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INSIGHT: Covid-19 and Transfer Pricing Implications for Digital Companies

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The Covid-19 crisis has, among other things, caused a rapid shift in consumer spending to online channels. Since the start of the pandemic, our use of remote and digital tools has become thoroughly integrated into our everyday life: online banking, video conferencing, remote education, video calls, online gaming, internet entertainment, to name but a few. This dramatic increase in digital services presents unique transfer pricing challenges that multinational entities (MNEs) should consider while planning to expand.

The Organization for Economic Cooperation and Development (OECD) has been working on the question of how tax generated from digital activities should be allocated among the member nations and is hoping to deliver the Unified Approach by the end of 2020. In the interim, many countries have taken unilateral measures (e.g., digital services taxes or (DST) that might result in double taxation for some companies.

In this article, we describe the approach that OECD is working on, the unique transfer pricing challenges faced by digital economies, and what MNEs could consider in the interim until the OCED recommendations are finalized and generally accepted.

Recent Transfer Pricing Developments and Current Digital Services Tax

Starting 2015, the OCED began working on its Base Erosion and Profit Shifting Project (BEPS), which, among other things, identified the tax challenges of the digital economy as one of its focus areas. The BEPS project led to a significant revision in the OCED's transfer pricing guidelines that sought to align transfer pricing outcomes with value creation in various tax jurisdictions.

The OECD is working on the unique transfer pricing issues created by the digital economy. In 2019, the OECD, as a part of its Program of Work, started developing a consensus through a two-pillar approach—with Pillar 1 focusing on nexus and profit allocation and Pillar 2 on ensuring a minimum level of taxation.

As a part of Pillar 1, the OECD agreed to arrive at a consensus-based solution by the end of 2020. This "Unified Approach" provides for a three-tiered mechanism of profit allocation that would tax the multinationals, within the scope of the new nexus, on three categories (i.e., Amounts A, B, and C) of group-wide profit in market jurisdictions:

- Amount A is each country's "new taxing right" regardless of whether a consumer-facing business has a physical presence in that country. Amount A is calculated as a "share of deemed residual profit allocated to market jurisdictions using a [yet to be determined] formulaic approach."

- Amount B is a "[yet to be decided] fixed remuneration for baseline marketing and distribution functions that take place in the market jurisdiction" instead of traditional transfer pricing methods.

- Amount C provides a dispute resolution mechanism for taxpayers and tax authorities to adjust the profit allocation outcome that could be arrived under Amount B. Either party could argue that, based on the arm's-length principle, the returns for the activities performed in the jurisdiction should be higher than the fixed return allocated under Amount B.

The OECD, despite the Covid-19 challenges, has been continuing its efforts to harmonize global tax rules. The

OECD has been working on a blueprint that it hopes to make public in October of this year. It has been reported that, in the blueprint, OECD will propose dropping Amount C and retaining only Amounts A and B. The blueprint, among other things, discusses the reasons underlying the change and offers alternate dispute prevention and resolution mechanisms.

While the OECD continues its work, many governments have enacted digital services taxes as an interim measure. The underlying rationale provided by governments is that digital businesses derive enormous value from their citizen-users participating on the digital platforms of such companies both directly and through ''network effects.'' In Europe, about half of the countries have either announced, proposed, or implemented DST, ranging from 2% in the U.K. to 7.5% in Turkey. Several countries outside Europe (e.g., India, Indonesia) have imposed DST as well.

Most of the countries are implementing DST on a transactional basis—by targeting the digital transactions that occur in their jurisdictions, regardless of an entity's physical presence. However, there are differences among nations as to which transactions would be included in determining the revenue base for DST. Every country's applicable tax base, though broadly targeted to include revenues from digital activities, diverges with regard to the exact transactions that would be included. For example, a review of the European nations that have implemented or proposed DST reveals that each nation's applicable tax base varies to include revenues from one or more of the following categories: *online advertising, online marketplace, social media platforms, internet search engine, provision of user data, sale of user data, targeted advertising, use of multilateral digital interfaces, advertising services based on users' data, advertising revenues, the transmission of user data generated from using a digital interface, audiovisual media service, and commercial audiovisual communication, and online services including advertisements, sales of content, and paid services on social media websites*.

Transfer Pricing Challenges For Digital Activities

The OECD's 2017 transfer pricing guidelines purportedly seek to align value attributed to a jurisdiction with ''key functions performed, important risks assumed, and important assets used'' in that jurisdiction. Several commentators view that the revised guidelines are not consistent with the arm's-length standard. We do not address this issue in this article.

Given the interconnectedness of functions performed and the assets used by digital companies in different jurisdictions, it is a daunting task to identify the value created by a particular location. For example, as the Australian Treasury recognizes, ''The profits of businesses that derive value from user participation are the result of a range of inputs, including intellectual property and the contribution of capital by the owners of the relevant businesses.''

To understand this complexity, consider the hypothetical example of a global digital advertising/shopping company—Company X. Company X analyzes several aspects of customer behavior, such as the content that a customer has browsed, the time a customer has spent browsing each page, the items that a customer ends up purchasing, and the contents of such a customer's product reviews. Utilizing this data, Company X runs predictive algorithms to understand customer behavior and make relevant recommendations.

Such data, while being generated locally, could be transmitted to data servers in other locations, for use after consolidation across geographic markets. Data consolidation across markets would allow a company to understand trends unique to the local markets in which it operates and to gather valuable insights regarding products and customers across geographies. Subsequently, Company X could rely on some ''general'' insights gleaned from the data aggregated from its previously established markets to enter new markets in different jurisdictions. In short, assessing and assigning value attributable to user participation in various geographies is challenging. As the OECD acknowledges, ''there are differences of opinion on whether and the extent to which data and user participation represent a contribution to value creation.''

A digital business model (especially when it involves consolidation or flow of data across jurisdictions) complicates the value delineation process since apportioning the combined value created by users across geographies to users in specific jurisdictions is challenging:

- When data is consolidated across countries, different markets/users may contribute differently to the volume and quality of user content.

- Insights based on user data from one or more countries contribute to the revenue generation in other markets. For example, insights gleaned from mature or advanced online markets could be used in newer markets with no established data. Further, such insights could be applied differently to suit different markets.

- Different businesses rely on user-generated data in different ways. For example, while some companies rely heavily on user content, others (e.g., booking websites) may not.

- Newer digital business models use artificial intelligence and machine learning, making it difficult to assess the degree of reliance on user-generated data.

Besides, the value delineation is complicated by the ecosystem of hardware, software, and services located in different geographies enabling the various digital activities required to create the final value.

What Can MNEs Do in the Interim?

As evident from above, the complexity in digital value delineation is a challenge of enormous proportions and not likely to be resolved quickly. It will probably be some time before the revised profit allocation tax rules are both finalized and generally accepted by all stakeholders. While MNEs have no control over when the OECD revised profit allocation rules will be harmonized, they can brace themselves for the DST-related changes in the interim, from an operational, strategic, and financial planning perspective. Below, we discuss some recommendations for MNEs.

- **Assess activities**: Given the differing views of what each country considers taxable, MNEs should assess as to what activities might fall within the scope of the new DST on a country-by-country basis. Some countries might choose to include new activities as a part of their ''in-scope'' revenues, based on what some of their peers have included. It might be helpful for MNEs to proactively work with the relevant tax authorities to arrive at a mutual understanding regarding the scope of the taxable base. Given the fluidity of new tax laws, MNEs should consider proactively assessing their policies, maintain required documentation, and be audit-ready.

■ **Build scalable systems**: MNEs that have a substantial digital presence or are planning new digital activity should consider, at a minimum, putting systems in place that would make it easy to identify relevant sales in all major geographies. The sales identification by geography and by activity is critical irrespective of whether an MNE has (or plans to have) a physical presence in a location. Rather than taking a myopic approach and setting up systems that extract information only for the revenues/segments that are currently affected, it might help to build a scalable long-term solution that can easily address any changes to the activities considered to fall within the scope of the taxable base. Further, given that some countries (e.g., France) have implemented DST retroactively, some MNEs may lack the compliance systems needed to extract the required information and should consider identifying ways to measure retroactive ''in-scope'' revenues, if the need arises.

■ **Budget for costs**: While some MNEs might choose to pass on DST-related costs to their sellers, others might choose not to. The choice is likely to be determined largely by market conditions. The combined financial impact of the new and retroactive digital taxes, along with any potential double taxation, will need to be considered.

■ **Prepare for disputes**: Even if the OECD finalizes its Unified Approach in the near future, there is plenty of scope for disagreement among the jurisdictions or between tax authorities and taxpayers. If, as noted in the blueprint, Amount C is done away with, the stakeholders would need to access alternate dispute resolution mechanisms.

The above recommendations, though simple conceptually, could pose a considerable burden on some MNEs from an implementation and execution viewpoint.

Summary

The OECD has been trying to resolve the question of how taxes generated from digital activities should be allocated among the member nations for several years and is hoping to deliver the Unified Approach by the end of 2020.

In the interim, two significant events have occurred: (a) several MNEs have leveraged Covid to enter new digital markets and/or expand their existing digital footprint, and (b) many governments have introduced DST.

Even after the OECD finalizes the Unified Approach, there is plenty of scope for disagreement among stakeholders and room for a delay before the new guidelines are generally accepted. Further, as revenue-starved economies try to recover from Covid, governments might find it hard to forego lucrative DST revenues, especially if the new tax apportionment codes do not yield the results they desire.

Against such a backdrop, MNEs are likely in for a long stretch before the DST in various countries are replaced with harmonized international transfer pricing guidelines. Given the complexity of such issues, MNEs should study existing and planned digital activity with a new lens as they chalk their broader business strategy. Moving forward, MNEs can expect tighter scrutiny and might need to increase efforts to assess, plan for, and comply with changes, as well as factor in these additional costs into strategic decision-making.

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