# O.E.C.D. ON DIGITAL BUSINESS – SERIOUSLY?!

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**Tags**
B.E.A.T.
G.I.L.T.I.
Digital Economy
O.E.C.D.

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On February 13, 2019, the O.E.C.D. issued a discussion draft addressing the tax challenges of the digitalization of the economy[1] and asked for feedback – in a shockingly brief timeframe – by March 1. Although the deadline is now generously extended to March 6, the draft itself is nothing to scoff at. Tax administrations and multinational enterprises ("M.N.E's.") should take this very seriously. Even organizations that do not the typically consider themselves digital businesses may be affected. Given that digital business was one of the first sectors identified by the B.E.P.S. Project, the current progression is troubling.

The draft has two *three* major sections:

1. **The Old Part.** The first provides for revised income allocation based on new nexus rules. In essence, the activity of a user, a local market intangible, or a significant economic presence should attract profits and thus taxes.

2. **The New Part.** The second provides for either a minimum taxation concept, following the global intangible low-taxed income ("G.I.L.T.I.") rules introduced in the U.S. from 2018 onwards, or transactional deduction barriers based on the level of taxation on the other end of the transaction.

3. **The Silent Part.** Actually, there are only two sections in the O.E.C.D. draft. Although it talks about base erosion payments, the draft does not dedicate a section to this topic and is expressively silent on the approach introduced by the U.S. – the base erosion anti-abuse tax ("B.E.A.T.")

## PART ONE – TOTAL DISASTER

The starting point is the notion that U.S. digital giants should pay taxes in other countries. This is contrary to the typical arm's length standard, insofar as functions, risk-taking, and assets are typically centralized and profits and taxes should arise where the substance sits. Granted, this is not the reality when we remember the Cayman Islands. However, this is a U.S. problem in the end and one partially solved by G.I.L.T.I.

The ideas contained in the first part of the draft are meant to allow arbitrary taxation with no real local contribution. Take for example the local customers. If the headquarters performs the majority of the development, enhancement, maintenance, protection, and exploitation of intangibles ("D.E.M.P.E.") functions under the current

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[1] O.E.C.D., "OECD Invites Public Input on the Possible Solutions to the Tax Challenges of Digitalisation," press release, February 13, 2019.

concept, the entitlement to the profit should reside with the headquarters. This is now supposed to be turned on its head, so that the location of customers should give rise to taxation on the profit – just because they sit in the country (a tremendous simplification).

This is nice for other economically developed O.E.C.D. members *vis-à-vis* the U.S. However, tax administrations in China, India, and other locations are waiting for this role to turn towards them. They would be happy to consider a local customer, supplier, or other economically important "contribution" to allow for income allocation. Hence, this first set of ideas, if it becomes real, will backfire.

Moreover, it will spill over to the traditional economy. For example, take a traditional consumer business running a limited risk distributor ("L.R.D.") abroad. Following the O.E.C.D. framework, the local tax administration notifies the business that it benefits from online reviews, local customers, and the importance of the local market. Now, the business must take steps to enact a profit split.

This leads us to the next problem: How to perform a profit split without traditional anchor points and without any reference to the arm's length principle? The answer is by relying on a largely non-functional mutual arbitration network.

Whether you are in a government, in a digital business, or even in a traditional economy, now is the time to eliminate the idea of "contribution." Otherwise, the ultimate result could be the arbitrary taxation of profits, anywhere in the world.

## PART TWO – ADMINISTRATION WITH LITTLE EFFECT

The two main ideas in the second part of the draft (G.I.L.T.I. and deduction barriers) have one thing in common: a massive increase in administration. For 15 years, people have been saying that the job of a tax advisor will soon be obsolete, as machines will take over thanks to digitalization. However, the opposite seems to be coming true. Because of digitalization – or at least the taxation of the digital economy – the job will be safe.

In the case of G.I.L.T.I., the income of all subsidiaries must be determined according to the location of the headquarters and generally accepted accounting principles ("G.A.A.P."). This requires a lot of manual work.

In the case of deduction barriers, the following considerations must be made: Who is going to carry the client over the bar? Who will organize the proof of taxation? Who will assess the effective taxation?

Good news for the tax advisor, as can be seen now in the U.S., where modelling became a new business and prices for certain tax advice rose after tax reform. Bad news for M.N.E.'s that are subject to compliance regulations everywhere and struggling to concentrate on their business.

From a tax justice perspective, the proposals seem reasonable and may ease some pressure on governments. It makes sense to take out aggressive structuring with such measures. It is doubtful, however, that there will be much of a financial impact after M.N.E.'s restructure their transactional and value chain models.

From an economic perspective, there are downsides. Not all countries would follow the G.I.L.T.I. approach and headquarters suffering as a result of the G.I.L.T.I. provision may be interested in relocating to countries without controlled foreign corporation ("C.F.C.") rules. A deduction barrier, on the other hand, is nothing more than a tariff on intangibles. The world seems to have forgotten the value of free trade.

## PART THREE – WHAT ABOUT B.E.A.T.?

The O.E.C.D. paper does not address B.E.A.T. Neither did it exist in U.S. tax reform plans until it was introduced one week before the tax reform was enacted. Nevertheless, it is important to keep in mind. The B.E.A.T. is easy to implement and leads to effective double taxation that most likely cannot be resolved.

The danger is that this easy solution for tax administrations leaves all problems with the taxpayer. B.E.A.T. is easy to implement and easy to calculate. It brings "justice" to administrations fighting base erosion. It has a limited risk of facing mutual arbitration between countries or other countries wanting to participate in taxing home country profits. All in all, this approach only leads to additional tax revenues with no downsides for the tax administration. For taxpayers facing double taxation, the problems abound.

## CONCLUSION

Part one is a dinosaur from 2013 in a world where much has changed. Tax reform in the U.S. brought the country some relief from a justice viewpoint. European governments hopefully realize that such approaches fall back on them.

Regrettably, part two is relatively likely to be enacted. Germany has already enacted a license deduction barrier and the Finance Minister expressed his approval of the G.I.L.T.I. approach. One can envision the crazy world that will arise when countries enact G.I.L.T.I. rules and deduction barriers at the same time. An entire article could be devoted to a deduction barrier case for a subsidiary that makes payments to another M.N.E. subject to two G.I.L.T.I. regimes and applies the U.S. tax on foreign-derived intangible income ("F.D.I.I.") plus immediate depreciation in the context of group taxation.

Finally, one should not rule out the silent part three. Although not on the official agenda, M.N.E.'s can expect to be beaten by the B.E.A.T. in countries other than the U.S. When discussing the O.E.C.D. proposal, it might make sense to push for a G.I.L.T.I. or transactional deduction barrier approach in order to avoid the B.E.A.T. However, this form of taxation is a relatively logical consequence in cases where the O.E.C.D. project falls short of its taxation goals.