The Asset Management Industry
SERVING INDIVIDUAL INVESTORS
INVESTMENT COMPANY INSTITUTE

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OECD Work Programme to Develop Consensus Solution on Tax Challenges Arising from Digitilisation of the Economy

[31808]

June 14, 2019 TO: ICI Global Tax Committee
Management Company Tax Subcommittee
Tax Committee RE: OECD Work Programme to Develop Consensus Solution on Tax Challenges Arising from Digitilisation of the Economy

We are organizing a working group to consider the impact on asset managers of proposals being considered by the Organisation for Economic Co-operation and Development (OECD),[1] at the direction of the G20, to address "tax challenges" arising from the "digitalizing" economy. A similar initiative is underway at the United Nations (UN).[2]

We must emphasize that the OECD initiative is NOT limited to digital companies. Every asset manager with cross-border activities can expect to be impacted by the initiative's broad scope. The precise impact will depend on the OECD's final product—both in general and with respect to the unique aspects of asset management.

Introduction

At its core, the OECD is considering fundamental changes to the international tax regime for:

1. allocating taxing rights based upon activities within a market jurisdiction and without regard to a physical presence and;
2. ensuring that multinational entity (MNE) profits are taxed at some minimum rate.

These two fundamental changes (described as separate "pillars"—for which coordination would be needed) are discussed most recently in the OECD's May 2019 "Programme of Work." As the title suggests, the OECD is seeking to develop a "consensus solution" to tax challenges arising from the digitalisation of the economy. The Programme of Work notes that "a growing number of jurisdictions are not content with the taxation outcomes produced by the current international tax system." More specifically, members of the OECD Inclusive Framework[3] have concluded that the OECD Base Erosion and Profit

Shifting (BEPS) outputs did not address adequately the public's concerns with the amount of tax paid by MNEs in different countries.

The timeline in the OECD's Programme of Work calls for a political consensus on "the outlines of the architecture" by January 2020 and a technical solution by the end of 2020. The OECD has stated that "the solution should reflect the right balance between precision and administrability for jurisdictions at different levels of development, underpinned by sound economic principles and conceptual basis."

Under Pillar One, the OECD is looking to develop a consensus regarding how taxing rights on income generated from cross-border activities should be allocated among countries. Pillar One involves revised nexus and profit allocation rules (sometimes referred to as a "new taxing right"). The fundamental driving concern for Pillar One (expressed most forcefully by developing country and civil society representatives) is that "market jurisdictions" are not receiving sufficient tax revenues from MNEs.

Under Pillar Two, the OECD is looking to develop a consensus regarding some minimum level of tax that would apply to all MNE corporate income. The so-called "GloBE" (global anti-base erosion) proposal includes both an income inclusion rule and a tax on base eroding payments. Pillar Two is designed to avoid profit shifting to low-tax jurisdictions. This proposal has very strong support from Germany and France.

Pillar One – In General

The OECD's "digitalizing economy" initiative has sought to reach consensus on where taxable "value" is "created" and how this value should be taxed. The three value-creating characteristics identified as arising in the digitalizing economy are: (1) scale without mass; (2) heavy reliance on intangible assets: and (3) data and user participation.

The March Public Consultation Document. Three proposals were advanced by the OECD for discussion during the March public consultation.

User participation. The first "Pillar One" proposal is based upon the view that "user participation" creates taxable value. The business models that would appear most significantly impacted by this proposal are highly digitalized business such as social media platforms, search engines, and online marketplaces. This proposal generally has been ascribed to the United Kingdom; similar proposals have been advanced in the European Union. Only residual (non-routine) profits would be allocated under this user participation proposal. Existing transfer pricing rules would continue to apply.

Marketing intangibles. The second "Pillar One" proposal—broader than the first—would allow jurisdictions to tax MNEs that access the market through "marketing intangibles." These intangibles would include trademarks, trade names, customer lists, customer relationships, and proprietary market and customer data that is used in marketing. The marketing intangibles proposal would involve modifying transfer pricing rules to require non-routine income attributable to marketing intangibles and risks associated with those intangibles to be allocated to the market jurisdiction. The income attributable to marketing intangibles would be allocated to each market jurisdiction based upon an agreed metric, such as sales or revenues. Importantly, trade intangibles (such as technology-related intangibles generated by research and development) would not be taxable in the market jurisdiction under this proposal. This proposal generally has been ascribed to the United States.

Significant economic presence. The third Pillar One proposal—potentially much broader than the first two—would allow jurisdictions to tax MNEs based upon "significant economic presence" (SEP). Factors that would evidence a "purposeful and sustained interaction" with a market jurisdiction could include sustained marketing and sales promotion activities in addition to more digital technology/automated means. Profits (including both routine and residual profits) would be allocated based upon fractional apportionment (that could include factors such as sales, assets, and employees—with "users" being a fourth factor in appropriate circumstances). This proposal contemplates the possibility of collecting tax through withholding.

Importantly, from a political perspective, the SEP proposal is supported by many developing countries[4] and civil society representatives. As noted by the UN's Committee of Experts on International Cooperation in Tax Matters, "[o]n profit attribution, the SEP proposal recognizes both production and sales as essential for generation of profits, and neither can be ignored for the purpose of determining the profits that would be taxable in a jurisdiction."[5]

The Programme of Work. The subsequently-issued Programme of Work notes that the three proposals, despite their differences, all would allocate more taxing rights to the market jurisdictions where customers or users are located. Importantly, the new taxing right would arise "where value is created by a business activity through (possibly remote) participation that is not recognized in the current framework for allocating profits." The OECD's technical work programme for developing a consensus approach for addressing Pillar One considerations will involve three "building blocks:"

- determining the amount of profits subject to the new taxing right and allocating those profits among jurisdictions;
- designing a new nexus rule based upon "business presence in a market jurisdiction" that is not constrained by physical presence; and
- developing instruments to ensure full and efficient implementation and administration of the new taxing right.

Profit Allocation Rules. The Programme of Work identifies several different possible methodologies for determining and allocating MNE profits. These methods are: (1) modified residual profit split (MRPS); (2) fractional apportionment; and (3) distribution-based approaches. The profits subject to allocation could be determined across the MNE or through business line or regional segmentation. The new taxing right could be limited, according to the Programme of Work, based upon the nature or size of a given business; "due consideration" also would be given whether the new taxing right would apply to "financial instruments." Various approaches to recognize the impact of losses also will be examined.

New Nexus Rules. The Programme of Work will consider whether to develop a new nexus rule based upon "remote taxable presence" or to modify existing treaty-based rules for finding a permanent establishment.

Implementing the New Taxing Right. The Programme of Work also must address economic double taxation, examine the interaction between the new and existing taxing rights, provide effective dispute prevention and resolution procedures, and consider multilateral coordinated risk assessment. Administration issues would include identifying the taxpayer that has the tax liability and filing responsibility. Enforcement and collection mechanisms will be needed if the entity with the tax liability is not a resident of the taxing jurisdiction.

One implementation option would involve a “simplified registration-based collection mechanism” that could operate in conjunction with enhanced exchange of information (based possibly on the BEPS Action 13 Country-by-Country (CbC) reports). Data points that might be necessary for both tax administrations and members of the MNE group could include items such as total profit, total profit per business line, and revenue. The Programme of Work recognizes that technical and practical issues would arise in determining in determining the location of the ultimate customer as well as in crafting new reporting obligations and exchange of information protocols.

Pillar One – Issues for Asset Managers

Asset managers’ business models differ in many significant respects from the business models of technology firms such as the “GAFAs”[6] and consumer product companies that are more often analyzed under these proposals. Among the questions that must be addressed if any agreed proposal is to operate fairly and effectively for asset managers are the following:

- Is the relevant market jurisdiction the location of: (1) the fund; (2) the fund’s affiliated and/or unaffiliated distributor(s); (3) the fund’s investors; (4) the companies in which the fund invests; or (5) something else?
- If the location of the fund’s investors is relevant:
    - is the determination based upon the residence of the shareholder of record (that might be a nominee) or the underlying investor?
    - how is location determined when an institutional investor such as a pension fund is the investor?
    - how is the asset manager to determine the residence of undisclosed investors holding through a nominee?
    - what obligations will be imposed on nominees and/or platforms to disclose the residences of their customers?
- Who is the taxpayer? The ultimate parent? The management company? Each related service company? An affiliated distributor? Each branch or subsidiary by location?
- When does the relevant taxpayer have a sustained and significant involvement in a market jurisdiction? If revenue (such as the management fee) is a relevant consideration, does the management fee get “sourced” to market jurisdictions based upon AUM or something else? What other indicators (number of shareholders, advertising spend, etc.) might be relevant for asset managers?
- What potentially relevant role does technology play in fund distribution? Do digital distribution platforms present unique issues?
- How are profits determined? Overall? By product line (such as RIC, UCITS, PE fund, hedge fund)?
- If routine profits are exempt from allocation, how should asset managers determine “routine” profits? A fixed percentage over total cost? Should the fixed percentage vary by industry (and, if so, on the basis of what factors)? Should risk premiums be relevant? Should routine profit vary by jurisdiction—on the basis of increased risk or other factors?
- How should losses be treated?
- What types of “data mining” activities involving investors might cause asset managers to have “users” under various proposals?
- Are there any other fact patterns that might be deemed to create “users” who are not also fund investors?
- What other thoughts do we have on the extent to which a fund’s customers create

"value" in the asset management industry?

The discussion above assumes that the funds themselves are not within the Pillar One scope as they are not themselves businesses with profits to be allocated across market jurisdictions. Presumably, funds are the type of "financial instruments" that the Programme of Work references as possible exemptions. What factors should be advanced to support a fund-level carve-out and/or distinguish funds from other investors, perhaps including investment pools also managed by an asset manager that participate more actively in the management of the companies in which they invest?

Pillar Two – In General

The GloBE tax proposal in Pillar Two includes two new rules—that would need to be coordinated—to address ongoing concerns about MNE efforts to shift profits to low-tax jurisdictions. These proposals, while impacting profits involving intangibles in the digitalizing economy, have much broader impact.

Income Inclusion Rule. The first (income inclusion) proposal would tax in the parent jurisdiction the income of a branch or controlled entity that otherwise would be taxed at a low effective rate. This rule effectively is designed "to stop a harmful race to the bottom." As noted by the OECD, this proposal would "build on" the OECD Action 3 recommendations and "draw on aspects of" the US Global Intangibles Low-Taxed Income (GILTI) regime.

The income inclusion rule would apply, on a jurisdiction-by-jurisdiction basis, to "significant (*e.g.*, 25%)" interests (held directly or indirectly) in a company. Credits would be provided, also on a jurisdiction-by-jurisdiction basis, for any tax paid on the attributed income. This new rule would supplement, rather than replace, a jurisdiction's controlled foreign corporation (CFC) regime.

Various design issues are discussed in Box 2.1 (on page 29) of the Programme of Work. Numerous technical issues, including those discussed in paragraph 100 of the public consultation document, would need to be addressed. One simplification approach that might be considered—as it could eliminate the need for each subsidiary to recalculate its income using tax base calculations of the parent jurisdiction—would be to use financial accounting rules to determine net income (with appropriate adjustments for e.g., losses and timing differences).

Tax on Base Eroding Payments. The second (tax on base eroding payments) proposal would deny a deduction or treaty relief for certain payments unless that payment otherwise was taxed at or above a minimum rate. This proposal includes both an "undertaxed payments" rule and a "subject to tax" rule.

The undertaxed payments rule would apply only to payments made to a related party (which could be based upon 25% common ownership). Various design issues are discussed in Box 3.1 (on page 31) of the Programme of Work. Numerous technical issues, including those discussed in paragraph 105 of the public consultation document, would need to be addressed.

The subject to tax rule would apply to "undertaxed" payments that otherwise would be eligible for treaty relief. The proposal envisions the following articles of the OECD Model Convention as being within scope: Article 7 (Business Profits); Article 9 (Associated Enterprises); Article 10 (Dividends); Articles 11-13 (Interest, Royalties, and Capital Gains); and Article 21 (Other Income). The public consultation document suggests that the

proposal generally could be limited to related party payments although the scope could be broader for interest, royalties, and capital gains. Additional technical issues, including those discussed in paragraph 108 of the public consultation document, would need to be addressed.

Pillar Two – Issues for Asset Managers

Global asset managers are gaining experience with GloBE-type proposals as the Pillar Two proposals are informed by the US GILTI and BEAT provisions. While there may be fewer asset manager-specific issues under Pillar Two than under Pillar One, your insights are needed here as well. One specific area for industry comment may involve preventing management company ownership of fund shares (such as during start up) from causing the fund and the manager to be treated as related persons.

ICI Global Working Group – Formation and Operation

Strong representation on this working group is necessary because this OECD/G20 initiative has the potential to change fundamentally the existing relatively well-understood international tax regime. The potential changes include an expansive view of taxable presence, profit allocation rules that are based partially or entirely upon customer location, and globally agreed minimum tax rates. The significant additional burdens and costs of any such fundamental changes would fall directly on asset managers and indirectly, to some extent, on fund investors.

The working group will hold a series of conference calls over the summer to, among other things:

- analyze the appropriate principles for determining where, in the fund industry context, value is created;
- develop a detailed list of industry concerns with both Pillars One and Two;
- consider the business ramifications of various alternative approaches;
- craft solutions to minimize the negative impact on managers; and
- address the potential for presumably unintended consequences for funds.

We will reconvene the group, at least primarily through conference calls, as each more refined version of the proposal is released by the OECD. The group also will consider further developments by the UN and significant unilateral measures.

The group's work product will be shared with policy makers in the United States and other important jurisdictions, with senior OECD officials, and with global thought leaders such as Business at OECD (formerly BIAC).

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Please contact Katie Sunderland (at katie.sunderland@ici.org or 202-326-5826) or me (at lawson@ici.org or 202-326-5832) if you are interested in going this working group.

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endnotes

[1] OECD documents relevant to the public policy concerns, and possible approaches for addressing them, include: the Programme for Work agreed in June 2019 by the G20 Finance Ministers (Programme of Work to Develop a Consensus Solution to the Tax Challenges Arising from the Digitalisation of the Economy); a public consultation document issued in February 2019 (Addressing the Tax Challenges of the Digitalisation of the Economy) and the comments received prior to the March 2019 public hearing, (Public comments received on the possible solutions to the tax challenges of digitalisation); a "policy note" issued in January 2019 (Addressing the Tax Challenges of the Digitalisation of the Economy – Policy Note); an "interim report" in 2018 (Tax Challenges Arising from Digitalisation - Interim Report 2018; and the 2015 "Final" Report on BEPS Action 1 (Addressing the Tax Challenges of the Digital Economy- Final Report).

[2] https://www.un.org/esa/ffd/wp-content/uploads/2019/04/18STM_CRP12-Work-on-taxation-issues-digitalization.pdf.

[3] The OECD Inclusive Framework includes both OECD members (from developed countries) and tax authorities from almost 100 other jurisdictions (many of them developing countries).

[4] Indeed, India has released its own version of an SEP for public consultation. *See* https://www.irsofficersonline.gov.in/Documents/OfficalCommunique/118042019150655.pdf.

[5] https://www.un.org/esa/ffd/wp-content/uploads/2019/04/18STM_CRP12-Work-on-taxation-issues-digitalization.pdf.

[6] "GAFA" is the acronym for Google, Apple, Facebook, and Amazon—four firms generally recognized as the type of technology-related firm within scope of these proposals.
