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THE OECD PROPOSAL TO REVOLUTIONISE WORLDWIDE TAXATION: OUR ASSESSMENT

Six years ago the OECD started work on BEPS – its project to counter international tax avoidance strategies. Last week, the OECD proposed something much more radical: a proposal to entirely reshape the basis on which tax is allocated between different countries.

This briefing outlines the new OECD proposals, and assesses both their potential impact, and the likelihood they will be adopted.

Back in 2012, the G20 instructed the OECD to begin work on proposals to counter the arrangements that many multinational companies were accused of using to artificially erode the taxable base in their customers' jurisdictions and shift profits to tax havens. This became the Base Erosion and Profit Shifting Project (**BEPS**), with fifteen detailed proposals published in November 2015.

However many people, including apparently the OECD itself, regard BEPS as a failure. In part that is impatience: much of BEPS is only now being implemented, four years later. In part it's disappointment that billions of new taxable revenue was not generated – probably because the scale of the avoidance was less than some newspaper headlines suggested. But in part there is a genuine feeling in some quarters that BEPS was aimed at the wrong target. Plugging loopholes is not enough.

That led to the new OECD programme. It's sometimes termed "BEPS 2.0", but that gives a misleading impression this is a mere evolution of the original BEPS proposals. That is very much not the case.

The Programme of Work

The OECD has now published a programme of work to find a long-term and consensus-based solution to the "tax challenges of the digitalising economy". The intention is to do so by 2020 – which is an extremely ambitious timeframe.

Whilst the EU, UK and others have been proposing specific taxes on particular digital businesses, the OECD are proposing something much more radical, potentially the most significant change since the norms of international taxation were set almost a century ago.

Key issues

- The OECD is conducting global efforts to radically change the international tax regime
- It could have a major economy-wide impact, not confined to technology companies
- Agreement is sought by 2020, but the economic and political difficulties are immense
- Digital businesses may wish to be actively engaged in the process; others, particularly those with complex international structures, should at least keep a watching brief

The programme builds on "two pillars" of proposals, with the "outlines of the architecture" to be agreed by the 129 participating members in January 2020. There are 20 new technical workstreams in total, all interlinked and involving multidisciplinary teams. Working parties, task forces and reporting groups are at the ready, to begin their work immediately on all measures.

The trouble, of course, is that while the economics are difficult, the politics are nigh impossible.

Crucially we do not yet have an economic analysis or impact assessment of the proposals. Waiting impatiently in Chapter IV of the programme is a plan to assemble a team to explore fundamental economic questions and inform each country's political judgments.

This is all very uncontroversial if the answer is simply that digital and other businesses pay more tax everywhere. However the result is unlikely to be so straightforward. Two key questions are:

- *What are the expected effects of the proposals on the level and distribution of tax revenues across jurisdictions?*

  The almost inevitable consequence of the proposals is a redistribution of taxing rights from the home of large corporations (particularly the US) to the "market" jurisdictions where they make their sales (the rest of the world). It is not obvious why the US would agree to this.

- *More specifically: what economic impact will the various proposals have for different types of MNEs, sectors and economies (e.g. developing countries; resource-rich countries, etc.)?*

  Many of the non-OECD countries involved in the process, and many NGOs, want to see a fundamental redistribution of taxing rights away from the developed world and towards the developing world. They, not unreasonably, see the BEPS focus on taxing "where the value is created" as in practice allocating taxing rights to rich countries. However this creates some difficulty for developed-world policymakers, whose populaces expect OECD initiatives to result in more tax being paid to their treasuries, not less.

Without this analysis, it does not seem plausible for countries to give the "political steer" that the OECD requires by January 2020. How can countries agree to something before they understand its distributional effect, or how it impacts the relevant sectors of their economy?

The work will proceed in earnest but, as mentioned in the programme, the available data may not permit an analysis of the impact on particular sectors, industries or business models. The concepts are too novel, the methods untested, and the scope encompasses the whole economy.

Hope rests on the reality that, without a long-term consensus, more discordant unilateral measures, such as the UK's digital services tax, will proliferate. This may create imperative for compromise. But it is hard to see how the major actors, particularly in Europe and the US, can align by the end of 2019 on core elements of proposal, while the economics remain uncertain. Any agreement to proceed may, therefore, be highly provisional, with the "real" political agreement having to be sought much later in the process, when the economic consequences of the proposals are more clear.

The work programme can be broadly summarised as follows:

Pillar One – Revised Nexus and Profit Allocation Rules

Pillar One considers the reallocation of taxing rights. The aim is to allocate more profit to the jurisdiction where customers and users are located, known as the "market jurisdiction". Previous proposals from the OECD, EU, UK and others focused on "user participation", "marketing intangibles" and "significant economic presence" ideas. Those are now harmonised in a single model, with three options:

1. Modified residual profit split method – this would allocate part of a group's non-routine profit to the market jurisdiction, using existing transfer pricing methods. There are four technical steps: (i) determine total profit; (ii) remove "routine profit"; (iii) determine what is in scope of the taxing right; and (iv) apply criteria (an "allocation key") to split the profit between the entities, for example by reference to the relative value of their contribution. It could be on a group-wide or entity basis. It involves minimal conceptual change from the current regime though is highly technical. Intellectually interesting for transfer pricing specialists, but unlikely to produce a simple and practical solution.

2. Fractional apportionment – this method, otherwise known as "formulary" apportionment, requires fundamental modification of the existing rules. The idea is to tax groups on the basis of their consolidated profit, and allocate between countries based on a formula, for example taking into account sales, assets and employees in each country.

   Formulary apportionment has been historically rejected by most (indeed often all) OECD members, but supported by NGOs, some academics and some developing world jurisdictions. Given this background, it was unsurprising to see it dismissed abruptly in the BEPS Action 1 Report of 2015.

   The proposal now is to apportion profits of the whole enterprise to the digital presence, either on the basis of a predetermined formula or variable allocation factors.

   Given the historically controversial nature of formulary apportionment, it would be surprising to see this achieve a consensus now. Indeed, even amongst those in favour of this approach, there is likely to be significant disagreement as to the formula to be applied and the base to which it is applied.

3. Distribution-based approaches – these approaches, tabled in responses to the OECD's consultation, propose a simpler method than the modified residual profit split. The idea is to allocate a base-rate of profit in the market jurisdiction for a group's marketing, distribution and user-related activities (e.g. 2% on its sales). This might be adjusted using relevant levers, such as the group's overall profitability. It needs to be considered whether it would also apply to locally-based activities. The simplicity of the approach, in contrast to the other options, suggests to us that it is the most likely to be adopted. The debate would be about the level of profit and the levers, rather than the design of profit allocation formulas.

There is also a workstream to design the nexus rule that would determine when a market jurisdiction has a taxing right. This includes, for example, a deemed permanent establishment if the group exhibits "a remote yet sustained and significant involvement in the economy of a jurisdiction". The alternative, to avoid interpretive debates, would be to automatically provide for a taxing right over the measure of profits that is allocated under the relevant formula.

There is an important technical point here. Changes to profit allocation rules can be made through consensus, by changing OECD guidelines. Individual countries may take different approaches and, whilst double taxation in some cases may arise, those different approaches should not prevent Pillar One from being more or less effective.

However changes to the nexus rule require changes to double taxation treaties. Otherwise any new domestic nexus rule introduced by, for example, France, would be overridden by the US/France double taxation treaty when a US company makes a digital sale to France.

That likely means another "multilateral instrument", amending multiple tax treaties simultaneously. But more importantly, it means that corporations based in countries that do not ratify the multilateral instrument will escape the new nexus rule. Ratification delays are very common (one of the main reasons why the original BEPS proposals have taken so long to come into force). And, most importantly of all, the US Senate has been refusing to ratify any tax treaties, of any kind, since 2010.

If the US doesn't ratify the treaty implementing Pillar One, how effective will it be?

Pillar Two – Global anti-base erosion proposal

Now branded as GLOBE, the second pillar proposes to introduce a global variation of the US anti-abuse regime known as GILTI, introduced as part of the Tax Cuts and Jobs Act of 2017.

This would include an "income inclusion rule", to ensure that income of a group is subject to tax at a minimum rate. The OECD prefers a fixed global rate as the simplest option. The proposal is seductively simple, although there is considerable room for debate on the rate, any carve-outs and co-ordination with other rules. It has been open for discussion for many months now, without any sign of a growing consensus.

The other key aspect is an "undertaxed payments rule" that would deny a deduction for payments to related parties if the payment is not subject to the minimum rate in the recipient country (or in the country of the recipient's parent under CFC rules). This could be complemented with a "subject to tax rule" by subjecting the payment to withholding or other taxes at source and denying treaty benefits. There are number of issues to be explored, including the benefits of a withholding tax over a deduction denial approach.

It will be noted that GILTI is a highly complex set of rules which, 18 months after its enactment, is still not completely understood by many affected businesses. In part this is because of the pre-existing complexity of the US controlled foreign company rules, which GILTI supplements but does not replace. GLOBE can, therefore, be considerably more streamlined than GILTI. However it will still be a complex set of rules, which poses a challenge in terms of both achieving consensus and achieving a ruleset that can be realistically applied by developing world tax authorities with limited resources.

Any change to withholding tax rules will require tax treaty amendments, raising the same practical difficulties identified above.

The Road Ahead

The OECD will progress each workstream, so that a recommendation on the core elements can be tabled for agreement at the beginning of 2020. Some economic analysis will be prepared to inform this decision, however as noted above, it is not clear how sophisticated or complete this will be.

The economic and political problem aside, it strikes us that so much of the programme involves theoretical debate on the economic methods. Not much, it would seem, on the legal drafting that will be vital to its agreement and implementation. There is, for example, reference to amending Articles 5 and 7 of the OECD Model Convention, maybe also Article 9, perhaps in a supplemental or new multilateral treaty. These will be hugely significant legal changes that require lengthy consideration. As and when the programme moves on from abstract theory to hard implementation, businesses will need to carefully assess the legal effect of the proposals.

For now, digital businesses will likely want to be actively involved in the development of the proposals; others should at least maintain a watching brief. Those international businesses which have not yet familiarised themselves with GILTI may wish to do so, and to start a high level assessment of the likely impact on their group.

Do please call or email your usual Clifford Chance contact, or any of the partners listed below, if you would like to discuss further.

CONTACTS

UK

Dan Neidle
Partner

T +44 207006 8811
E dan.neidle
@cliffordchance.com

UK

Julian Feiner
Senior Associate

T +44 207006 1734
E julian.feiner
@cliffordchance.com

UK

Nick Mace
Partner

T +44 207006 4679
E nicholas.mace
@cliffordchance.com

UK

Nicola Hemsley
Senior Associate

T +44 207006 4215
E nicola.hemsley
@cliffordchance.com

Belgium

Alexandre Ooms
Partner

T +32 2 533 5073
E alexandre.ooms
@cliffordchance.com

France

Alexandre Lagarrigue
Partner

T +33 1 4405 5273
E alexandre.lagarrigue
@cliffordchance.com

France

Jitka Susankova
Counsel

T +33 1 4405 5435
E jitka.susankova
@cliffordchance.com

Germany

Felix Mühlhäuser
Partner

T +49 69 7199 1051
E felix.muehlhaeuser
@cliffordchance.com

Hong Kong

Anthony Fay
Foreign Legal Consultant

T +852 2826 2407
E anthony.fay
@cliffordchance.com

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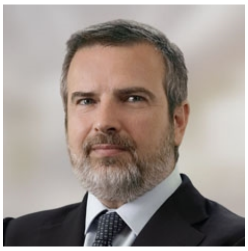
Italy



Carlo Galli
Partner

T +39 02 8063 4525
E carlo.galli
@cliffordchance.com

Luxembourg

Geoffrey Scardoni
Partner

T +352 48 50 50 410
E geoffrey.scardoni
@cliffordchance.com

Netherlands

Michiel Sunderman
Partner

T +31 20 711 9658
E michiel.sunderman
@cliffordchance.com

Russia

Alexander Anichkin
Partner

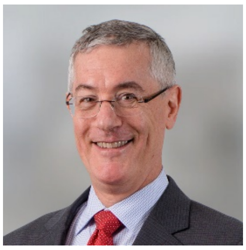
T +7 495 258 5089
E alexander.anichkin
@cliffordchance.com

Spain

Pablo Serrano
Partner

T +34 91 590 9470
E pablo.serrano
@cliffordchance.com

USA



David Moldenhauer
Partner

T +1 212 878 8384
E david.moldenhauer
@cliffordchance.com