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OECD Note is Prelude to March Public Consultation on Global Tax Solutions

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With the release January 29, 2019 of an important tax policy note (the “Note”), the Organization for Economic Cooperation and Development (the “OECD”) has introduced greater direction for its BEPS mandate to introduce proposals to address the tax challenges of the “digitalization” of the economy. The note can be read in full here.

The international tax community is now anxiously awaiting the publication of the OECD “consultation paper” on or around February 11, 2019 ahead of a “public consultation” March 13-14 at OECD headquarters in Paris and further detail on the concepts highlighted in the Note. The Task Force is committed to a second interim report to be published in June 2019 for the G20 summit in Fukuoka, Japan and a final report to be published by or before the end of 2020 (but very likely to be publicly available before then in “draft” form).

Background on the OECD Digital Tax Task Force to date

As a reminder, under the auspices of the base erosion profit shifting ("BEPS") project, the OECD published in 2015 "Action Plans" for eliminating tax revenue gaps that have emerged in recent decades under an international tax system, derived almost 100 years ago, which tax authorities around the world agree is no longer fit for purpose. At the risk of oversimplifying, the dynamics of the so-called digital economy which relies heavily on nimble intellectual property transactions and much less so on physical presence for generating sales, has led to tax planning advantages for digital business models that the public no longer considers to be "fair". In 2017, the OECD created the Digital Tax Task Force to undertake an in-depth analysis of the features of a multitude of digital business models. The ultimate goal of the Task Force is to deliver consensus-driven solutions for eliminating the tax revenue gap that has emerged in the digital economy. The Task Force defined the challenges arising from the digitalization of the economy in its first interim report published in March 2018. Some countries felt the Task Force work had slowed if not gotten off track, triggering competing legislative proposals beginning last spring, first by the EU Commission and now by unilateral action of a growing number of countries. These unilateral actions, for better or for worse, intensified the tax policy discussion among the driving countries behind the Task Force, namely, France, Germany, the UK, and the US. The OECD hoped that the publication of this Note would create some direction and momentum for the project as it prepares its next interim report scheduled for publication in June 2019.

New Tax Nexus Concept, Transfer Pricing, and US Tax Reform inspired "Pillars"

According to the Note, the Task Force will now focus on two "pillars" of specific proposals that it has decided to keep on the table for discussion "without prejudice" as the Note emphasizes. The first pillar focuses on the allocation of taxing rights and the second pillar addresses remaining BEPS issues.

Proposals under the first pillar would allocate more taxing rights to market or user jurisdictions where value is created by a business activity through participation in the user or market jurisdiction that is not recognized in the conventional framework for profit allocation. These proposals require reconsidering current transfer pricing rules. The Note concludes that these proposals would lead to solutions that go beyond the arm's length principle. The proposals will also go beyond the limitations on taxing rights determined by reference to a physical presence (nexus). The Task Force agreed to explore changes to the permanent establishment threshold, for example the concept of significant economic presence or significant digital presence, principles for change that have been discussed before in the BEPS project.

As a gesture to developing countries, the Note reiterates that administrative simplicity is a condition for any solution proposed in the final report and "to take account of the different levels of development and capacity of members". A solution could include withholding taxes where they do not result in double taxation.

The second pillar will explore taxing rights that would strengthen the ability of jurisdictions to tax profits where the other jurisdiction with taxing rights applies a low effective tax rate to those profits. The Note directly links these concepts to similar ones under the TCJA but without mentioning them by name, i.e., the global intangible low taxed income ("GILTI") provision and the base erosion anti-tax avoidance ("BEAT") provision.

In a webcast at the time the Note was published, Pascal Saint-Amans, Director of the OECD's Centre for Tax Policy and Administration, and chief spokesperson for BEPS developments, broke down the two pillars into four areas of proposals in a way not summarized in the Note but worth capturing here: user participation, marketing intangibles, expansion of the nexus concept, and a three-in-one category: income inclusion rule, a tax on base eroding payments, and a coordination rule to give jurisdictions the right to "tax back" profits derived from a jurisdiction that apply no or low tax to such profits.

The Note only provides a flavor of the detail that it is hoped will be included in the forthcoming consultation paper. The public consultation is a necessary step, of course, in such an important policy development process, but the public consultation should be pretty predictable based on past experience, also given the relatively short period of review of the consultation paper before the public consultation occurs. The real value of public input will likely follow the public consultation as the stakeholders in the business community have more time to produce thoughtful analyses to supplement the content in the consultation paper.

The Impact of US Tax Policy Leadership

At least to the public and many interested tax authorities, the Task Force project seemed to be stuck in neutral for some time last year due to significant initial resistance from different sources to change anything in light of the rollout of BEPS legislation across jurisdictions and for other reasons. Some observers argue that, with BEPS as a European initiative, the US government already under the Obama administration was skeptical about getting actively involved in changing the world tax order. The US government role has changed now in a positive way with the enactment of innovative, BEPS-inspired provisions under the Tax Cuts and Jobs Act of December 2017 and the emergence of new international leadership in the US Treasury Department under Deputy Assistant Secretary for International Tax Affairs, Lafayette G. "Chip" Harter, III. The US Treasury policy makers have gone from pursuing a reactionary strategy to a proactive strategy and this has given the OECD team the direction it had been lacking in the absence of US proposals. The other influential countries emerging in this process are France, Germany and the UK.

Next Milestone: February Release of Task Force Consultation Document

The imminent Task Force consultation paper will include further detail on the pillar concepts described in the Note. Publication is expected by or before February 11, 2019, according to the most recent OECD comment. We will offer further guidance on what the paper means for US business interests internationally when that content becomes available.