Decoding Digital and Transfer Pricing

Developments in Digital Taxation

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The current international tax framework, which dates back to the 1920s, allocates taxing rights based on the location of physical assets, capital and labour, source of income and residence of taxpayers. While the tax framework has worked well at a time when the nature of world trade was predominantly physical, the meteoric rise of digital businesses has put enormous pressure on the traditional international tax framework, and its adequacy in addressing the digital economy has been called into question by many Western jurisdictions.

Digital businesses have the ability to access a market via technological means without necessarily having physical presence in that market. Relying heavily on highly mobile intangible assets, digital businesses can also create a significant economic presence in one jurisdiction despite having most of its profit-generating assets and labour located in a different jurisdiction. These characteristics of digital businesses have made the current international tax framework in need of significant updates.

Bringing the audience up-to-speed on the latest international developments on digital taxation were Accredited Tax Advisor (Income Tax) Sam Sim, Practice Council Member, New York University School of Law, Mukesh Butani, Managing Partner, BMR Legal, and Associate Professor Darren Koh, Vice-Dean, School of Law, Singapore University of Social Sciences. The three tax experts shared their insights on the digital taxation landscape, critically examined the various international proposals, and left the audience with much to think about on the way forward.

EU Proposal on Significant Digital Presence

As part of the G20-OECD Base Erosion and Profit Shifting (BEPS) project, the OECD had recommended that income of multinational corporations (MNCs) be taxed in countries where value is created. BEPS Action 1 examined the digital economy challenges and opined on several possible ways to tax the digital economy without coming to a specific consensus recommendation.

Thereafter, under the European Union (EU) proposal for a permanent solution to taxing the digital economy, a company would have to pay tax in each EU Member State where it has a "significant digital presence". The company would be considered to have a significant digital presence based on three quantitative thresholds – revenue from supplying digital services exceeding €7 million, number of users exceeding 100,000, or number of online business contracts exceeding 3,000. These proposals depart from traditional international tax principles in that it is possible for a company to create a significant digital presence and hence have a taxable nexus in the EU Member State even if it is completely "virtual" and has no physical presence in that Member State.

Once significant digital presence is established, the company would then have to attribute its profits to be taxed based on transfer pricing principles. Here again traditional transfer pricing principles face the challenge of determining the value created and allocating profits arising from user participation and data (for example, information from online user data used to generate advertisement insights), services connecting users (for example, online marketplace) and other digital services (for example, subscription to streaming services).

Accredited Tax Advisor (Income Tax) and Practice Council Member, New York University School of Law - Mr Sim shared his insights and updated the audience on the latest international developments in digital taxation.

OECD Task Force for Digitalised Economy

Parallel to the EU's effort, the BEPS Inclusive framework's Task Force For Digitalised Economy (TFDE) is also working on detailed proposals to address the digital economy.

The TFDE proposal centered around two central pillars.

PILLAR ONE: TACKLING THE BROADER CHALLENGES OF THE DIGITAL ECONOMY THROUGH ADDRESSING THE NEXUS RULES AND THE ALLOCATION OF TAXING RIGHTS

The TFDE proposals entail that businesses would allocate more profits to market jurisdictions with whom they interact, regardless of the extent of their physical presence in those markets. Specifically, three policy alternatives were proposed:

(i) user participation;
(ii) marketing intangibles;
(iii) significant economic presence.

(i) "User participation" proposal

Under the "user participation" proposal, profits are allocated to jurisdictions where "active and participatory user bases" are located. A social media platform, for example, may be considered to have an active and participatory user base in a particular country if the number of users it has in that country exceeds a certain threshold, and in so doing creating a taxable presence in that country.

User participation deviates from a traditional nexus analysis in that taxable presence is determined based on a quantitative test (instead of a principle-based test in a traditional nexus analysis).

Fundamentally, it also assumes that there is value in the company's activities when certain quantitative thresholds are met, triggering a taxable presence. This intrinsically put pressure on the subsequent transfer pricing analysis as the company may be obligated to allocate certain profits associated with the quantified threshold in arriving at the appropriate profit allocation.

(ii) “Marketing intangibles” proposal

The “marketing intangibles” proposal essentially seeks to modify existing transfer pricing rules to give more emphasis to marketing intangibles (including brand, trade name and customer data) when allocating profits, effectively assigning more non-routine returns to the market jurisdictions.

Specifically, a certain amount of non-routine or residual income attributable to the marketing intangibles could first be allocated to the market jurisdictions based on agreed metrics before other income is allocated based on existing transfer pricing principles. Considering that additional residual profits is intended to be allocated to marketing intangibles beyond conventional transfer pricing analysis, it remains to be seen how the proposal will reconcile with the arm’s length principle.

(iii) “Significant economic presence” proposal

The “significant economic presence” proposal considers a taxable presence in a jurisdiction where a non-resident has a significant economic presence, based on factors that show a purposeful and sustained interaction with the jurisdiction via digital technology. It involves the definition of tax base, determination of allocation keys and weighing of each allocation key.

PILLAR TWO: INCOME INCLUSION AND TAX ON BASE EROSION

Pillar Two comprises two proposals that perhaps go further than those in Pillar One. The first proposal on “income inclusion rule” requires a company to include the income of its foreign branch (or controlled entity) in its tax base if such income was subject to an “excessively low” effective tax rate. The second proposal on “tax on base eroding payment” seeks to deny tax deduction of payments to a related party if that payment was “insufficiently taxed”, and to only grant tax treaty benefits if the beneficiary is “sufficiently taxed” in the other treaty jurisdiction.

Accredited Tax Advisor (Income Tax) and Vice-Dean, School of Law, Singapore University of Social Sciences - A/P Koh moderated the panel discussion and raise sharp questions on the various proposals to address digital taxation.

OBSERVATIONS ON THE TFDE’S PROPOSALS

The TFDE’s proposals in Pillar two, by contrast, speaks to whether an income has been “sufficiently taxed”. The TFDE’s proposals introduce the concept of an additional minimum level of tax required over the rates set by each sovereign jurisdiction. These new proposals are expected to have a wide-ranging impact on businesses if implemented.

It is interesting to note that some of the TFDE’s proposals, particularly those under Pillar Two, are fundamentally different from the proposals in the OECD 2015 BEPS report. One key difference is that the 2015 BEPS report focused on whether an income has been appropriately taxed and if not, to update the rules, rather than drawing a line based on a specific minimum tax rate. In doing so, the sovereign right of each country to set its own tax rate is respected.

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Digital Taxation in India

With over 550 million broadband subscribers as on Feb 2019[1], more than 100% increase in digital payments[2] and extensive use of e-commerce and digital advertising, India has a huge digital economy that is rapidly growing, making it an important country to watch out for in terms of digital taxation.

EQUALISATION LEVY

In India, a six-percent equalisation levy is chargeable on payments made to non-residents for specific services (currently online advertisement, any provision for digital advertising space and any other facility/service for the purpose of online advertisement).

India is the first country to adopt equalisation levy as an interim measure to address the digital economy, with effect from June 1, 2016 in line with BEPS Action 1. It would be interesting to see whether more countries will follow India's lead and adopt similar mechanisms.

NEXUS-BASED TEST: SIGNIFICANT ECONOMIC PRESENCE (SEP)

Like the EU's proposal of significant digital presence, India has also brought the concept of a nexus-based test of significant economic presence with effect from 1 April 2019. While the EU proposal includes specific thresholds, India is yet to prescribe specific thresholds to its proposal.

Importantly, India's SEP proposal is a good indication that the concept of significant digital presence is not only discussed at the EU, but more widely considered in major economies in other parts of the world.

Mr Butani deep-dived into the tax challenges of the digital economy and illustrated the digital trends with recent Indian cases.

It should be noted that digital taxation is not just limited to digital companies. Whether you are young start-up company creating an app or a 100-year-old brick-and-motor company venturing into e-commerce, you may be still be affected in some way or the other by the proposed digital taxation rules.

As tax authorities around the world gripple with the digital economy and try to come to a consensus on the way forward, stay updated and think through what the proposals may mean to you and your company.

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[1] "Press Release No. 27/ 2019", Telecom Regulatory Authority of India, 18 April 2019
[2] "Digital Payments", NITI Aayog, July 2018

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