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Improve nexus rule for fair distribution of taxing rights to developing countries

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One of the open issues for Pillar One in the discussion on the taxation of the digital economy is the nexus threshold, which would determine which Multinational Enterprises (MNEs) have a taxable presence. Big developed economies or smaller developing economies both may be deprived of taxing rights as a result of nexus thresholds as presently described in the Pillar One proposal. Further, even where smaller thresholds are adopted, some countries may still be denied taxing rights. Financial threshold was never a parameter of distributing taxing rights between the countries. A minor tweaking of the tax certainty process could address the issue.

This article recommends giving the taxing right over Amount A of Pillar One, which covers the main portion of taxable profits from the digital economy to all the market jurisdictions, but to give rights related to affected tax jurisdictions only to those countries meeting the nexus thresholds. This approach will result in a fair distribution of taxing rights and will also ensure that there is no additional burden on the tax certainty process, which will be easier for developing countries.

1. Background

The Group of Seven (G7) has issued a communiqué on June 5[1] indicating their agreement on various aspects of Pillar One and Pillar Two. The meeting of Inclusive Framework is scheduled on June 30th and July 1st where various aspects of these pillars will be fiercely discussed and negotiated. There are a number of issues on which different stakeholders have different views.
One such open issue is "nexus". This article explains the issue and makes an attempt to give a solution which could be acceptable to all parties. Prima facie it may appear that a higher nexus threshold gives unfair treatment to smaller economies. However, in certain situations, this could deprive taxing rights even to larger economies.

[1] Available from https://www.gov.uk/government/publications/g7-finance-ministers-meeting-june-2021-communique/g7-finance-ministers-and-central-bank-governors-communique.

2. Nexus

Chapter 3 of the Pillar One Blueprint[2] deals with nexus. Nexus essentially indicates that the Multinational Enterprise (MNE) has a significant and sustained engagement with the market jurisdiction. In the absence of such engagement, the market jurisdiction (non-nexus country) would not be allowed taxing rights over Amount A[3].

The blueprint contemplates different nexus requirements for Automated Digital Services (ADS) and Consumer Facing Businesses (CFB). For ADS, nexus would be only in the form of revenue sourced from the market jurisdiction, say EUR 1mn. If the in-scope revenue sourced by the MNE, as per the revenue sourcing rules, from a particular country (market jurisdiction) exceeds this threshold, such country will be eligible for allocation of Amount A. The nexus requirement for CFB would be higher. It would be a monetary threshold (say Euro 2mn) and “plus factor”. The plus factor could be physical presence or simply higher revenue threshold.

Application of this nexus rule can be explained on the basis of the following example:

Example 1

<u>Facts:</u>

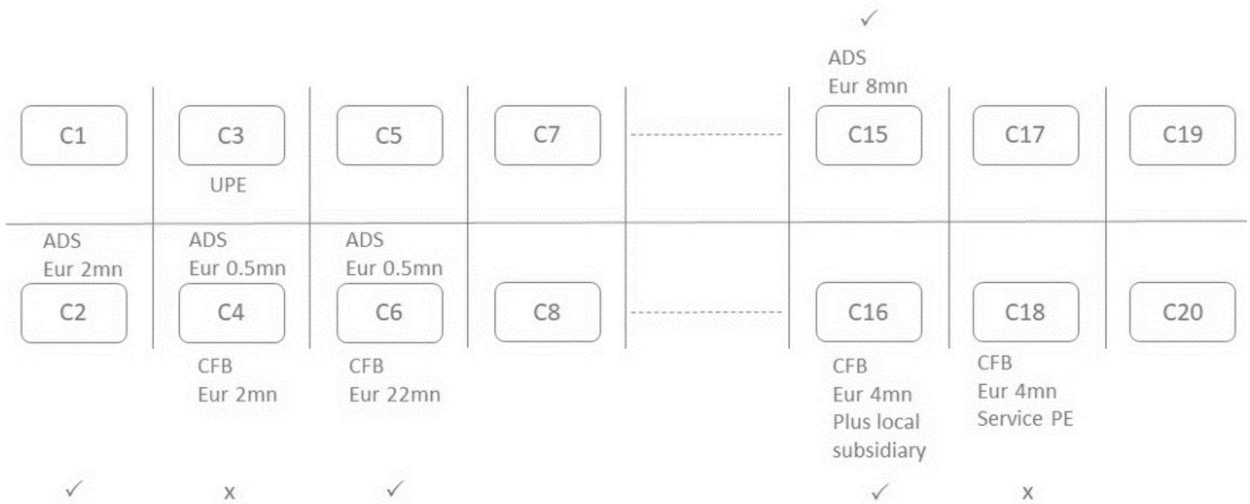
MNE Group A has presence in / derives revenue from twenty countries [Country 1 (C1) to Country 20 (C20)]. The Group satisfies both the global revenue threshold and de minimis foreign in-scope revenue threshold.

The nexus requirement and other data as regards presence and in-scope revenue, as per revenue sourcing rules, in certain countries are tabulated hereunder:

<table>
<tr><th>Nexus requirement (assumed)</th><th>Country</th><th>ADS Revenue (Euro mn)</th><th>CFB Revenue (Euro mn)</th><th>Physical presence</th></tr>
<tr><td rowspan="6">Requirement for ADS
Revenue of Euro 1mn
Requirement for CFB
Revenue of Euro 2.5mn
Plus factor – Physical presence [Article 5(1) PE i.e. fixed place of business or local subsidiary] or revenue of Euro 20mn</td><td>C2</td><td>2</td><td>0</td><td></td></tr>
<tr><td>C4</td><td>0.5</td><td>2</td><td></td></tr>
<tr><td>C6</td><td>0.5</td><td>22</td><td></td></tr>
<tr><td>C15</td><td>8</td><td></td><td></td></tr>
<tr><td>C16</td><td></td><td>4</td><td>Subsidiary</td></tr>
<tr><td>C18</td><td></td><td>4</td><td>NA</td></tr>
</table>

[2] The Organization for Economic Cooperation and Development, *Tax Challenges Arising from Digitalization-Report on Pillar One Blueprint* (Paris, 2020). Available from https://www.oecd-ilibrary.org/taxation/tax-challenges-arising-from-digitalisation-report-on-pillar-one-blueprint_beba0634-en.

[3] Amount A is an agreed fraction of residual profits of the MNE group which will be allocated amongst the market jurisdictions and the market jurisdictions will be able to levy tax on the amount so allocated even if there is no permanent establishment in such country or jurisdiction. As per the current proposal by the G7, 20% of the residual profit of the MNE Group will be treated as Amount A. Profits above 10% profitability margin will be treated as residual profits.



<u>Evaluation of Nexus</u>

Country	**Does Nexus exist**	**Remarks**
C2	Yes	ADS revenue exceeds threshold
C4	No	Neither ADS nor CFB revenue threshold met
C6	Yes	CFB revenue exceeds threshold and "plus factor" met
C15	Yes	ADS revenue exceeds threshold
C16	Yes	CFB revenue exceeds threshold and "plus factor" met
C18	No	CFB revenue exceeds threshold but "plus factor" not met. Service PE is not to be treated as "physical presence"

It can be observed that although the MNE derives revenue from C4 and C18, in the absence of nexus, these countries will not get taxing rights over Amount A.

3. Nexus rules for small and developing economies

Pillar One Blueprint acknowledges that for small developing economies lower nexus thresholds would be considered. The relevant paragraph is reproduced:

> *213. Depending on where revenue thresholds are set, consideration may also need to be given to using a lower nexus standard for small, developing economies. Given the size of their economies within the context of determining a significant and sustained engagement in the market, and the additional complexity in applying and verifying the plus factors for tax administrations with often very limited resources, both principles and practicalities may argue for further reflection. This may also need to involve considerations relating to compliance simplifications and administrative costs, including for other jurisdictions.*

It needs to be noted that even if lower revenue thresholds are set, it would still result in a situation where in some countries are deprived of taxing rights.

4. Does nexus result in a fair distribution of taxing rights?

Under the existing tax treaties, distribution of taxing rights is not dependent on any financial threshold. The source country is able to exercise its taxing rights under the tax treaty even for a single dollar. If that be the case, it certainly looks unfair that the source country / market jurisdiction will not be allowed taxing rights unless the MNE derives certain minimum revenue from that country.

It will be fair to note that this treatment looks unfair also because the nexus is expressed in monetary terms. For taxing rights on business profits, permanent establishment is “nexus” under the tax treaties. However, when compared with other sources of income, say interest, royalties etc. the source country has ability to tax even a single dollar. Accordingly, unfairness cannot be completely ruled out. Further, permanent establishment itself has failed as a nexus in the case of the digitalized economy.

5. Justification for denying taxing rights

Pillar One gives taxing rights where the MNE has a significant and sustained engagement with the market jurisdiction and denies taxing right when this engagement does not exist. This gets easily accepted when a permanent establishment is treated as a nexus. However, doubts do arise when nexus is simply expressed in the form of revenue derived from a country as per the revenue sourcing rules.

Interestingly, para. 188 of Pillar One Blueprint also appears to be giving a different dimension. This is reproduced hereunder:

> *The nexus rules design intends to protect the interests of smaller jurisdictions, and in particular developing economies, and their desire to benefit from the new taxing right. It recognises the need for low and proportionate compliance costs.*

This suggests that smaller jurisdictions and developing countries may find the compliance costs to be higher. Considering the complications involved in the group assessment process, via the panel based approach described in Chapter 9 of the Blueprint, it may be really difficult for the emerging small economies to participate in such processes due to limited capacity of the administration and related costs. Nonetheless, it may be difficult to understand how does the nexus rule design “*protect the interest of smaller jurisdictions and emerging economies*” by denying taxing rights.

6. Can absence of nexus deny taxing rights to large economies?

While the Blueprint suggests that nexus is an issue for smaller economies, it could deny taxing rights even to larger countries depending on the facts of the case.

In Example 1 analyzed above, the following additional assumptions can be made:

- C4 is a large economy, say a G7 country.
- The ADS product launched by the MNE is not yet completely introduced in C4.

- The MNE is testing the market in C4 and would introduce its product in the country in the next couple of years.

C4 will be denied taxing rights over Amount A in absence of satisfaction of nexus threshold. However, C4 is one of the largest countries / economies in the world and has all the resources and capabilities to participate in the group assessment processes described in Chapter 9 of the Blueprint.

7. Suggested approach – Allocation of Amount A without "affected tax administration" rights

7.1 Concept and role of affected tax administration

Tax administrations in other jurisdictions where the MNE group has a constituent entity and those where it has a market that meets the applicable threshold are jointly referred to as "affected tax administrations" in the Blueprint. The Blueprint contemplates involvement of affected tax jurisdictions in various tax certainty processes including the following:

- Exchange of original / corrected self-assessment return and documentation package with affected tax jurisdictions
- Opportunity to the affected tax administrations to review data and object to the stand taken by the MNE
- Inclusion of affected tax administrations in the comprehensive network for exchanging information
- Affected tax administration insisting setting up of a Review Panel
- Inclusion of affected tax administration in the Review Panel
- An affected tax administration not on the panel identifying a possible concern with an MNE group's Amount A allocation and raising it with the lead tax administration
- Submission of the Review Panel finding to the affected tax administrations not on the panel for their approval.
- Possibility of one or more affected tax administration not agreeing with the conclusion of the review panel and escalation to the determination panel
- Involvement of affected jurisdiction in the determination panel

Tax administrations need the desired level of capacity to participate in these processes. Further, involvement of a large number of jurisdictions in the processes also make it complicated and slow as there could be more objections from affected tax administrations.

7.2 No right to participate in tax certainty processes in absence of nexus

A simple approach to protect taxing rights of non-nexus countries could be to allocate Amount A but to deny rights to participate in the tax certainty processes. Under this approach:

- Amount A allocation will happen to all countries from where the MNE derives revenue as per the revenue sourcing rules (i.e. including countries where the MNE does not have nexus).
- Countries where the MNE has nexus are treated as affected tax jurisdictions and allowed to participate in the tax certainty process as laid down in the Blueprint.

- Countries where the MNE does not have nexus will not be allowed to participate in the tax certainty process. The relevant documents would however be shared with the tax administration of these countries.

This will ensure that all countries will get Amount A allocation and the tax certainty process would also not be burdened.

7.3 Trustee to protect rights of non-nexus countries

To ensure that the rights of countries without nexus are protected during the tax certainty processes, a Trustee may get involved in these processes. The concept of Trustee needs to be further developed for this purpose. Alternatively, the representative from the developing country on the Panels may be treated as a Trustee for this purpose.

7.4 Conclusion

The approach suggested in part 7.2 above is evaluated on various parameters.

- From the perspective of the non-nexus countries, they will not have any say in the tax certainty process and it may appear that they will be at the mercy of what others decide. However, as against having no taxing rights on Amount A or having no consensus on the Pillar One, it would be a far better result to have taxing rights on Amount A.

- From the perspective of the non-nexus countries, the suggested approach will neither put burden on limited capacity of the tax administration nor will it result in increased cost for the tax administration.

- From the perspective of ease of tax certainty process, there would not be added complexity or burden. It would only result in some additional excel sheet computations or sharing of relevant documents with some more countries (i.e. non-nexus countries) without these countries having the ability to participate in or object to the processes.

- From the perspective of the MNE, the MNE would get credit for taxes paid in the non-nexus countries and there will not be double taxation. It may appear that under this approach the MNE will have to do additional compliance in non-nexus countries. However, at a policy level it looks unreasonable to deny taxing rights to small countries merely because the MNE will have to indulge in additional compliance. When the MNE is earning revenue from these countries, and has customers and users in these countries, compliance with local laws would be justified.

- From the perspective of distribution of taxing rights, it looks unreasonable that some countries are denied taxing rights because the MNE has not earned adequate revenue from that country. Amount of revenue was never a parameter for distribution of taxing rights in tax treaties. Even if lower thresholds are adopted for small economies, there would still be some countries which would be left out from Amount A. Rule distributing taxing rights cannot discriminate between the countries in this manner.

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