Global Consensus on a Digital Service Tax: Where We Are Now

What is the background of the discussion?

The G20 countries, in collaboration with the OECD, initiated a project in 2013 to prevent and counteract base erosion and profit shifting (BEPS) strategies by multinational enterprises for tax avoidance through cross-border transactions, and released 15-point action reports in 2015. To implement the BEPS project, the Multilateral Instrument (MLI) was signed in 2017, and the OECD/G20 Inclusive Framework (IF), which brings together 137 countries, was established in 2016 to implement on its recommendations. The IF continues to give its backing to relevant projects.

Preparing new tax rules and actions against tax avoidance in the digital economy—which is characterized by profit realization without a physical presence, a high reliance on intangible assets, and value creation through user participation—has been the BEPS project's highest priority. Since the publication of its 2015 Action 1 Report, Addressing the Tax Challenges of the Digital Economy, the IF has been engaged in detailed discussions on the issue. As part of the process, it has sought input from external stakeholders and held several public consultations. After issuing interim reports on the digital economy in March 2018 and January 2019, it released blueprints on key points of discussion on October 12, 2020.

What are the key points the report discuss?

The key points of discussion are largely grouped into two pillars. Pillar One focuses on new nexus and profit allocation methods that are suitable for business models based on digital technology. Pillar Two focuses on a global minimum tax on foreign-source income to prevent the problem of tax avoidance facilitated by the use of digital technology.

Why do we need new taxation rules?

In Pillar One, a new taxation paradigm taking into account the characteristics of the digital economy mentioned above is considered. Currently, in order for a country to exercise its taxing rights on income generated by a foreign company's business activities in that country, the company normally have a physical presence in the country, a permanent establishment, such as a branch office or warehouse. However, digital economy income is generated from business activities based on digital technology, such as the Internet, with no need for a physical presence. Under existing taxation rules, it is difficult for countries to tax a foreign company's income. The IF, therefore, is seeking to establish new, consensus-based tax rules for the digital economy on which all the countries participating in the current discussion can agree. Right now, the discussion is moving toward expanding the taxation rights of the market jurisdiction in which users are located, even if the company does not have a permanent establishment in that country. Methods discussed include allocating a calculated portion of multinational companies' above normal profits generated from the market to market jurisdictions based on the amount of sales.

What approaches are being considered to prevent tax avoidance?

In Pillar Two, several approaches are being discussed to prevent tax avoidance. The first method, called the "Income Inclusion Rule," would require a parent company to include the income of a foreign subsidiary in its taxable income. According to this rule, if the foreign subsidiary was taxed at below the minimum tax rate, the rule would trigger additional "top-up tax" payable in the parent company's country. This would ensure that the multinational as a whole paid at least the minimum tax.

The second method, called the "Undertaxed Payment Rule," states that if the income a subsidiary (payee) pays to an overseas related entity (such as the parent company) for items like management service fees is not taxed or is taxed at a low rate in the country where the overseas entity is located, the country in which the subsidiary is located would deny the subsidiary a deduction of the paid amount. Additional methods under review include i) transferring taxation rights to the residence jurisdiction by applying tax credit method instead of income exemption method under tax treaty for taxes already paid, if any, to the source jurisdiction. This so-called "Switch-Over Rule" would apply if foreign-source income was not taxed in either the residence jurisdiction or the source jurisdiction ("double non-taxation") or is taxed at a low rate in the source jurisdiction; and ii) having the source jurisdiction deny tax treaty benefits, such as a preferential tax rate on incomes like interest and royalties, which are taxed below a minimum rate in the residence jurisdiction. This is known as the "Subject to Tax Rule."

What are the next steps and how soon will they be implemented?

The basic framework for Pillars One and Two is near completion, but the details on above normal profit allocation, the types of businesses to which the Digital Service Tax (DST) might apply, and how high the minimum tax rate, and so on should be still need to be finalized. For reference, the DST was initially targeted to automated digital services, such as online search engines and social media platforms. However, considering the fact that consumer-facing businesses, including the manufacturing industry, do business via digital technology, these types of business are increasingly in the IF's sights. The IF originally planned to complete and publish its final report by the end of this year, but, due to the coronavirus pandemic, it looks to be delayed until mid-2021.

Is the final agreement immediately enforceable once it is published?

After the IF member countries do agree on the final report, it won't be enforced immediately. To implement it, the legislation process should be followed. Multilateral tax treaties will have to incorporate its results, member countries will have to ratify them, and individual countries' tax laws will have to be amended. On a practical basis, it will be at least a few years until it comes into effect.

How is the South Korean government responding to the digitalization of the economy?

Unlike certain European countries that have already started to impose a fixed-rate tax on the sales of digital enterprises, it seems unlikely that the South Korean government will introduce taxes such as the DST before international consensus is reached on the IF's discussions. Those countries already incorporating the DST into their tax laws in order to exercise exclusive taxation rights on the income generated by the digitized economy, may be facing trade and tax conflicts with other countries. The goal of the IF's discussions on matters like the DST is to allocate taxation rights appropriately to the multiple countries involved in the digital economy. A solution based on international consensus—one that minimizes tax conflict—is what everyone is striving for. The South Korean government has formed a joint private-public BEPS task force and is closely monitoring the international discussions on BEPS. To the author's knowledge, the government has been actively voicing its opinions in the discussion.

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