Taxing the Digital Economy

The dawn of the digital economy brings new tax challenges around the world. Now governments are scrambling to roll out unilateral tax rules to adapt to this new business environment. – By Anthony Tam

The Organisation for Economic Co-operation and Development's (OECD) 2019 workplan on addressing the tax challenges of the digitalized economy signals a path towards a fundamental change in how the international tax framework will operate. The OECD's proposals would have impact not just on digital businesses but also on consumer goods companies. The proposals will have a far-reaching impact on multinational enterprises irrespective of how heavily involved these multinational enterprises are in the digital businesses.

The digital economy has revolutionized the traditional ways of conducting business across the world. Emerging production and consumer models along with new technologies have created a fresh set of tax challenges and have strained the existing international tax rules which have been slow to adapt to the new business environment. Many governments of different countries have been rolling out their own unilateral tax rules, such as the "Diverted Profits Tax" introduced by the UK government, and are demanding greater transparency. It is against this background that the OECD came out with proposals to combat these issues.

The workplan

In October and November 2019, the OECD launched two proposals towards this initiative for public consultation, called Pillar One and Pillar Two. The workplan is to arrive at a consensus agreement on the new international tax rules by the end of 2020.

The Pillar One proposal

The Pillar One contains three alternative proposals. These proposals differ in the approach and scope of reallocation of taxing rights. However, the common aspects in these proposals will allow the OECD and its member states to resolve the technical issues by grouping the issues facing the digital economy into three building blocks, namely, the new profit allocation rules, new nexus rules and the implementation of new market jurisdiction taxing right. The proposal by the OECD sets out three different methods – modified residual profit split method, fractional apportionment method and distribution-based approach – to quantify the amount of profits to be reallocated to market jurisdictions and methods to determine how the profits should be allocated, or reallocated, as the case may be. It also indicates that consideration should be given to size-based limitation. In other words, the Pillar One proposal should only impact multinational groups of a certain size.

This can be illustrated in the following example. A UK parent company owns certain intellectual property and licenses the right to a Hong Kong subsidiary which would carry out the marketing and distribution of the products derived from using the intellectual property. The Hong Kong subsidiary not only distributes to customers in Hong Kong, but also to customers, say, in mainland China. It has no presence in China but may be selling to customers in China through the Internet. Under the proposal, there would be a new nexus in China, and the China tax authority should have certain taxing rights on the profits earned from selling to customers in China. Various profit allocation methodologies are introduced. It should be pointed out that the Hong Kong subsidiary may be selling to China not just by digital means but by other means as well. While the Pillar One proposal was launched to address the digital economy, the proposal could apply to other non-digitalized consumer-facing businesses.

It remains to be seen what the final conclusion would be. Regardless of what the outcome would be, it is quite clear that to address the taxation of the digital economy, the introduction of the new nexus concept, i.e., where the customers are, would be something businesses would need to consider going forward. The new nexus concept would operate regardless of whether distributors have in-country marketing or distribution presence or are selling through related or unrelated distributors in the country where the customers are located.

The reallocation of taxing rights would have implications to Hong Kong businesses, which sell to customers in many other countries. Going forward, a portion of the profits earned by the Hong Kong business would be re-allocated to the jurisdiction where the customers are.

The Pillar Two proposal

To tackle remaining instances of international profit shifting to no/low tax jurisdictions under the Pillar Two, the OECD proposes a set of four rules, each of which would be coordinated with each other. Essentially, the rules would allow a country to apply a "minimum" tax if a company in that country has businesses with its related companies in a country that has a tax rate below certain threshold. The idea of the OECD is not to take the tax to be collected by the country of a lower tax rate, but to allow the country of the higher tax rate to impose an additional tax. For example, if a UK parent company has a Hong Kong subsidiary with which there are related party transactions to the extent the effective tax rate of the Hong Kong subsidiary is below the minimum tax rate to be agreed and specified by the OECD, the proposal will permit the UK tax authority to impose an additional tax to the group equal to the difference between the minimum tax and the actual Hong Kong tax paid.

Conclusion

As the OECD notes, the Pillar One and the Pillar Two recommendations represent a significant change to the international tax architecture.

The work related to the key features of the consensus-based solution to Pillar One is to be completed in June 2020. A final report will be produced by the end of 2020. Businesses should follow the OECD's work closely and to provide input, as well as preparing themselves for the roll out of these proposals. It is important that the Hong Kong Government would step up to negotiate with other tax authorities. B

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