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International tax alert

OECD BEPS Action 1: The digital economy

April 1, 2014

The Organisation for Economic Co-operation and Development (OECD) released a discussion draft on March 24, 2014 as part of its base erosion and profit shifting (BEPS) Action Plan, in relation to Action 1, Tax Challenges of the Digital Economy. The discussion draft includes the preliminary results of the work carried out by the Task Force on the Digital Economy.

The document does not represent a consensus view from the G20/OECD countries involved but is designed to provide substantive details for public comment.

Challenges and proposals

The discussion draft identifies four main policy challenges arising from the digital economy:

Nexus: The continual increase in the potential of digital technologies is coupled with a reduced need for extensive physical presence in order to carry on business.

Data: The growth in sophistication of information technologies has permitted companies in the digital economy to gather and use information to an unprecedented degree. This raises the issues of how to attribute value created from the generation of data through digital products and services, and how to characterize such increase in value for tax purposes.

Characterization: The development of new digital products or means of delivering services creates uncertainties in relation to the proper characterization of payments made in the context of these new business models.

Value added tax (VAT) collection: Cross-border trade in both goods and services creates challenges for VAT systems, such as Canada's goods and services tax regime, particularly where such goods and services are acquired by private consumers from suppliers abroad.

The discussion draft identifies the administrative challenges of taxing the remote provision of services, as well as the potential to levy tax based on virtual presence, and proposes a framework for evaluating options to address the broader tax challenges raised by the digital economy. The proposed framework is based on the 1998 Ottawa Taxation Framework Conditions from earlier work in this area. The principles are neutrality, efficiency, certainty and simplicity, effectiveness and fairness and flexibility.

Findings

The discussion draft examines the evolution over time of information and communication technology, including examples of new business models, and identifies the key features of the digital economy. It identifies the challenges of segmenting the digital economy and confirms that treating digital business as separate from more traditional businesses for tax purposes would be difficult, if not impossible.

The task force recognizes that many BEPS concerns apply equally to digital and traditional businesses, and anticipates that the development of the other Actions in the BEPS Action Plan will help to address concerns regarding the digital economy. These include, in particular:

Prevent the artificial avoidance of permanent establishment (PE) status (Action 7): The work to be done to limit artificial avoidance of PE status may assist countries where changes to the definition of PE allow them the right to tax sales. This work will review whether sales are concluded by dependent agents as well as the specific exemptions from PE status for certain activities such as warehousing of physical products for quick delivery to customers.

Limit base erosion via interest deductions and other financial payments (Actions 4 and 9): Deductions for excessive intra-group interest paid to low tax jurisdictions will be considered as part of the work on Action 4, and will apply equally to the funding of innovative digital businesses.

Counter harmful tax practices more effectively (Action 5): This work will look at intangibles regimes to determine whether they are harmful, focusing on the need for substantial activity.

Ensure that transfer pricing outcomes are in line with value creation (Actions 8-10): The BEPS work on transfer pricing, and particularly intangibles, will be key to assisting with the work on the digital economy. The objective is to appropriately reflect the value of intangibles if they are transferred intra-group, and to align income from intangibles with the economic activity that generates it. In addition, clearer guidance on global value chains and when it is appropriate to use a profit split method will be relevant to some digital businesses.

In addition, the discussion draft notes that the VAT collection challenges created by cross-border trading are also magnified by the digital economy as consumers and businesses can buy from - or sell to - any country, and specifically identifies: imports of low value parcels from online sales and the growth in cross-border supplies of remotely delivered digital services. The borderless nature of the digital economy produces specific administrative issues around identification of businesses, determination of the extent of activities, information collection and verification, and the identification of customers.

Potential options proposed to the task force

Several options have been proposed to the task force. These include the matters discussed above in relation to other Actions, and also:

- The creation of a PE for fully dematerialized digital activities based on a "significant digital presence" even where there are no people activities
- A "virtual permanent establishment" concept, such as one based on the maintenance of a website or technological conclusion of contracts or through other on-site services at the customer's location

- A withholding tax on payments made for digital goods or services
- The lowering of the threshold for low value imports and the requirement that vendors register and account for VAT in the jurisdiction of importation
- The requirement that non-resident suppliers of remote digital business to consumer supplies register and account for VAT in the jurisdiction of the consumer (as implemented in the European Union 2015 place of supply changes)

Timetable and next steps

The OECD has requested comments on the discussion draft by April 14, 2014. A public consultation event will be held at the OECD on April 23, 2014 before finalization at the G20 meeting on September 20 and 21, 2014. Further work on matters related to the digital economy will be carried out by the teams looking at the other specific Actions.

Deloitte's comments

The discussion draft emphasises the reliance on the other measures in the BEPS Action Plan to address concerns in relation to the digital economy.

Difficulties include determining rules for the attribution of profit to PEs or the approach to profit splits for digital businesses, in particular where significant people functions exist in countries other than that of the market. Withholding taxes and other revenue-level taxes are always problematic; for some businesses, they will be too high relative to overall margins, and for others may be too low. The rapid evolution of technology also brings challenges, and designing a tax system that will remain appropriate is a significant challenge. It is critical that the implementation of the BEPS proposals be both practical and simple for businesses to adopt so as not to create an unreasonable compliance burden for a small gain in neutrality, and to ensure that the further development of the digital economy is not discouraged.

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