

TAX BRIEFING

Taxation of the digital economy - Current developments

The OECD/G20 Inclusive Framework on BEPS is of the opinion that current tax systems no longer ensure a fair and effective taxation of the growing digital economy. Efforts are therefore underway to grant the market states new taxation rights and to apply minimum taxation through various new regulations. In this regard, the OECD presented the drafts or Blueprints for its Two-Pillar Approach (Pillar One and Two) for public consultation on 12 October 2020. Given the major differences between the positions of the countries involved, it remains to be seen whether consensus can be reached by mid-2021 as planned. Failure to reach an agreement would most likely result to the continuation of existing unilateral measures or the introduction of new ones and, as a consequence, trade disputes, which would lead to increased double taxation and legal uncertainty for taxpayers.

This newsletter summarizes the OECD's Two-Pillar Approach as well as the most important findings and questions and provides an outlook.

Digital Economy - The OECD publishes the Blueprints for its Two-Pillar Approach (Pillar One and Pillar Two) - An Overview and the most important Findings and Questions

Background and Status Quo

Due to the increasing digitalization of the economy, which has accelerated as a result of the COVID-19 crisis, numerous countries fear tax shortfalls. The reasons for this are the prevailing corporate income tax regulations, which are linked to a physical presence in a state. As digitization reduces or even abandons the physical presence of a multinational company in the market states – e.g. in the form of distribution companies – the existing regulations for the taxation of profits of multinational corporations are no longer considered appropriate.

On 12 October 2020, the OECD has issued its Blueprints for the introduction of new rules concerning "digital" nexus and profit distribution (Pillar 1) and a global minimum taxation standard (Pillar Two) for multinational enterprises for public consultation.

The OECD's Two-Pillar Approach

1) Pillar One

Pillar One aims at allocating taxation rights to those states where multinational companies provide either automated digital services ("ADS") or other services to consumers ("consumer facing businesses", "CFB").

The allocation is made by the so-called Unified Approach based on three key components: Irrespective of whether a physical presence exists, a share of the residual profit of a multinational enterprise is allocated to the market or user state by means of formula-based profit allocation (Amount A). In addition, a fixed compensation for routine functions related to marketing and sales activities in the market country is determined (Amount B). Furthermore, processes to improve legal certainty through effective mechanisms for the prevention and settlement of disputes between the states involved are also provided for.

The new taxation right on Amount A is only applicable to those multinational enterprises that meet the activity and the threshold test. As mentioned above, the activity test requires the existence of automated digital services (ADS) or other services to consumers (CFB). ADS include, for example, online advertising services, online search engines, digital content services,

online gambling and standardized online teaching services, as well as the sale or other re-use of user data and the online sale of goods and services. This is intended to capture services such as those provided by Google, Amazon, Facebook and Apple. The definition of CFB is very broad. This term covers companies that sell goods or services to consumers. It also includes indirect sales through intermediaries as well as franchisees or licensees. Certain industrial sectors such as the financial services, commodity, aviation and shipping sector are excluded.

The threshold test is fulfilled by exceeding two threshold values. The following two threshold values are under discussion, but have not yet been definitively agreed upon: On the one hand, exceeding consolidated sales of EUR 750 million, on the other hand, achieving sales from "in-scope activities" outside the domestic market of more than EUR 250 million.

2) Pillar Two

Pillar Two includes the introduction of complementary rules, which, taken together, should ensure minimum taxation of multinational enterprises. Rules will be established to give states the right to overarching taxation where other states have not exercised their primary taxing rights or where the profits collected are generally subject to low effective taxation.

The rules include in particular the Income Inclusion Rule (IIR) and, subsidiarily, the Undertaxed Payment Rule (UTPR) as well as the Subject to Tax Rule (STTR) and switch-over clauses. No agreement has yet been reached on the level of minimum taxation, but a minimum taxation in the range of 10%-12.5% is being discussed.

3) Functionality of the two Pillars

According to initial analyses by the OECD, the introduction of Pillar One would mean a significant reallocation of taxing rights amounting to approximately USD 100 billion in profits among the various jurisdictions. This would lead to a slight increase in global tax revenues. In comparison, the OECD expects Pillar Two measures to contribute even more significantly to an increase in global corporate income tax revenues. Overall, tax revenues are expected to increase by around 4% of current corporate income tax revenues. The OECD assumes that the incentives for shifting profits to low-tax countries will be reduced.

The OECD is convinced that the proposals would enhance tax certainty and increase the efficiency of the global allocation of capital by increasing the importance of non-tax factors (e.g. infrastructure, education level or labor costs) in investment decisions. In any case, the proposals will lead to additional compliance and administrative costs for multinational enterprises and also tax administrations.

4) Most important Questions and Findings

On the basis of these Blueprints the following questions arise for taxpayers:

- Am I affected as a taxpayer in Switzerland?
- Which turnover thresholds will (initially) apply and which (commercial/tax law) assessment bases are relevant?
- Which digital services will be covered?
- What proportion of the profit should be taxed in the market states and according to which formula and on which basis is it allocated?
- How is taxation to be carried out when the enterprise is also physically present in the market state (i.e. application of existing transfer pricing principles)?
- Who has to pay the tax and which state has to eliminate double taxation?
- What is the targeted minimum tax rate?

It should be noted that no agreement has been reached (yet) by the OECD/G20 Inclusive Framework on BEPS regarding the taxation of the digital economy and that these questions can only be answered with certainty once the drafts have been finalized.

Nevertheless, it is emphasized that the two Blueprints are a solid basis for a future consensus.

Outlook

The public consultation is open until 14 December 2020, by which time stakeholders are invited to submit their comments. The aim is to reach a consensus among the 137 participating states by mid-2021, which should also include the abolition of uncoordinated unilateral measures that individual countries have introduced in the meantime. If this goal is achieved, it can be expected that these principles will enter into force in Switzerland from around 2025, provided that no referendum is held.

The European Commission has already announced that it will implement its proposal for a digital tax if the OECD fails to reach an agreement on the taxation of the digital economy by mid-2021. The EU's current plans include a digital tax of 3% on the total gross income of multinational enterprises that reach certain cumulative turnover thresholds within the EU and worldwide (worldwide: EUR 750 million; within the EU: EUR 50 million). However, the project is also highly controversial among the EU member states, so it is not foreseeable at this point

whether the EU would be able to work together single-handedly.

The UN committee has also worked out a proposal which should be included in the UN Model Convention. At issue is the introduction of a withholding tax on gross income from automated digital services, the amount of which can be agreed bilaterally by the respective states in the respective double taxation agreement. Optionally, the possibility of net taxation on qualifying profits resulting from digital services will be granted. In view of the current OECD project, it seems rather unlikely that the draft will be accepted by members from industrialized countries. However, should the OECD project fail, the pressure from developing and emerging countries to tax profits from the provision of automated digital services will continue. The waiver of a developing or emerging country from levying digital taxes is likely to depend on the willingness of the respective contracting states to recognize the new taxation right proposed by the UN committee.

Tax Partner AG

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Prof Dr René Matteotti is a tax attorney and a tenured Professor of Law with a specialization in Swiss, European and international tax law at the University of Zurich. His areas of expertise particularly include corporate tax law and international tax law (including transfer pricing). René has long-standing practical experience as a tax attorney in representing domestic and international clients before tax authorities and courts. Hereby he particularly supports enterprises in the resolution of disputes in the course of tax audits, in tax ruling requests and mutual agreement procedures. As an expert, he also regularly provides legal opinions on complex tax law issues.

René is, amongst others, a member of the Tax Chapter of EXPERTsuisse, a member of the Federal VAT advisory committee appointed by the Federal Council, editor-in-chief of the academic tax journal ASA and president of the Swiss Association of Tax Law Professors. He is author of numerous academic articles on topical tax issues and regularly gives lectures at conferences in Switzerland and abroad.



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Monika Bieri has over 12 years of experience in national and international tax matters. She began her career as a tax consultant with Ernst & Young. After specializing in tax matters (LL.M. in International Taxation), she worked as a consultant in the tax department of an international insurance group. In 2016, Monika joined Tax Partner as a consultant on national and international corporate tax law issues. Her focus is on finance companies and real estate tax law. She also advises clients on transfer pricing and tax issues in the area of entrepreneurs – companies. She is the author of various publications in the field of national and international tax law.

Tax Partner AG, Taxand Schweiz

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