Kluwer International Tax Blog

Once more on a short-of-expectation BEPS outcome and the erratic domestication of a weak guidance: The case of the digital economy

Guillermo O. Teijeiro (Bomchil) · Monday, August 29th, 2016

The post-BEPS international tax scenario is in transition to a much more inter-nation equitable system, where the national tax base will be much better protected against erosion and profit-shifting corporate manipulations than it was in pre-BEPS times.

The international tax system, however, is not yet stable,[1] and despite OECD's efforts to uniform national responses within the current implementation stage, it is a fact that simultaneous OECD-G20, EU, and unilateral state's efforts under the BEPS label, frequently collide among them and/or with more fundamental international tax principles.

Within this unstable scenario it is also easily perceivable that *the cat and mouse game* inherent to taxation is particularly a fierce battle in the digital economy area; among other reasons, because of the nature of the digital economy manifestations which are constantly evolving, and, hence, making international tax rules rapidly outdated.

Only sixteen years ago, at the Munich IFA Congress, discussions centered on whether a server –as automated equipment without personnel– might constitute a PE under the OECD MC. Those attending that Congress might still remember former IBM Tax VP Prof. Mattson's intervention, vividly arguing that an early XX century Swiss case used to back up the OECD MC Commentaries on automated equipment as a PE, was a historic misconstruction, simply because the facts and circumstances in the relevant case clearly referred to an automated dispenser equipment that actually required the presence of personnel of the foreign enterprise to perform various activities on the equipment, such as cleaning and refill.

Three years later, the 2003 version of the OECD MC included in the Commentaries to article 5, paragraph 7, subparagraphs 42.1 to 42.10, the first and unique comments on e-commerce, making the location of the server the pivotal concept meeting the physical presence (objective) test of the PE concept. The experience soon revealed that the location of the server meant nothing as regards activity in a given market, as that said location might be and usually is absolutely dissociated with the market location and, hence, the new comments became rapidly outdated and useless.

It is self-evident that borderless digital economy's business models are nowadays much more rich, complex, and sophisticated than e-commerce state of the art manifestations in 2003; and still the digital economy is a moving target hardly graspable by traditional residence and source concepts,

at home and market jurisdictions.[2]

The OECD-G20 Final Report on BEPS Action 1 (Addressing the Tax Challenges of the digital Economy) and corresponding final reports, illustrate the direct tax challenges posed by the digital economy to market jurisdictions as well as the limited scope of the traditional PE concept as a tool to allocate income obtained therefrom to destination countries. The OECD-G20 BEPS Report's response to the issues fell short to be a comprehensive approach and lacked a uniform recommendation to be implemented by market economies, somehow allowing inter-nation imbalances to rise. This is of course a significant issue in industrial and emerging countries as well.[3]

Approaches for a comprehensive response are indeed highlighted in Chapter 7 of the Final Report on Action 1 (i.e., significant economic presence test, withholding tax on digital transactions, and equalization levy) but none was adopted nor uniformly recommended. Moreover, the main features of the three options were foremost meagerly described, so that application at the national level might show great variances, as the already started domestication process in selected jurisdictions shows.[4]

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.[5]

As anticipated, an option contemplated in the final report 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.[6] This alternative raises a number of questions, including that (i) direct taxation of foreign automated internet sales and services might be deemed to lack sufficient nexus with the taxing jurisdiction, unless a significant economic presence is detected, (ii) 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 taxation of remote online similar sales and services would be incoherent with the treatment afforded to traditional inbound sale and service income; and (iii) a withholding tax on digital transactions from abroad might conflict with treaty law commitments (particularly the treatment of business income).

Based on the foregoing, The UK Diverged Profit Tax (DPT) was designed as a levy which is applied separately from the income tax, and, hence, aimed at bypassing challenges coming from the fact that income tax conventional rules would still treat income from inbound sales and services as foreign source (as well as EU law –applicable at the time–and trade obligations).[7]

The UK DPT standalone gross-basis final withholding tax on digital transactions still raises serious doubts on its international legitimacy: Is it enough to change the *nomen iuris* of a tax and resort to a fictional source rule (a SAAR or deemed PE) to go beyond business income jurisdictional principles under international tax conventional law? Is it international tax jurisdiction on business income a concept extendable beyond the traditional carved-in-stone PE paradigm, which has remained untouched even under the OECD-G20 BEPS Project? Is the UK DPT manifest evidence

that the BEPS' outcome on the taxation of the digital economy fell short to address the inherent international tax issues?

The third and final alternative presented by the Final Report on BEPS Action 1 was the creation of an equalization levy, either 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.

An example of this tool is the Indian 6% equalization tax that came into effect on June 1st, last; the tax was conceived as a levy separate from the income tax applicable on every consideration received by non-residents from Indian tax residents for the provision of online advertisement, digital advertising space, or other similar online advertisement services. The levy is to be withheld by Indian residents from the consideration paid to nonresident service providers.[8]

Aside from the fact that the equalization levy, by its own nature, does not allow the crediting against income tax at the nonresident´s home country (a common issue to withholding taxes designed as separate levies such as the UK DPT), a much more fundamental jurisdictional issue taints this levy and makes it highly controversial: It is a well settled principle that international income tax jurisdiction may not be based on a legal fiction; and that is precisely how the levy functions when advertising expenses incurred by Indian residents are deemed a succedaneums of actual activity in India by the nonresident recipient of the payments.[9] In this context, the query is, again, whether just by changing the *nomen iuris* of the tax the levy is able to overcome an *ultra vires* taint under general and conventional (treaty) international tax law.[10] As in the case of the UK DPT I frankly doubt these levies can be easily legitimated under international jurisdictional principles.

From a different perspective, and assuming that, hypothetically, the equalization levy is kept afloat after passing an income-type jurisdictional scrutiny, one may imagine the aggregate over-taxation that would result from the simultaneous application of similar levies by market jurisdictions (not to mention the overlap with VAT on the importation of services).

At this point, looking at all the difficulties inherent to the application of traditional jurisdictional principles to the taxation of income from the digital economy, as well as the lack of a more decisive response from the BEPS Project, one may well wonder whether it would not be better to start considering a migration to a destination-based corporate tax model, a still untested but highly attractive alternative to tax income from the digital economy.[11]

Meanwhile, unless until the taxation of the digital economy is reassessed, something that apparently will not happen until 2020, national conflicting experiments will be repeated without a meaningful, solid, and uniform conceptual basis, and, consequently, with grave consequences to the industry in terms of multiple, cascade taxation. Moreover, with the present lack of definitions, the expected rapid irruption of the emerging economies trying to grasp a wider basis from borderless digital economy income may end up in a worldwide tax chaos of unilateral diverging measures and countermeasures, and with serious damages to the tax administrations in terms of harmful tax competition, and the business sector as well.

This is an area of taxation where there is still time to react and reconsider a more precise and uniform response aligning diverging interests, gathering all relevant stakeholders' inputs, and preserving the industry from the risks of multiple layers of taxation which I envision will be the

undesired result under the current post-2015 BEPS status. The proposed 2020 revision should be speed up by at least a couple of years and meanwhile it would be highly desirable to reach a commitment under the umbrella of G20/OECD, on the widest possible comprehensive basis of countries, not to advance with digital economy taxation at the domestic level until the proposed revision process is terminated and a new outcome released.

[1] In an article published last year, 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 coming from a perceived intention of governments to grasp as much income from borderless activities as possible — such as the various manifestations on the digital economy — whether at residence or at the customers' jurisdictions (accord., 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).

[2] See Teijeiro, *The BEPS Project Lack Comprehensive definition on the Taxation of Digital Economy in Market Jurisdiction*, Kluwer International Tax Blog, October 24, 2015.

[3] Back in 2015, and pending the appearance of the final Reports, I had 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. (Accord. Teijeiro, id. note 1, (Third Part), Tax Planning International Review, volume 42, #6, June 2015, at p. 9-10). Following the release of the Final Report on Action 1, my fears concerning future unilateral and uncoordinated country responses that might lead to a jungle of jurisdictional overlaps and cascade taxation in the digital economy area deepened.

[4] Although the 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 and even contradicting experiments at the national level.

[5] 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 systems, respectively. The report also recommended that the 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.

[6] 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.

[7] On DPT 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). A similar levy has been proposed to be implemented in Australia as from July, 2017.

[8] Parekh and Wagh, International tax proposals in Budget 2016 – India's 'Digital Tax' googly!, The Tax Booster; Teijeiro, *Detecting clouds before the Post-BEPS storm becomes uncontrolled*, Kluwer International Tax Blog, March 30, 2016; Gupta*, Equalisation Levy is not so equal,* August 13, 2016 Https://www.linkedIn.com/pulse/equalisation-levy-so-equal-ca-rohit-gupta-

[9] This principle was clearly stated by the Indian Supreme Court *in re Vodafone*, January 20, 2012.

[10] The Report of the Committee on Taxation of E-Commerce (dated on February 2016, and prepared by the Committee on Taxation of E-Commerce formed by the Central Board of Direct Taxes, Department of Revenue, Ministry of Finance, Government of India), found no possible challenges on this basis.

[11] See on point, Devereaux and de la Feria, *Designing and Implementing a destination-based corporate Tax*, Oxford University Centre for business Taxation, WP 14/07, May, 2014; reproduced in Tax Notes International, May, 2015.

To make sure you do not miss out on regular updates from the Kluwer International Tax Blog, please subscribe here.

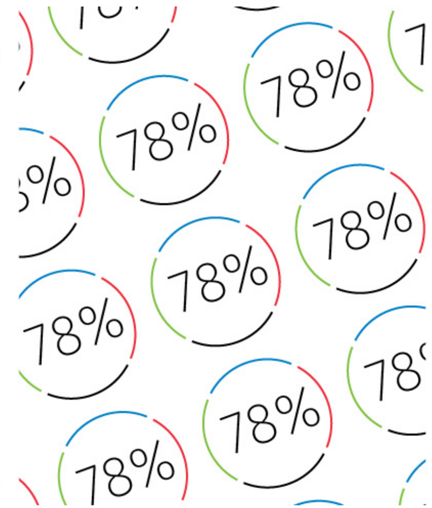
Kluwer International Tax Law

The **2022 Future Ready Lawyer survey** showed that 78% of lawyers think that the emphasis for 2023 needs to be on improved efficiency and productivity. Kluwer International Tax Law is an intuitive research platform for Tax Professionals leveraging Wolters Kluwer's top international content and practical tools to provide answers. You can easily access the tool from every preferred location. Are you, as a Tax professional, ready for the future?

Learn how **Kluwer International Tax Law** can support you.

78% of the lawyers think that the emphasis for 2023 needs to be on improved efficiency and productivity.

Discover Kluwer International Tax Law.
The intuitive research platform for Tax Professionals.



2022 SURVEY REPORT
The Wolters Kluwer Future Ready Lawyer
Leading change

This entry was posted on Monday, August 29th, 2016 at 4:53 pm and is filed under BEPS, OECD
You can follow any responses to this entry through the Comments (RSS) feed. You can leave a response, or trackback from your own site.