ACTION ITEM 1:
THE O.E.C.D.'S APPROACH TO THE TAX CHALLENGES OF THE DIGITAL ECONOMY

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The O.E.C.D.'s Action Plan adopted in Saint Petersburg in 2013 aims at tracking where economic activities generating taxable profits are performed and where value is created. It aims at ensuring that taxation follows the economic activities and the creation of value and not the other way around. Action Item 1 of the Action Plan (the "Action 1 Deliverable") focuses on the tax challenges of the digital economy. Along with the 2014 Deliverable on Action 15 (Developing a Multilateral Instrument to Modify Bilateral Tax Treaties), the Action 1 Deliverable is a final report.

The Action 1 Deliverable published on September 16, 2014 mainly reiterates the March 2014 Public Discussion Draft on Action 1 (click here to access our article on the 2014 Public Discussion Draft). It restates that, while B.E.P.S. is exacerbated in the digital economy space, the digital economy cannot be ring-fenced from other sectors of the economy for B.E.P.S. purposes because the digital economy is an ever growing portion of the entire economy. The Action 1 Deliverable thus refers to other Actions to address common B.E.P.S. issues that are not specific to the digital economy. Action Item 1 also refers to the O.E.C.D.'s International V.A.T./G.S.T. Guidelines with regard to V.A.T. issues raised by the digital economy. Although the Action 1 Deliverable adds relatively little to the previously published Public Discussion Draft on Action Item 1, the benefit of a set of uniformly accepted rules should not be understated. With European countries struggling to raise tax revenue in order to close budget gaps, the risk of adverse unilateral action by one or more countries is real. During a symposium held in Rome at the beginning of the month, certain European countries, and especially Italy, pushed for unilateral action with regard to the taxation of the digital economy.[13] If that action proceeds to enactment, digital tax chaos could be encountered.

Like the Public Discussion Draft, the Action 1 Deliverable gives an extensive explanation of the evolution of the digital economy, its key features, and the ensuing B.E.P.S. opportunities arising from the conduct of a digital business. It restates the previously identified 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

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[13] "Profiles of Fiscal Policy and Markets for Digital Services and E-Commerce," Rome, October 6, 2014.

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of tax in intermediate countries, the minimization of tax in the ultimate parent’s home jurisdiction, and cross-border acquisitions by purchasers that are exempt from V.A.T.

The Action 1 Deliverable lays out how B.E.P.S. issues arising in the digital economy can be addressed. It emphasizes restoring taxation at the level of the market jurisdiction and the jurisdiction of the parent company, which is referred to as the restoration of taxation on stateless income. In an attempt to illustrate that no ring-fenced approach should be chosen, Action Item 1 refers to Action Items 2 through 10 of the B.E.P.S. Action Plan for solutions. Action Item 1 also raises B.E.P.S. issues with regard to consumption taxes and refers to the Guidelines 2 and 4 of the O.E.C.D.’s “Guidelines on place of taxation for business-to-business (B2B) supplies of services and intangibles.”

Chapter 7 of the Action 1 Deliverable delves deeper into the challenges raised by the digital economy and isolates the following broad categories that constitute the main B.E.P.S. challenges:

- Nexus (reduced physical presence and related nexus issues),
- Data (characterization and attribution of value),
- Characterization of payments made, and
- Administrative challenges (identification by the taxing authorities of economic activities, extent of activities, collecting and verifying information regarding the offshore entity, difficulty of identifying the location of customers).

The Action 1 Deliverable lists the following potential options to address these tax challenges and points out that some of the solutions will apply to several overlapping challenges:

- <u>Modifications to the exemptions from permanent establishment (“P.E.”) status.</u> This would entail re-assessing the exemptions from P.E. status contained in paragraph 4 of Article 5 of the O.E.C.D. Model Tax Convention in light of the evolution of the digital economy. Certain preparatory and auxiliary activities in the article constitute the core functions for certain digital businesses. Among the options under consideration are the elimination of the entire paragraph, the elimination of only certain subparagraphs, or the addition of a condition that the exemptions are only available when the activity conducted is preparatory and auxiliary in nature.

- <u>New nexus based on significant digital presence.</u> Business ventures engaged in “Fully dematerialized digital activities” would have a taxable nexus in another country if a “significant digital presence” is maintained in that country. Action Item 1 provides a list of elements that would determine whether an activity is a fully dematerialized digital activity. These include the dedication of the core business to digital goods or services, the fact that contracts are generally concluded remotely via the internet or the telephone, the prevalence of online payments, etc.

  Once engaged in a fully dematerialized activity, nexus in a specific jurisdiction would exist should the enterprise have a significant digital presence in that jurisdiction. For this purpose, a "significant digital presence" could be deemed to exist, *inter alia,* in one of the following scenarios: significant number of contracts signed with tax residents of a particular jurisdiction; wide use or consumption of digital goods or services in a particular jurisdiction; substantial payments made to the enterprise by clients located in a particular jurisdiction; the fact that a branch located in the other jurisdiction offers secondary functions that are strongly related to the core business of the enterprise with regard to clients of that other jurisdiction.

- <u>Replacement of the P.E. concept with a significant presence test.</u> This would include some level of physical presence and an ongoing relationship with a customer base in the country of physical presence.

- <u>Creation of a withholding tax on digital transactions.</u> The financial institutions involved with payments for goods or services would be required to withhold the tax, so as to avoid withholding of this tax by customers of the foreign digital goods and services provider.

- <u>Introduction of a "Bit" tax.</u> This tax would be based on bandwidth usage of a website. The number of bytes used by a website would be taken into consideration in calculating the tax, as would the turnover of the enterprise. The tax would be progressive and creditable against corporate income tax.

- <u>Several solutions with regard to consumption tax</u>.

In sum, the Action 1 Deliverable principally restates the previously published Public Discussion Draft on Action Item 1. The noticeable differences relate to length and the inclusion of examples of typical tax planning structures in the digital economy. It defers to other Deliverables when addressing the tax challenges of the digital economy.