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The BEPS Project Lacks Comprehensive Definition on the Taxation of Digital Economy in Market Jurisdictions

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An open door for emerging economies or the beginning of the end in international tax co-ordination

In an article published earlier this year,[1. Teijeiro, *Opening the Pandora's Box in the International Tax Field* (First Part), Tax Planning International Review, volume 42, #4 (April 2015), p. 4 ss.] I alerted on the instability of the current world tax scenario, based on a number of different but confluent circumstances including, *inter alia*, potential inter-country tax imbalances that might originate in the perceived desire of governments (from industrial and emerging economies as well) to grasp income from borderless activities — such as the various manifestations on the digital economy — whether at residence or at the place of destination (*i.e.*, the customers' jurisdictions).

I also observed that should the BEPS Project failed at the end to impose uniform principles on the taxation of the digital economy, chances were certain that countries would attempt to stretch source rules and business presence tests beyond the application of the traditional PE concept, or even depart completely from it to try alternative paths for taxation such as formulary apportionment or destination-based corporate tax, just to mention a couple of them.[2. Accord. Teijeiro, id. Note 1, (Third Part), Tax Planning International Review, volumen 42, #6 (June 2015), at p. 9-10.]

Following the release of the final BEPS package earlier this month, and based on the content of the Final Report on Action 1 (*Addressing the Tax Challenges of the digital Economy*) and remaining correspondent actions (*e.g.*, Action 7), the fears of unilateral country responses that might lead to a tax jungle in the digital economy area deepen. And this is so because BEPS final outcomes in this area and accompanying actions are just halfway patches that appear not to fulfill expectations, particularly in market jurisdictions.

Insofar as Action 1 is concerned, the discussion draft issued last year had fell short to the Action's goals, and the final document, instead of stepping forward with a OECD-G20 shared comprehensive recommendations, simply recognized that absent that response, countries may wish to go further individually, adopting a substantial economic presence test or digital PE concept, a withholding on digital economy's yields (such as the UK Diverted Profit Tax), or an equalization levy. If these initiatives (or other available alternatives such as formulary apportionment or destination-based corporate tax) were to become widespread on an unilateral basis, it is not difficult to foresee a digital economy tax world where countries' incoordination, jurisdictional overlaps, and, possibly, cascade taxation, might become rampant.

Someone may argue that the discussion of source rules, the definition of a new nexus to attribute the income yields from digital economy manifestations, and related income characterization issues are indeed issues which are beyond the objectives of the OECD-BEPS Action Plan, but that it is not certainly the case.[3. In accordance with the BEPS Action Plan, OECD, 2013, the objective of Action 1 consist of:

"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 characterisation 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 crossborder supply of digital goods and services. Such work will require a thorough analysis of the various business models in this sector."]

Having said that, let's turn to the concluding recommendations arrived at by the Tax force on the Digital Economy (TFDE)[4. TFDE is a subsidiary body of the Committee of fiscal affairs (CFA) in which non-OECD G20 countries participated in an equal footing with OECD countries, established in September 2013.] on the BEPS issues and the broader tax challenges raised by the digital economy:

(1) In the PE area, and in conjunction with the outcome of Action 7, it is agreed to amend the *negative list* (activities excluded) of Article 5, paragraph 4, OECD MC, to ensure that the exceptions contemplated therein are solely effective where the activities are of a preparatory or auxiliary character; and to introduce a new anti-fragmentations guide to ensure that it is not possible to benefit from the exceptions through the fragmentation of business activities among closely related enterprises;[5. This new guide adds up to the anti-fragmentation principle already furnished by the Commentaries to Article 5, OECD MC, in paragraph 4, subparagraph 27.1 concerning separate PEs of the same entity.]
(2) It was also agreed to amend the PE definition to address circumstances in which artificial arrangements relating to the sale of goods or services of one company in a MNE group effectively result in the conclusion of contracts, in which case the sales would be treated as if had been made by that company having a PE in the market jurisdiction;
(3) Recommendations on the design of CFC rules include definitions of CFC income that would subject income that is typically earned in the digital economy to taxation in the jurisdiction of the parent company.

Bearing in mind that the basic directives on e-commerce in the Commentaries to Article 5, paragraph 7, subparagraphs 42.1 to 42.10 have remained unchanged since 2003 and are thus outdated, it appears that the changes mentioned in 1 and 2 above will have little, if any, impact in enlarging the market countries' jurisdiction on today digital economy manifestations. In effect, that will happen only in isolated instances, *e.g.*, when physical goods are traded and need to be kept for delivery in the market jurisdictions, or when related services (*e.g.*, guarantee services) need to be provided, and are entrusted to another company within a MNE group through an artificial fragmentation of the business aimed at avoiding PE *status* in the market jurisdiction.

On the contrary, inclusion of income items earned in the digital economy in CFC income (royalties, IP income, income from sales and services; and, at the minimum, funding returns allocated under transfer pricing rules to low-function cash boxes) appears to lead to a recommended all-embracing domestic rule tipping the balance in favor of residence jurisdictions, thus somehow making the area of digital economy taxation an exception to the otherwise perceived shift towards more source based taxation under BEPS' outcomes generally.

Chapter 7 of the Final Report on Action 1 deals with the broaden direct tax challenges raised by the digital economy and the options to address them, including a discussion of those not agreed upon and, hence, not recommended by TFDE. The options are: (i) a new nexus based on the concept of significant economic presence; (ii) a withholding tax on digital transactions; and (iii) an equalization levy.

These options are presented without expressing any preferences and thus, without a clear guide on their concrete application by countries concerned; moreover, their main features are foremost meagerly described, so that potential application at the national level may show great variances.[6. Although work on the digital economy taxation will continue, meaningful revisions of the alternative options should not be expected before 2020; this is a period long enough to observe the appearance of diverging experiments at the national level.]

The significant economic presence test would create a taxable presence at the market jurisdiction on the basis of factors that evidence a purposeful and sustained interaction with the economy of that country via technology and other automated tools, such as a local domain name and a local Website or digital platform, availability of a local payment option; or even user-based factors, including monthly active users (MAU) in the country, the regular conclusion of on-line contracts with resident users, and the volume of digital content collected from resident users and customers.[7. In a sense, absent the physical presence requirement, proper of the *brick and mortar* traditional businesses, the test is more close to Anglo-Saxon concepts such as *trade or business* or *doing business* in (as opposed to doing business with) of the US and UK domestic tax laws, respectively.] It is recommended that digital and user-based factors (to be chosen in accordance with the features and characteristics of the particular market) be also combined with a revenue factor, *i.e.*, revenues obtained from remote transactions into the country in excess of a revenue threshold, in order to ensure that only cases of significant economic presence are covered.

The question is why a source, emerging economy, would need to resort to a significant economic presence test in its domestic laws to tax digital economy's income yields and the response in rather simple (i) direct taxation of foreign automated internet sales and services might be deemed to lack sufficient nexus with the taxing jurisdiction, (i) the market jurisdiction may consider income from foreign sales of tangible goods and/or foreign services into the country to be foreign source income, in which case unless a significant presence test is introduced, taxation of remote online similar sales and services would be incoherent with the treatment afforded to traditional inbound sale and service income; and (ii) because net-basis taxation of digital economy income might be deemed preferable.[8. In any case, since application of traditional gross profit allocation rules in the case would be difficult, countries might wish to resort to fractional apportionment or deemed profit methods.]

A second option to be considered is a standalone gross-basis final withholding tax on digital transactions, *i.e.*, payments to nonresident providers of goods and services ordered online (digital sales transactions), under certain specific conditions.[9. An example is the UK Diverted Profit Tax (DPT) conceived as a separate levy from the income tax and designed as a full proof tool against challenges based on EU law and trade obligations. See, *inter alia*, Baker, *Diverted profits Tax: A partial response*, British Tax Review, 2015-2, p. 167-171; Neidle, *The diverted profits tax: flawed by design*, British Tax Review, 2015-2, 147-166; Self, *The UK's New Diverted Profits Tax: Compliance with EU Law*, Intertax, 43, 4, p. 333-336 (2015).] In this case the definition of the transaction covered as well as of the definition of the local collecting agent [*e.g.*, the customer (for B2B or B2G transactions) or a third-party payment processing intermediary (for B2C transactions)] are crucial design element to be considered.

The UK option of designing the withholding as a levy applied separately from the income tax might also help bypassing tax neutrality challenges coming from the fact that income tax rules would still treat income from inbound traditional sales and services as foreign source, if and when that is the case under the market jurisdiction's legislation. Of course that would not be a problem is income from traditional inbound sales and services were deemed domestic source income and, hence, taxed at destination.[10. Full taxation at source of inbound sales income, as well as full income taxation of inbound services would be, however, an aggressive positon from a jurisdictional viewpoint.]

The third and apparently simpler alternative discussed by TFDE is the creation of an equalization levy, for example under the form of an excise tax applied if and when it is determined the existence of a significant economic presence, or on all remote sales transactions entered into with customers in a market jurisdiction.

A common issue to withholding taxes designed as separate levies and equalization levies would be the crediting against the corporate income tax payable at home. One possible way out of this concern could be to limit taxation at the market jurisdiction under any of these forms to the case of income that would otherwise be untaxed at home, or allowing a special credit at home, something that looks at least troublesome.

The door appears to be open for emerging economies to grasp income from digital economy activities but different responses in terms of available tools might stretch jurisdictional principles beyond an acceptable reach, as well as catastrophically affects cross-border remote trades. Further guidance on the matter would have been welcome.

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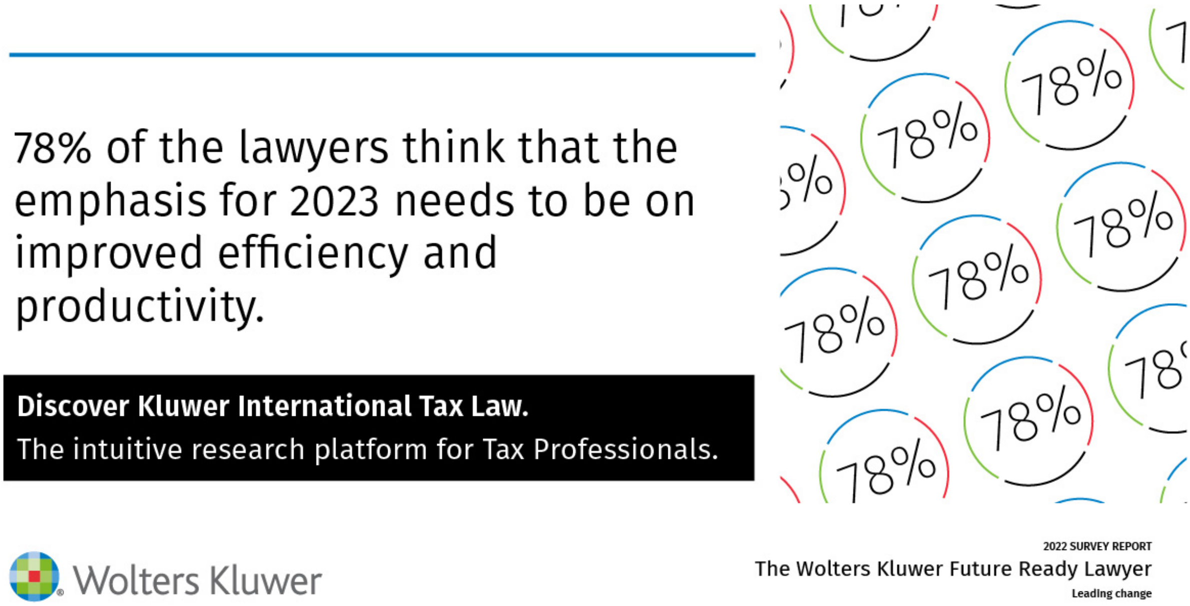

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