THE O.E.C.D.'S APPROACH TO B.E.P.S. CONCERNS RAISED BY THE DIGITAL ECONOMY

Authors
Stanley C. Ruchelman
and Alev Fanny Karaman

Tags
O.E.C.D.
B.E.P.S.
Digital Economy

On March 24, 2014, ten days after the O.E.C.D. released its public discussion draft on prevention of treaty abuse,[4] a second public discussion draft was released, addressing the tax challenges of the digital economy (the "Discussion Draft").[5]

The Discussion Draft emphasizes the concept that the digital economy should not be ring-fenced and separated from the rest of the economy, given its relationship to the latter. It provides a detailed introduction to the digital economy, including its history, components, operations, and different actors. Surprisingly, it does not propose any groundbreaking approaches to addressing the base erosion and profit shifting ("B.E.P.S.") challenges encountered in the digital economy. It simply reflects an approach that is consistent with the fight against B.E.P.S. – seeking to determine where economic activity takes place in the digital economy in order to best achieve taxation in a non-abusive fashion.

The Discussion Draft singles out six factors that characterize the digital economy in light of B.E.P.S. concerns:

1. Mobility of all facets of the digital economy, including the intangibles used, the users themselves, and the business functions carried on by various players in the business model;

2. Reliance on data;

3. Network effects;

4. Use of multi-sided business models;

5. Tendency towards monopoly or oligopoly; and

6. Volatility.

---

4 See Client Alert March 18, 2014 Re: O.E.C.D. Public Discussion Draft on Preventing Treaty Abuse.

5 See Public Discussion Draft BEPS Action 1: Address the Tax Challenges of the Digital Economy.

“The Discussion Draft addresses traditional B.E.P.S. concerns relating to direct and indirect taxation.”

The Discussion Draft addresses traditional B.E.P.S. concerns relating to direct and indirect taxation. These include the avoidance of a taxable presence in the market place, the avoidance of withholding taxes through treaty-shopping, the minimization of tax in intermediate countries, the minimization of tax in the ultimate parent’s home jurisdiction, and cross-border acquisitions by V.A.T. exempt purchasers. The Discussion Draft reiterates the O.E.C.D.’s stated goal in the B.E.P.S. project – that is, to ensure that taxation takes place at least once, preferably at the location of economic activities. This is particularly difficult to determine with respect to the digital economy, since the different actors, components, and users are generally spread over multiple jurisdictions.

With that in mind, the Discussion Draft proposes, *inter alia*, the following approaches to achieve appropriate taxation:

- <u>Revisiting the Treaty definition of permanent establishment (“P.E.”) with a focus on the various exemptions for specific activities</u>: These exemptions were drafted so as to avoid preparatory or auxiliary activities from giving rise to taxation. However, when applied to the digital economy, these preparatory or auxiliary activities may well constitute a core element of the given digital business.

- <u>Creation of a two-step nexus test based on an entity’s “significant digital presence” to evaluate whether P.E. exists</u>: A preliminary set of factors would determine whether a given activity is fully dematerialized – that is, in broad terms, no physical presence exists in a country and no physical object is furnished to the customer. Once this determination is made, a second set of factors would establish whether an enterprise engaged in a fully dematerialized activity has a significant digital presence, in which case specific methods have been followed to reach a class of users or consumers in a particular country. As an alternative to this two-step test, the Discussion Draft proposes the use of personal data to reach a conclusion as to the presence of a P.E.

- <u>Referring to the work of the Business Profits TAG, three alternative approaches to P.E. thresholds</u>: (i) “virtual fixed place of business,” (ii) “virtual agency PE,” and (iii) “on-site business presence PE.”

- <u>Creation of a withholding tax on digital cross-border transactions</u>: This would be achieved by requiring the financial institution involved in online payment to withhold the required tax.

- <u>With regard to V.A.T., a review of the exemption for low-valued goods</u>: The Discussion Draft highlights the increased flow of cross-border acquisitions of low valued goods generated by the digital economy and correlated decrease in V.A.T. revenue.

- <u>With regard to Business-to Consumer (“B2C”) transactions in the V.A.T. field, the most viable option is described as one under which the foreign supplier collects the V.A.T. and remits it to the jurisdiction of consumption</u>: This should be coupled with simplified registration regimes and thresholds, as well as with an international cooperation mechanism between jurisdictions.

Another challenge addressed by the Discussion Draft involves the methods for attributing value to the collection of digital data. This refers to the practice whereby sophisticated tracking techniques allows digital merchants to identify items of interest for a specific group of consumers (such as French teenage girls living in Paris who respond to clothing advertisements) and the data is then sold to merchants and used to target specific items to that category of consumer. The Discussion Draft also raises questions concerning the character of certain income flows related to the digital economy, such as payments for cloud computing. Do they constitute payments for services, royalty payments or business profits?

The Discussion Draft mostly refers to other actions of the 2013 B.E.P.S. Action Plan to effectively address the B.E.P.S. concerns raised by the digital economy. It refers specifically to Action 2 (Neutralize the Effects of Hybrid Mismatch Arrangements), Action 4 (Limit Base Erosion via Interest Deductions and Other Financial Payments), Action 5 (Counter Harmful Tax Practices More Effectively), Action 6 (Prevent Treaty Abuse), Action 7 (Prevent the Artificial Avoidance of PE Status), and Actions 8-10 (Assure that transfer pricing outcomes are in line with value creation). Regarding consumption taxes, the Discussion Draft refers to Guidelines 2 and 4 of the O.E.C.D.'s "Guidelines on place of taxation for B2B supplies of services and intangibles." In addition, the Discussion Draft examines the importance of C.F.C. legislation and takes the position that C.F.C. regimes should address the taxation of income generally earned in the digital economy.

Comments on the Discussion Draft could be submitted electronically until April 14, and submitters wishing to speak in support of their comments were required indicate their intention to do so by April 7.