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28 March 2013

For comments on Action 1, see **the highlighted text below**.

BEPS

Well, the big story in BEPS this week is, of course, the discussion draft which was issued by the OECD on Action 1 (the digital economy).

The draft was issued on 24 March, and it runs for 81 pages.

And I think it's fair to say that it is somewhat different from the other three discussion drafts which the OECD has issued on BEPS in the last few weeks.

Just to remind you : The OECD, first of all, issued a discussion draft on Action 6 (preventing treaty abuse) on 14 March. And then on 19 March, the OECD released two related discussion drafts on Action 2 (hybrid mismatch arrangements).

Those other three discussion drafts all contain specific proposals for changes to the OECD model treaty or to domestic law. In fact, in regard to the proposed treaty changes, the OECD has largely given us the draft provisions.

But the digital economy discussion draft does not give us concrete, specific proposals. It's more of a, well, discussion draft. It identifies issues, it discusses issues, it puts forward some potential responses - but it doesn't actually give us specific proposals. For that, we will need to wait for the next instalment.

Let me summarise what the document says, and then I'll come back to this lack of specific proposals.

The discussion draft consists of seven chapters.

Chapter I is an introduction.

Chapters II and III, which occupy about 30 pages, describe the emergence and key features of the digital economy.

Chapter IV identifies the opportunities for BEPS-like tax planning in the digital economy.

Chapter V discusses the impact (on BEPS planning in the digital economy) which will be caused by all the other Actions in the BEPS Project.

Chapter VI describes the broader tax challenges raised by the digital economy.

And finally, **Chapter VII** identifies potential options to address those broader challenges.

So, in essence, the discussion draft is making **two key points** :

- The **first** is that a lot of BEPS-like tax planning, which is undertaken in the digital economy, will be significantly limited by all the other Actions within the BEPS Project.

- And the **second** is that that will not be sufficient : more will need to be done to restrict BEPS-like tax planning in the digital economy – and the draft gives some possible options to do that.

But before it gets into those points, the document addresses an important threshold issue : just what is "the digital economy"?

The document states that it is not possible to identify a digital economy that is somehow separate from the traditional economy - both are entwined with each other. The OECD puts it this way :

"As digital technology is adopted across the economy, segmenting the digital economy is increasingly difficult. In other words, because the digital economy is increasingly becoming the economy itself, it would be difficult, if not impossible, to ring-fence the digital economy from the rest of the economy. Attempting to isolate the digital economy as a separate sector would inevitably require arbitrary lines to be drawn between what is digital and what is not…."

- **<u>First key point</u>**
- **Let's now have a closer look at the first of these two key points : in other words, a lot of BEPS-like tax planning, which is undertaken in the digital economy, will be significantly impacted by all the other Actions within the BEPS Project.**

  This topic is discussed in Chapters IV & V : chapter IV sets out the tax planning, and chapter V describes how the other Actions in the BEPS Project will address that planning.

  And both chapters look at tax planning at different levels : at the level of the market jurisdiction, at the level of the intermediate jurisdiction, and at the level of the ultimate parent.

  For example, in regard to tax planning to eliminate or reduce tax in the market jurisdiction, chapter IV refers to the common strategy of avoiding a taxable presence - which, of course, has always been a cornerstone of international tax planning, long before the rise of the digital economy. But the discussion draft then goes on to say :

  "However, while the ability of a company to earn revenue from customers in a country without having a PE in that country is not unique to digital businesses, it is available at a greater scale in the digital economy than was previously the case. Where this ability, coupled with strategies that eliminate taxation in the State of residence, results in such revenue not being taxed anywhere, BEPS concerns are raised."

  The response to that type of planning is in chapter V, which says that Actions 6 (prevent treaty abuse) and 7 (prevent the artificial avoidance of PE status) will both restrict that type of "no PE" planning.

  Not surprisingly, the OECD asserts that a significant adverse impact on BEPS planning will be inflicted by the collective force of all of the other Actions.

  Let me quickly take you through the OECD's support for that assertion.

  As I said, it firstly looks at the impact on tax planning at the level of the <u>market jurisdiction</u>. And it points to BEPS Actions 6 and 7 and it says that, collectively, those two Actions should, in its words, "restore taxation in the market jurisdiction".

  It then looks at Actions that will restore taxation in <u>both market and ultimate parent jurisdictions</u>. Here, it points to six of the BEPS Actions : Action 2 (hybrid mismatch arrangements), Action 4 (limiting base erosion via interest deductions), Action 5 (counter harmful tax practices), and Actions 8 to 10 on transfer pricing.

  And then it looks at Actions that will restore taxation in the <u>jurisdiction of the ultimate parent</u>. Here, it points to Action 3 (strengthen CFC rules).

- **<u>Second key point</u>**
- **But the discussion draft seems to acknowledge that those other BEPS Actions will not be sufficient to adequately deal with the tax challenges of the digital economy.**

For example, take Action 7 (prevent the artificial avoidance of PE status). The scope of Action 7 refers to possibly limiting the exceptions to PE status in Article 5(4) and also to addressing commissionaire structures. Neither of those steps would create a taxable presence for many business models in the digital economy. Something more fundamental would need to be done.

So, in Chapter VII, the discussion draft sets out a list of potential options.

And the OECD is careful to put in a caveat at the start. It states :

“It is anticipated that the final report on the tax challenges of the digital economy [which is due by September 2014] will analyse a number of potential options to address the broader tax challenges raised by the digital economy. These options will include several that have already been proposed to the Task Force, as well as options that may be proposed by stakeholders in response to this discussion draft. It is anticipated that the final report will develop the options in substantial detail and analyse the pros and cons of each.”

So, here is the list of potential options :

- Number 1 : Modifications to the exceptions from PE status – by trimming down Article 5(4) or perhaps even deleting Article 5(4) entirely.
- Number 2 : A new nexus based on the concept of “significant digital presence”.
- Number 3 : A so-called “virtual permanent establishment”.
- Number 4 : A withholding tax on digital transactions.
- And number 5 : VAT options.

"Significant digital presence"

Let’s have a closer look at number 2, the “significant digital presence”.

And here the OECD has coined an interesting new term : “fully dematerialised digital activity”.

And for every term, there must be an acronym. “Fully dematerialised digital activity” is difficult to turn into an acronym, but I’m going with FU-DDA. Not to be confused with the FUBAR [FBAR] from the US.

It essentially refers to a supplier of digital goods or services, where no physical presence is required in the market country – it’s all on-line.

The discussion draft sets out 8 potential elements of what is FU-DDA (“fully dematerialised digital activity”). You can see them here on the slide. I won’t read them out, but if you want to study them, just hit the pause button.

If you do have a FU-DDA, then you will have a “significant digital presence” in a market country (and, thus, a taxable presence there) if you have a substantial amount of commercial activity in respect of that country. The discussion draft says that that would be tested in a number of different ways – for example : your digital goods or services are widely used or consumed in the country.

The OECD makes the following comment in regard to this “significant digital presence” concept:

“Development of [this option] would require evaluation of the [8 potential elements] to determine which combination of factors would result in an appropriate nexus to address the tax challenges of the digital economy effectively, while providing enough clarity to minimise potential dispute. It would also require consideration of how profits would appropriately be attributed, and whether doing so would require modification of the current rules for the attribution of profits to PEs. The work would also need to consider whether such a change would require a change in the attribution rules for all enterprises, or whether changes could be limited to fully dematerialised digital businesses.”

"Virtual permanent establishment"

Let's have a closer look at number 3, the so-called "virtual permanent establishment".

This concept has been borrowed from the work done over 10 years ago by a Technical Advisory Group (TAG) on e-commerce. The OECD says that it has been included in the discussion draft "for completeness" – which doesn't convey a high level of confidence that it will be aggressively pursued.

The TAG considered three broad alternatives :

- A "virtual fixed place of business PE"
- A "virtual agency PE"
- And an "on-site business presence PE"

Withholding tax on digital transactions

Number 4 on the options list is the creation of a withholding tax on digital transactions.

This would be a final withholding tax on certain payments made by residents of a country for digital goods or services provided by a foreign e-commerce provider.

The OECD says this :

"In considering this type of option, the Task Force will need to consider … how to address the challenges of withholding such a tax in the case of transactions with individual consumers. Since international payments for digital economy transactions are generally made using credit cards or electronic payments, one option to be considered would be to require withholding by the financial institutions involved with those payments."

VAT options

And the final option on the OECD's list concerns VAT.

Here, the discussion draft focuses on two issues :

- Firstly : VAT exemptions for imports of low valued goods
- And secondly : inbound B2C transactions – or, as the OECD calls it, "remote digital supplies to consumers"

Lack of specific proposals

I mentioned earlier that the digital economy discussion draft is quite different from the other BEPS discussion drafts which have been issued in recent weeks, in that it doesn't contain any specific proposals.

Is that surprising?

Well, perhaps it's not.

The other discussion drafts (preventing treaty abuse and hybrid mismatch arrangements) concern relatively uncontroversial topics. I would not imagine that there was a great deal of conflict in the drafting meetings.

In contrast, deciding what to do with the digital economy is a topic of great conflict : from the minimalist approach which is advocated by the US, to more aggressive approaches which are supported by several countries, including France and the UK. In fact, as an aside, I noticed that in the BEPS position paper which the UK government published as part of its Budget last week,

there is a statement that the UK will take unilateral measures in regard to the digital economy "if progress on updating the existing international framework fails to materialize" – and no pun intended.

So more conflict means a true discussion of options (or, perhaps if you're a cynic, a kicking of the can down the street), rather than concrete, specific proposals.

The OECD has asked for comments by 14 April.

If you would like to obtain a copy of the discussion draft, visit BEPS Central by following the link in the summary slides at the end of this video.

And don't forget to tune in to the OECD's next BEPS webcast, which is scheduled for next Wednesday, 2 April at 3pm Paris time.