Tax Insights
from Tax Accounting Services

Financial reporting considerations of taxing the digitalizing economy

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In brief

Business structures and the process of value creation have evolved in part through the digitalization of the global economy. Such evolution has posed broad tax challenges which the Organization for Economic Cooperation and Development (OECD) is currently evaluating. Sometimes referred to as BEPS 2.0, the OECD is examining various proposals concerning changes to current profit allocation and nexus rules, as well as a global minimum tax, which were first detailed in a *consultation document*. Additionally, on 31 May 2019, the OECD released a *work plan*, *Programme of Work to Develop a Consensus Solution to the Tax Challenges Arising from the Digitalisation of the Economy,* stating that it expects to provide a long-term, consensus-based solution in 2020. A further document, as well as a public consultation, are expected later this year. In addition to the OECD's efforts, separate unilateral measures addressing the digitalization of the economy have been introduced by a variety of countries, including France and the United Kingdom.

Both the OECD proposals and the various unilateral measures could radically alter the allocation of taxing rights between countries for all multinationals, with the impact not being limited to highly digitalized businesses. Obtaining international consensus on appropriate methods of taxing the digitalizing economy will not be without challenges, and the process will require considerable effort to effectuate this level of change. However, given the fact that unilateral measures continue to be introduced, as well as the pervasive nature of these forthcoming proposed changes, companies should begin preparing for the potential modifications to the international tax framework by monitoring developments and evaluating the potential impacts. To aid in the assessment of certain financial reporting implications, we summarize below key considerations from the OECD documents, as well as certain unilateral developments from various countries.

See our Insight *OECD Policy Note scopes work on the future of the international taxation system* for an overview of the provisions being considered.

In detail

The taxation of the digitalizing economy will likely change the way businesses are taxed - not only 'tech companies' and highly digitalized business, but all multinational enterprises (MNEs). The OECD is actively working towards facilitating a long-term, consensus-based solution to address the impact of digitalization on nexus and profit allocation rules, as well as minimum tax proposals, by 2020. In addition, the European Union (EU) and certain countries are currently enacting or proposing tax law changes in this area, some of which are effective as early as 2019. This article considers the potential financial reporting impacts associated with the various digital tax proposals and aims to highlight certain key areas that may create challenges in applying the financial reporting model.

Financial reporting model

ASC 740, *Income Taxes* and IAS 12 address how companies should account for and report the effects of 'taxes based on income' under US GAAP and international accounting standards, respectively. While the scope of ASC 740 and IAS 12 may appear self-explanatory, the unique characteristics of the various tax regimes across the world can create complexity when determining whether a particular tax is based on income. Careful consideration will need to be given to the various digital tax proposals to determine whether each of the tax regimes are, in substance, taxes based on income or not.

Neither US GAAP nor IFRS clearly define the term 'tax based on income' or specify characteristics that differentiate taxes based on income from taxes that are not. We believe that 'taxes based on income' implies a net rather than a gross taxable amount (i.e., that taxes on income are determined after revenues and gains are reduced by expenses and losses). Taxes based solely on revenues (e.g., turnover) would not be considered taxes based on income.

OECD proposals

The OECD is currently evaluating proposals to address the tax challenges arising from the digitalization of the economy, many of which would alter the allocation of taxing rights between countries for many international businesses. Specifics on the proposals were outlined in a detailed consultation document released by the OECD in February.

The OECD received comments from stakeholders and met with over 60 country delegations and several hundred delegates from businesses, trade associations, non-governmental organizations (NGOs), and other stakeholders in a two-day consultation meeting. During this meeting, many stakeholders focused on the broader principles of the proposals in hopes that a high-level agreement can be reached among governments by the beginning of 2020, recognizing that there will be considerable efforts required to conclude on the technical details after a political agreement is reached.

A detailed work plan was subsequently released by the OECD on 31 May 2019.

The proposals are being examined under two pillars. Pillar One focuses on the allocation of taxing rights amongst countries (through three separate proposals). Pillar Two focuses on measures to address global base erosion.

Pillar One - revised profit allocation and nexus rules

Although we understand that the OECD is working on a proposal to 'unify' the three proposals, for purposes of this paper we will analyze three proposals set out in the consultation document focusing on the reallocation of taxing rights: the marketing intangibles proposal, the user participation proposal, and the significant economic presence proposal.

The marketing intangibles proposal suggests that taxing rights should be amended to allow market jurisdictions to tax 'marketing intangible' profits (or losses) regardless of a physical presence or activities. This proposal includes changes to the nexus concept that could go beyond the requirement of a physical presence, and is likely to apply broadly to many businesses, rather than just those that are highly digitalized.

The user participation proposal explores revisions to existing rules on nexus and attribution based on 'active user participation'. This proposal is premised on the concept that sustained engagement and participation with a user base (in a taxing jurisdiction) is critical to the creation of value, and likely would apply only to highly digitalized businesses.

The significant economic presence (SEP) proposal also proposes revisions to existing rules on nexus and attribution, but does so by identifying where a non-resident enterprise has a SEP, based upon sales, but with a number of subsidiary factors that evidence a 'purposeful and sustained interaction with the jurisdiction via digital technology and other automated means'. Such factors may include, but are not limited to the existence of a local user base and the maintenance of a website in a local language.

PwC observation: *These proposals challenge historical norms and could significantly impact global effective tax rates for MNEs as a result of a shift in the allocation of profits between jurisdictions with different statutory tax rates. Further, changes in profits allocated to certain jurisdictions may impact the realizability of any related local deferred taxes (e.g., deferred tax assets for net operating loss carryovers).*

The user participation and marketing intangibles proposals may require the use of a modified residual profit split (MRPS) method to determine global non-routine returns subject to allocation, which would then be allocated to local jurisdiction(s) through an allocation key. Alternatively, the significant economic presence proposal considers a fractional apportionment method, which among other considerations generally determines global profits to be allocated to local jurisdiction(s) without a distinction between routine and non-routine profits. Simplified 'distribution-based' approaches may also be considered.

As noted above, both the MRPS and fractional apportionment methods will first require the determination of an MNE's total profits on a global basis, which might suggest, among other considerations, a common set of accounting rules for the computation of total profits. The allocation of such profits will further require the evaluation of certain allocation keys, such as revenues, assets, users, etc. Certain simplifications may also be considered by the OECD, such as the use of specified baseline profits in market jurisdictions and the potential for safe harbors or other exclusions.

PwC observation: *Uncertainty exists concerning which accounting rules (US GAAP, IFRS, local GAAP or otherwise) may be applicable for both the determination of total profits, as well as any allocation keys that are based upon financial reporting metrics. Differences between the various accounting standards (e.g., different standards for revenue recognition) may give rise to inconsistent profit allocation outcomes.*

PwC observation: *Depending on which accounting rules ultimately apply, many MNEs may not have adequate financial reporting systems in place to produce total global profits under accounting rules different from those currently utilized in their consolidated financial reporting.*

Furthermore, potential OECD considerations regarding the allocation and treatment of MNE losses may require additional tracking and maintenance of 'cumulative loss accounts,' further requiring MNEs to update current financial reporting systems and processes.

As noted above, the OECD is further considering the development of new nexus rules, intended to redefine the concept of a business presence in a local jurisdiction, even without the existence of a local physical presence. Such development of new nexus rules may result in amendments to the definition of a permanent establishment (PE) as defined in Articles 5 and 7 of the OECD Model Convention, or the development of standalone rules for the establishment of a new nexus, separate from the PE concept. Among other considerations, this would require changes to existing tax treaties, including potential amendments or supplements to the *Multilateral Convention to Implement Tax Treaty Related Measures to Prevent BEPS (MLI).*

PwC observation: *Previously established rules for nexus and permanent establishment may be altered as a result of these efforts. MNEs should continue to monitor the progress of these potential changes to determine any impacts on income tax provisions, including any accruals for uncertain tax positions (UTPs) relating to PE exposures or otherwise. From a process and internal controls perspective, MNEs may encounter challenges in tracking potential changes to tax treaties and MLIs, as well as changes to existing local domestic tax laws for numerous taxing jurisdictions.*

Implementation of Pillar One will require modifications to existing dispute resolution processes between taxing jurisdictions to mitigate the impacts of double taxation. This may further include changes to other existing mechanisms for the elimination of double taxation (e.g., changes to exemption or credit systems currently in place).

PwC observation: *Changes to current tax administration practices, including dispute resolution practices between taxing jurisdictions, may create challenges. For MNEs subject to US GAAP, enterprises may have not recognized UTPs for nexus-related exposures under 'administrative practice' accommodations in the income tax accounting standard. Potential changes to tax administrative practices may impact these prior conclusions.*

PwC observation: *Under US GAAP, a UTP arising in one jurisdiction may give rise to a corresponding tax benefit by reducing taxable income in another jurisdiction. MNEs should closely monitor these potential changes to existing dispute resolution processes to determine impacts to these offsetting tax benefits, if any.*

Additionally, consideration will need to be given to the interaction between these new taxing rights and current existing taxing rights, including but not limited to the imposition of withholding taxes on certain payments.

PwC observation: *To the extent that any new or existing taxing rights are administered through withholding taxes (or other alternative mechanisms), further evaluation will be required to determine if such amounts constitute taxes based on income under US GAAP or IFRS, or whether such impacts should be recorded outside of the income tax accounting model.*

Pillar Two - global anti-base erosion proposal

The second pillar focuses on considerations to address global base erosion, particularly where it is argued that existing rules do not provide a comprehensive solution to the risk of moving profits to low or no tax jurisdictions. The proposal under this pillar focuses on three elements:

- An income inclusion rule to include profits as income in the hands of related party investors, if that income was subject to an effective tax rate below an established minimum tax rate;
- A denial of deduction for source countries or a potential imposition of source-based taxation (e.g., withholding taxes) for certain payments, unless the payment was subject to an established minimum tax rate;
- Coordination rules to avoid double taxation.

PwC observation: *The denial of deductions element of Pillar Two has some similarities to the US base erosion and anti-abuse tax (BEAT). It is unclear at this point if the OECD would recommend enforcement through a withholding tax or an actual denial of a tax deduction.*

While the global anti-base erosion proposal contains certain details, several broader questions remain, and more analysis is required before specific provisions will be decided. To the extent these provisions operate in a manner similar to current BEAT and Global Intangible Low-Taxed Income (GILTI) regimes under US federal income tax law, these proposals may qualify as a 'tax based on income' and, therefore, could be accounted for under the income tax accounting standard. However, further analysis will be required.

PwC observation: *The income inclusion proposal appears to have elements similar to the US GILTI regime. As such, some may question whether the impact of some kind of minimum tax or alternative tax regime needs to be considered in the measurement of deferred taxes if there are temporary differences that, upon reversal, would impact the calculation of income. Further discussion and analysis will be necessary once proposals are finalized.*

Additionally, similar to considerations under Pillar One, the OECD is considering the use of financial accounting data and rules for determinations under Pillar Two, which may result in differing outcomes depending on the accounting standard(s) utilized. Consistent with considerations under Pillar One, MNEs will need to consider the potential impacts on and capabilities of current financial reporting systems and processes when complying with any potential new regimes.

Next steps

The OECD is attempting to facilitate a consensus proposal by 2020. The OECD's existing working parties met in June and July of this year to consider relevant technical issues in connection with their Programme of Work, and will do so on an ongoing basis. The Steering Group of the Inclusive Framework will continue to develop a unified approach under Pillars One and Two, which they intend to submit to the Inclusive Framework at the beginning of 2020 for approval.

PwC observation: *Even if consensus is reached at the OECD level by 2020, significant efforts will be required in order for specific details and measures to be agreed upon and implemented by jurisdiction. Companies should consider how to update their processes and controls to ensure that tax law changes are appropriately tracked and accounted for in the period of enactment under US GAAP, substantive enactment under IFRS, or other relevant local accounting standards.*

Unilateral measures

While several countries have noted that their preference is for global rule changes, certain of these countries are currently introducing unilateral measures to address digital taxation.

Turnover tax proposals

Several countries are considering a 'turnover tax' (or 'equalization tax') as a new way to tax the digitalizing economy. Generally, turnover taxes would levy a certain percentage tax on revenues generated from digital services for companies that meet a certain turnover threshold. Turnover taxes typically ignore the costs associated with sales and instead impose tax on sales or gross receipts. Revenues subject to the tax would generally be attributed to countries partially based on assumptions about the value that users of digital services create.

Examples of countries that have either implemented a form of turnover tax, or that are evaluating turnover tax proposals include:

- France's digital services tax applied to 'revenue from digital services' (a 3% revenue tax)
- United Kingdom's proposed digital services tax (a 2% UK deemed revenue tax with certain thresholds)
- India's equalisation levy on digital advertising (a 6% revenue tax in force since June 2016)
- Austria's proposed digital services tax on online advertising (a 5% revenue tax with certain thresholds)
- Mexico's proposed equalisation levy on digital services revenue (a 3% revenue tax)

PwC observation: *These turnover tax proposals may significantly impact highly digitalized businesses. While* *the tax rates applied in the turnover tax proposals are significantly less than those rates typically applied to income, the resulting tax effect can be significant. Additionally, given the fact that turnover taxes affect different business models in different ways (e.g., they can be more detrimental to companies with high gross revenues, even if they achieve a low profit), each company will need to consider the effect of these turnover taxes on its own business model.*

As turnover taxes operate as a gross receipts tax, they may need to be accounted for outside of the income tax accounting standard. However, companies should ensure a thorough review of the specific provisions before concluding on the appropriate accounting model to apply.

Other unilateral measures

Various countries have introduced other localized measures to address their concerns regarding the sufficient taxation of the digitalizing economy, and others are considering doing so. For example:

- Slovakia, India, and Israel's domestic permanent establishment threshold changes
- UK/Australia's Diverted Profits Taxes
- Australia's Multinational Anti Avoidance Law

Disclosures

Both the proposals from the OECD and the unilateral actions of various countries may significantly impact the taxation of global profits for MNEs. Accordingly, MNEs should consider these impacts with respect to financial statement disclosures. As these proposals are evaluated, the potential impact on consistency and comparability of financial statements, including disclosures, should be considered.

PwC observation: *Companies will need to consider the impact that enactment of these proposals could have on accounting estimates and assertions that may warrant disclosure in the financial statements. SEC registrants are required to discuss their current financial condition and expected changes in Management's Discussion & Analysis of Financial Condition and Results of Operations (MD&A).*

The takeaway

The digital proposals will likely result in significant changes. Some countries are moving forward with their own proposals - which can be effective on a retroactive basis as early as January 2019. Given the various digital tax proposals, accounting for the new provisions will be accompanied by challenges. As it is expected that the OECD proposals could impact all businesses, not just those that are 'highly digitalized' companies should ensure they are monitoring developments so they are prepared to account for them in the appropriate financial statement period. In addition, companies should begin to assess the resulting financial statement impacts, as well as impacts to financial reporting systems and processes, such that they are prepared as measures are implemented and to ensure that appropriate disclosures are made.

Let’s talk

For a deeper discussion of how this issue might affect your business, please contact:

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