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On the board's agenda | US

International taxes: Seismic changes may be coming

After decades of operating within a generally stable international tax regime, multinational companies have more recently seen a flurry of activity, thanks to a global focus on profit shifting and the US 2017 tax overhaul. With the potential for international tax rules to undergo seismic shifts in the next several years, board members would do well to keep an eye on the work being performed at the Organisation for Economic Co-operation and Development, or OECD.

Following the first phase of its Base Erosion and Profit Shifting (BEPS) project, the Paris-based OECD is hosting an ambitious project in which 130+ nations (collectively known as the "Inclusive Framework") are attempting to revise the international tax architecture to account for the ways in which the digitalization of the global economy has blurred traditional lines of jurisdiction. Whether consensus can be reached by so many countries with vastly different priorities, politics and domestic industries remains to be seen, but there may be significant risks to entities ignoring this project.

The OECD project has the potential to significantly impact a company's risk profile and strategic planning, two of the key areas of board oversight. Accordingly, directors should stay informed about the status of the project and how it might impact the companies they serve.

Center *for*
Board Effectiveness

But we're not a "digital" company… Are we?

In its earlier stages, the OECD's initiative was often talked about in the same breath as plans by some individual countries—or, in the case of the European Union, a small group of countries—to collect new taxes from a handful of Internet-based giants, most of which are headquartered in the US. Think online marketplaces, social media networks, sellers of online user data, and those with significant digital advertising revenue. And the broader OECD work is still referred to by some as the "digital tax" project. But this shorthand can be quite misleading; as far back as 2015, the OECD recognized that there really isn't much of a *non*-digital economy, anymore.

"Because the digital economy is increasingly becoming the economy itself, it would be difficult, if not impossible, to ring-fence the digital economy from the rest of the economy for tax purposes."[1]

Digitalization allows buyers and sellers to connect, individually and through online marketplaces; enables new business models to spring up in the so-called sharing, or gig, economy; allows niche brands to find a global audience; supports software, web services and algorithms that are critical to a firm's success; facilitates user participation; and makes possible the collection by companies of valuable customer and product data.

After negotiators from the US Treasury Department made clear that they would not sign on to an effort targeting high-profile, high-tech companies, the majority of which are based in the US, other countries at the negotiating table have generally conceded that any new regime will need to apply more broadly—not just to highly digital business models but also to other large, high-profit multinationals that benefit from marketing intangibles, including those based in other countries.

This shift—from focusing on the digital aspects of businesses to the returns that jurisdictions can tax when a multinational exploits marketing intangibles in that jurisdiction—has substantially broadened the potential scope of the OECD's ongoing work. It will have the effect of ensuring that more countries have skin in the game, but it means more types of business will, too.

So, you may not consider your company a likely target of something dubbed a "digital tax," but if, for example, you're using third-party distributors to sell tangible goods to customers in countries where you don't have a physical presence, you may fall within the scope. Ditto if you have an internationally recognized brand or other intangibles that drive customers to your products.

A proposal released in October 2019 attempts to move the process forward by blending elements of various jurisdictions' ideas. The OECD recommends focusing on "large consumer facing businesses," with extractive industries assumed to be exempted and the potential for financial services and other sectors to be exempted as well. It is important to recognize that "consumer facing" does not equate only to business-to-consumer (B2C) transactions. Participating governments want to consider scoping in many business-to-business (B2B) transactions as "consumer facing," the most prominent example being search engines selling advertising to businesses (B2B), using consumer data to drive ad value.

The OECD's proposal also gives the example of €750 million in revenue as a potential threshold for application, mirroring the country-by-country reporting requirements that came out of the OECD's 2015 BEPS Action Plan, but that figure will be up for discussion and negotiation. The threshold in a particular country may ultimately vary depending on the size of the relevant market jurisdiction.

1. Addressing the Tax Challenges of the Digital Economy, Action 1—2015 Final Report (OECD, Oct. 5, 2015) https://www.oecd.org/publications/addressing-the-tax-challenges-of-the-digital-economy-action-1-2015-final-report-9789264241046-en.htm

The push for a "unified approach"

At its core, the multilateral effort at the OECD—which also has a mandate from the finance ministers of the G20—is a two-pillar approach. In what they have dubbed "Pillar One" of the project, the OECD is seeking to write new rules that will reallocate some portion of companies' profits to the market jurisdictions where they have sales and/or users, but not necessarily a physical presence. This recognizes that physical presence is no longer required for entities to profit from a jurisdiction. "Pillar Two" of the project is to separately ensure that profitable companies are paying some minimal level of tax. Pillar One is arguably the more challenging of the two goals. Because it would reallocate taxing rights—which by definition means there would be revenue winners and losers in the process—broad consensus is required for any Pillar One plan to be implemented.

The current proposal under Pillar One[2] envisions a new nexus rule that is dependent not on the traditional principle of "permanent establishment," i.e., physical presence in the taxing jurisdiction, but on sales; and it includes a three-tiered mechanism for reallocating non-routine profits. This approach would allow jurisdictions to maintain taxing rights over income generated through routine activities in that jurisdiction but would then:

a) allocate to market jurisdictions some share of the non-routine return attributable to marketing intangibles, regardless of the business' residence or physical locations;

b) provide a fixed return for baseline marketing and distribution functions taking place in a market jurisdiction, based on the current arm's length principle; and

c) tax an additional return in accordance with existing transfer pricing rules where a jurisdiction can successfully establish—subject to robust and binding dispute resolution mechanisms—that there are more functions in the jurisdiction than have already been accounted for.

Pillar Two is the Global Anti-Base Erosion (GloBe) proposal, designed to address ongoing risks from structures that allow multinationals to shift profit to jurisdictions where they are subject to no or very low taxation. A November 2019 OECD document[3] calls for the development of a coordinated set of rules aimed at ensuring that multinational businesses pay enough tax somewhere—with the outstanding question of what is "enough," of course, being critical. These so-called "minimum tax" rules would be implemented by way of changes to domestic law and double tax treaties and would incorporate a coordination or ordering rule to avoid the risk of economic double taxation that might otherwise arise where more than one jurisdiction sought to apply these rules to the same structure or arrangements.

The US tax on "global intangible low taxed income" (GILTI), enacted in 2017, arguably falls into this category as a minimum tax. GILTI addressed concerns about profit shifting, so US-based multinationals might also be assuming that GILTI would immunize them from Pillar Two, but that is far from clear at this stage. Unlike Pillar One, Pillar Two does not necessarily require consensus by the Inclusive Framework members for countries to implement their own top-up minimum tax, denial of deduction, or withholding tax. However, this and other important topics are left unaddressed in the recent paper. Pillar Two could have a broad impact on companies' global tax profiles, so it is worthy of ongoing attention by directors and business leaders.

When could we see the impact?

This project is a political one as much as a technical one, and the participating governments have acknowledged the implementation challenges that lie ahead even if they reach consensus on the details. The participants originally hoped to have broad political agreement by the end of 2019, but there is now recognition that will *not* be achieved; they now hope to reach a political consensus on the direction of the two pillars by mid-2020, perhaps with some early milestone agreements in early 2020. The OECD working parties would then need an additional 18 months or so to do the technical work needed for implementation, with the effect that implementation could probably occur no earlier than 2022. This is still an aggressive timeline, given the number of countries involved and the dramatic changes being contemplated.

2. Secretariat Proposal for a "Unified Approach" Under Pillar One (OECD, Oct. 9, 2019) https://www.oecd.org/tax/beps/public-consultation-document-secretariat-proposal-unified-approach-pillar-one.pdf

3. Global Anti-Base Erosion Proposal ("GloBe")—Pillar Two (OECD, Nov. 8, 2019) https://www.oecd.org/tax/beps/public-consultation-document-global-anti-base-erosion-proposal-pillar-two.pdf.pdf

The slipping of the original deadline for high-level political agreement reflects the difficult task facing the political players, including the challenge of getting governments to sign off on major, transformative international tax policy changes in such a short time frame. Not surprisingly, governments want time to analyze different approaches to determine whether they will be winners or losers under whatever regime is agreed to.

However, with many countries anxious to stake a claim to profits beyond their traditional reach, the only greater risk for multinationals than a new global agreement may be failure to reach a new global agreement at all. Countries including France have already implemented unilateral tax measures targeting digital services revenue, and more countries are waiting in the wings, ready to move if the multilateral OECD process fizzles. This leaves some companies in between the proverbial rock and hard place: while they may not be enthusiastic about the new rules being discussed at the OECD, they must weigh whether a global agreement is preferable to a patchwork of uncoordinated rules in various countries.

Conclusion

The OECD project has the potential to change the international tax rules well into the future, impacting both the strategy and the risk profile for companies. Although the project is creating and will continue to create uncertainty, Board members are accustomed to dealing with uncertainty. They are in the unique position to engage with their respective business communities and governments, and the OECD itself, to learn how the proposals could affect their company's bottom line and strategic decisions and to communicate what they learn to their companies' managements. At the same time, management can engage with industry trade groups and business organizations actively participating in the OECD project, to help board members stay informed on the status of the project and how it might impact the companies they serve.

Questions for the board to consider asking:

1. Where is the company most vulnerable to the kinds of changes being considered? Where do we have significant sales but no physical presence?
2. There are many changes under consideration; which ones do we believe are the most likely to be implemented? The least likely?
3. What anticipated changes might occur in the US as a result of the work of the OCED?
4. Where does responsibility for this matter reside in the company? Does the responsible party or group have adequate resources?
5. Are we working with other companies or organizations similarly situated to participate in the decision-making process or in permissible lobbying activities?
6. Has management performed scenario planning to evaluate the impact of the various outcomes on their strategic plan?
7. Has management discussed adjusting our strategic and operating plans to reduce the tax exposure that may result from the changes under consideration?
8. If we were to tweak our strategic and/or operating plans, what impacts might that have on our stakeholders—employees, suppliers, customers, the communities in which we currently operate and shareholders?
9. What is the proper cadence to receive periodic updates on the status of this matter?
10. Should we assign responsibility for board oversight of this matter to a specific committee—i.e. audit committee—or should it reside with the full board?

Authors

Bob Stack
Managing Director
Washington National Tax
Deloitte Tax LLP
bstack@deloitte.com

Storme Sixeas
Senior Manager
Washington National Tax
Deloitte Tax LLP
ssixeas@deloitte.com

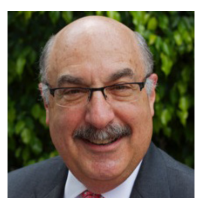
Contact us

Deborah DeHaas
Vice Chairman and
National Managing Partner
Center for Board Effectiveness
Deloitte
ddehaas@deloitte.com

Maureen Bujno
Managing Director
Center for Board Effectiveness
Deloitte & Touche LLP
mbunjo@deloitte.com

Debbie McCormack
Managing Director
Center for Board Effectiveness
Deloitte LLP
dmccormack@deloitte.com

Krista Parsons
Managing Director
Center for Board Effectiveness
Deloitte & Touche LLP
kparsons@deloitte.com



Bob Lamm
Independent Senior Advisor
Center for Board Effectiveness
Deloitte LLP
rlamm@deloitte.com