may be understood as a B2B transaction and be carved out of the scope of the Secretariat's proposal

Case Study (2 of 4) – Local distributor model



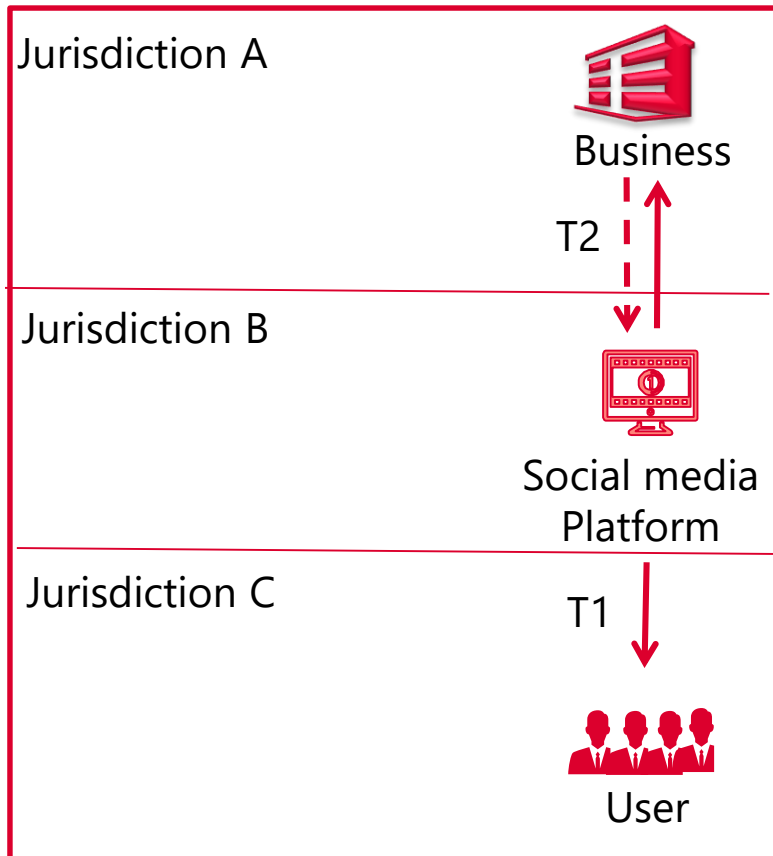
Business Model

- T1: Business in Jurisdiction A appoints Distributor in Jurisdiction B and sells them products
- T2: Distributor in Jurisdiction B sells to consumers in jurisdiction B

Challenges

- T1 may be understood as a B2B transaction and be carved out of the scope of the Secretariat's proposal

Case Study (3 of 4) – Social media platform model



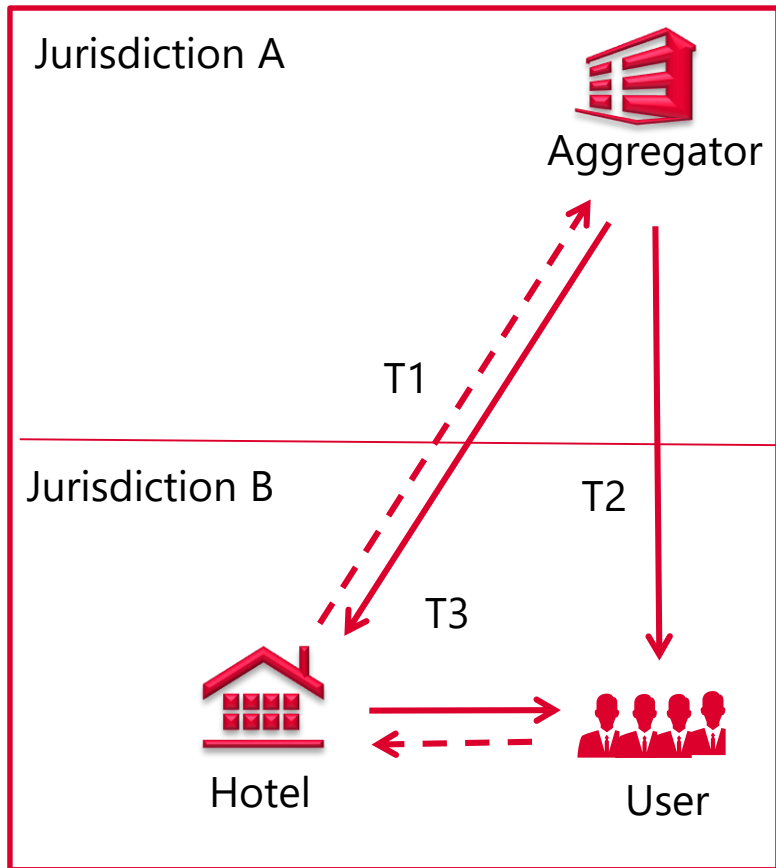
Business Model

- T1: Social media platform offers its services to users free of charge
- T2: The Social media platform sells advertising space and licenses user data to the Business in Jurisdiction A, in exchange for payment

Challenges

- The social media platform may carve itself out of the scope of the Secretariat's proposal by arguing that it is providing B2B services to the business

Case Study (4 of 4) – Online aggregator model



Business Model

- T1: Aggregator in Jurisdiction A lists Hotels based in Jurisdiction B on its online platform, in exchange for payment
- T2: Aggregator makes its platforms available to Users in Jurisdiction B without any charge

Challenges

- T1 may be understood as a B2B transaction and be carved out of the scope of the Secretariat's proposal

Scope – Challenges

- **Policy rationale:** The Secretariat's proposal does not offer any specific policy justification for limiting its scope to consumer-facing businesses
- **Clarification on definition:** Businesses that generate revenue from supplying consumer products, or providing digital services that have a consumer facing element
 - ❖ 'Consumer' limited to individuals who acquire goods or services for personal purposes – Hybrid businesses to segment operations and track customer?
 - ❖ Scope of 'consumer facing element' – linked to customization?
 - ❖ Revenue not to be equated with payment from the user
- **Limit carve-outs:** In order to ensure that the digital economy is not ring-fenced
- **Incentivize restructuring:** Limited scope may incentivize businesses to modify their models and position themselves as B2B businesses, falling outside the ambit of the above definition
- **Lack of sustainability:** Given the ever-evolving digital economy, the limited scope of the Secretariat's proposal may not be sustainable

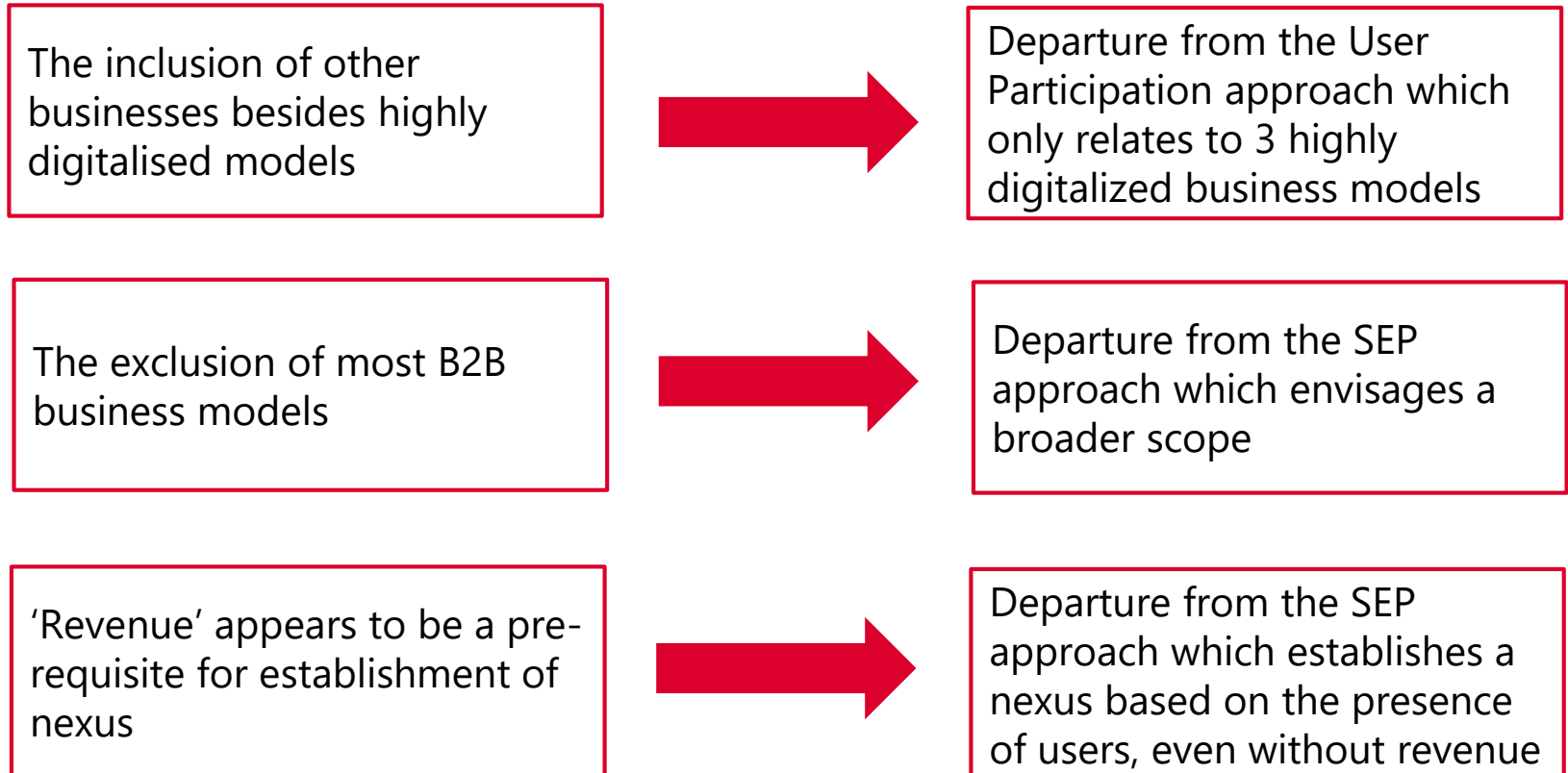
Nexus – Challenges

- **Clarify the threshold:** The Secretariat's proposal deems a 'revenue threshold in the market' to be the primary indicator as a 'sustained and significant involvement in that jurisdiction'. It should be clarified that this revenue threshold is:
 - ❖ Not the only factor
 - ❖ Need not be revenue earned or billed in the market jurisdiction itself
- **Confusing conversation:** 'Sale' is a term of art. One that is typically used under VAT laws. To avoid confusion, its use may be avoided
- **Incentivize restructuring:** Limited scope may incentivize businesses to modify their models and position themselves as B2B businesses, falling outside the ambit of the above definition
- **Lack of sustainability:** Given the ever-evolving digital economy, the limited scope of the Secretariat's proposal may not be sustainable

Section 3

Next steps

Trade-offs



The Indian Context

Equalization Levy

- Introduced in 2016.
- Charged at the rate of 6% of the amount of consideration received by non-resident, not having PE in India, for providing specified services.
- Limited only to advertisement services
- Leads to double taxation

SEP

- Introduced under the Income Tax Act in 2018
- Applicable to countries with which India do not have a Double Taxation Avoidance Agreement

Way Forward



- Principles to be kept in mind while finalizing the proposal:
 - ❖ Policy Rationale
 - ❖ Certainty
 - ❖ Simplicity
 - ❖ Sustainability
 - ❖ Equity and fairness
- Consensus may be difficult due to the varying interests of the stakeholders involved
- Broad consensus necessary to avoid double taxation, unilateral measures, and to maintain the relevance of international taxation principles
- Certain minimum standards may be laid down

Thank you