United Kingdom

BEPS Action 1: Address the tax challenges of the Digital Economy

On 16 September 2014, ahead of the G20 Finance Ministers' meeting on 20-21 September, the OECD published seven papers as a first tranche of deliverables under the Base Erosion and Profit Shifting ('BEPS') Project. The OECD will be continuing its work on the remainder of the 15 Actions on BEPS throughout 2015. It is clear that the G20 and OECD governments intend that recommendations under each of the BEPS Actions will form a comprehensive and cohesive approach to the international tax framework, including domestic law recommendations and international principles under the model tax treaty and transfer pricing guidelines. As a result, the proposed solutions in the first seven papers, while agreed, are not yet finalised and may be affected by decisions and future work on BEPS in 2015.

Deloitte Comments and Next Steps

The Digital Task Force has issued its paper on 'Addressing the Tax Challenges of the Digital Economy'. The paper concludes that there is no separate digital economy, distinct from other more traditional areas, and does not recommend a specific separate digital tax regime at this stage. Instead, the Task Force recognises that work being undertaken by the OECD in relation to other BEPS areas may address concerns in relation to the digital economy, notably in relation to the work on permanent establishments and transfer pricing of intangibles. The OECD will consider the attribution of profit to permanent establishments or the transfer pricing profit split methodology for digital businesses, in particular where significant people functions exist in countries other than the market (customer) country. The Task Force's mandate will be extended to monitor the outcome for digital businesses and will, if necessary, consider further steps if base erosion and profit shifting remain issues in the digital sector. In this regard, a number of options have been proposed to the Task Force have not yet been evaluated. A supplementary report reflecting the outcomes of the additional work and the final evaluation of the options is expected by December 2015.

In relation to indirect tax, measures have already been taken by EU member states to address perceived VAT leakage resulting from the growth and complexity of digital and e-commerce arrangements, particularly in relation to sales to consumers, including the place of supply of services changes that will apply from 1 January 2015.

The rapid evolution of technology also brings difficulties, and designing a tax system that will remain appropriate is a significant challenge. It is critical that the implementation of the BEPS proposals are both practical and simple for businesses to adopt so as not to create an unreasonable compliance burden for a small gain in neutrality, which, if disproportionate, will in turn, discourage the further development of the digital economy. Of the options proposed to the Task Force and not yet evaluated, none are very attractive in terms of either neutrality or practicality. Withholding taxes and other revenue-level taxes are always problematic, for example, as for some businesses they will be too high relative to overall margins, and for others may be too low.

Tax policy challenges raised by the digital economy

The report examines the development of technology and analyses the key features of business in the evolving economy. It identifies the challenges of segmenting the digital economy and concludes that treating 'digital' as separate from more traditional businesses for tax purposes would be difficult, if not impossible. Four main digital economy policy challenges are identified that need to be addressed by the BEPS work:

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

Data: The growth in sophistication of information technologies has permitted companies 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 characterise it for tax purposes.

Characterisation: The development of new digital products or means of delivering services creates uncertainties in relation to the characterisation of payments made in the context of new business models.

VAT collection: Cross-border trade in both goods and services creates challenges for VAT systems, particularly where such goods and services are acquired by private consumers from suppliers abroad.

Interaction with other BEPS work

The Task Force on the Digital Economy recognises that many BEPS concerns apply equally to digital and traditional businesses, and anticipates that the work on the other Actions in the BEPS Action Plan will help to address some BEPS concerns that arise in relation to the digital economy. These include, in particular:

Prevent the Artificial Avoidance of Permanent Establishment Status (Action 7): Changes to the definition of permanent establishment could allow market countries the right to tax local sales. This Action will look at artificial arrangements involving the conclusion of contracts and also the specific exemptions from permanent establishment status for certain activities such as warehousing of physical products for delivery to customers.

Limit Base Erosion via Interest Deductions and Other Financial Payments (Actions 4 and 9): Any restrictions on deductions for excessive interest from these Actions, whether in respect of related-party or third-party debt and inbound or outbound investment scenarios, would apply equally to the funding of innovative digital businesses. The task force suggests that a formulary type of approach which ties deductible interest payments to external payments will be considered, alongside other approaches.

Counter Harmful Tax Practices More Effectively (Action 5): This work will look at intangibles regimes to see if they are harmful, focussing on the need for substantial activity.

Assure that Transfer Pricing Outcomes are In Line with Value Creation (Actions 8, 9 and 10): The work on transfer pricing, and particularly intangibles, will be key to assisting in relation to valuable intangibles within innovative digital businesses. The objective is to 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.

Consumption Taxes: The report notes the VAT collection challenges created by cross-border trading are 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 potential options have been 'proposed to' the Task Force and work to evaluate them will be carried on alongside the rest of the BEPS work. The report proposes a framework for evaluating the options based broadly on the 1998 Ottawa taxation framework, the key principles being **neutrality**, **efficiency**, **certainty and simplicity**, **effectiveness and fairness**, **flexibility and sustainability**, and **proportionality**. The options proposed are:

- Modification to the exemptions from creating a permanent establishment for activities that were previously preparatory or auxiliary in the context of conventional business models, which may have become core functions of digital businesses;
- Creation of a permanent establishment for fully dematerialised digital activities based on a 'significant digital presence'. To address administrative concerns, minimum thresholds would be considered, potentially measured by reference to numbers of contracts, users and/or levels of consumption in local countries;
- Replacement of the existing permanent establishment concept with a 'significant presence' test to reflect the contribution of close customer relationships. The criteria could include: (i) the presence of long-term relationships with customers or users combined with some local physical presence, directly or via a dependent agent (ii) sales of goods or services through websites in local languages, offering local delivery etc, or (iii) supplying goods and services resulting from systemic data-gathering from persons in a country;
- A withholding tax on payments made for digital goods or services;
- A bandwidth or "bit" tax, based on the number of bytes used by a website, creditable against corporate tax;
- Lower thresholds for low value imports and requiring vendors to register and account for VAT in the jurisdiction of importation, facilitated by simplified, clear and accessible registration mechanisms; and
- Requiring non-resident suppliers of remote digital business-to-consumer supplies to register and account for VAT in the jurisdiction of the consumer (as implemented in the EU 2015 place of supply changes), recognising the importance of the VAT expertise of third-party intermediaries to small and medium entities in particular.

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