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International Tax

United States Tax Alert

March 26, 2014

OECD Releases BEPS Draft on the Digital Economy

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On March 24, 2014, the OECD released a public discussion draft on Action 1 of its Action Plan on Base Erosion and Profit Shifting (BEPS). Comments on the draft are to be sent to the OECD by Monday, April 14, 2014, three weeks from its release date. A public consultation meeting is scheduled for April 23, 2014. It is important to note that the recommendations set out in the draft do not represent the consensus views of the Committee on Fiscal Affairs or the Task Force on the Digital Economy.

Action 1 calls for the OECD to:

> "Identify the main difficulties that the digital economy poses for the application of existing international tax rules and develop detailed options to address these difficulties, taking a holistic approach and considering both direct and indirect taxation. Issues to be examined include, but are not limited to, the ability of a company to have a significant digital presence in the economy of another country without being liable to taxation due to the lack of nexus under current international rules, the attribution of value created from the generation of marketable location relevant data through the use of digital products and services, the characterization of income derived from new business models, the application of related source rules, and how to ensure the effective collection of VAT/GST with respect to the cross-border supply of digital goods and services."

The draft can be conceptually divided into four main areas of discussion:

- Background on the digital economy,
- Perceived opportunities for BEPS within the digital economy,
- Ways of addressing BEPS with respect to the digital economy (which largely focuses on the manner in which the other action items will address such concerns), and
- A discussion of the "potential options to address the broader tax challenges raised by the digital economy."

The proposed options discussed in the draft are:

1. Amendments to the permanent establishment definition,
2. Withholding taxes on digital transactions, and
3. Consumption tax (VAT) options

Amendments to the Permanent Establishment Definition

Modifications to the Preparatory and Auxiliary Exception

Several options in the draft would modify or eliminate the exceptions from permanent establishment with respect to preparatory and auxiliary activities.

The first option would eliminate the exception for preparatory and auxiliary activities for "certain businesses" where the following activities constitute core functions of the business:

- The use of facilities solely for the purpose of storage, display or delivery of goods or merchandise belonging to the enterprise;

- The maintenance of a stock of goods or merchandise belonging to the enterprise solely for the purpose of storage, display or delivery;

- The maintenance of a stock of goods or merchandise belonging to the enterprise solely for the purpose of processing by another enterprise;

- The maintenance of a fixed place of business solely for the purpose of purchasing goods or merchandise, or of collecting information, for the enterprise.

These "certain businesses" are not defined, just as the "digital economy" is undefined in the draft. Variations on this option are also discussed, including the elimination of the preparatory and auxiliary activities exception entirely.

Defining Permanent Establishment to Mean Significant Digital Presence

This option would provide that if an enterprise engaged in certain "fully dematerialized digital activities", then it could have a permanent establishment if it maintained a "significant digital presence" in the economy of another country. The draft describes some potential elements of when a "fully dematerialized digital activity" is conducted, including, for example:

- The core business of the enterprise relies completely or in a considerable part on digital goods or digital services;

- No physical elements or activities are involved in the value chain other than the existence, use, or maintenance of servers and websites or other IT tools and the collection, processing, and commercialization of location-relevant data; or

- Contracts are concluded remotely, exclusively via the Internet or by telephone.

If an enterprise was engaged in a fully dematerialized digital business, a permanent establishment would be deemed to exist if the business maintained a "significant digital presence." For example, a significant digital presence could exist when “a significant number of contracts for the provision of fully dematerialized digital goods or services are remotely signed between the enterprise and a customer that is resident for tax purposes in the country.”

Virtual Permanent Establishment

The draft also reproduces a few options for an alternative permanent establishment standard that have been previously discussed in other contexts and indicates it is adding them to the draft for completeness.

- “A ‘virtual fixed place of business PE’, which would create a permanent establishment when the enterprise maintains a website on a server of another enterprise located in a jurisdiction and carries on business through that website;

- A ‘virtual agency PE’, which would seek to extend the existing dependent agent PE concept to circumstances in which contracts are habitually concluded on behalf of an enterprise with persons located in the jurisdiction through technological means, rather than through a person; and

- An ‘on-site business presence PE’, which would look at the economic presence of an enterprise within a jurisdiction in circumstances in which the foreign enterprise provides on-site services or other business interface at the customer’s location.”

Withholding Tax on Digital Transactions

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

Consumption Tax Options

With regard to the application of VAT to digital commerce, the discussion draft outlines two potential options. The first would be to reduce or eliminate the generally available exemptions for imports of low valued goods. The second option would require a non-resident supplier to register and account for the VAT on supplies sold in the jurisdiction of the consumer. The draft recognizes the compliance burden involved and recommends simplified registration regimes and registration thresholds. In addition, the draft states that enhanced governmental enforcement activities related to non-resident suppliers would likely be required, involving exchange of information, assistance in recovery and simultaneous audits.