

**Foundation for International Taxation  
20<sup>th</sup> Jubilee Conference 1995 - 2015**

**“Taxation Challenges of  
the Digital Economy”**

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**Mumbai**

**December 3, 2015**

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# Agenda - Overview

- Background and OECD BEPS Action 1 Final Report
- Pressures to (Not) Revisit Tax Paradigms
- Destination Based Indirect Taxes
- Digital Economy (DE) per Traditional Direct Tax Norms
- What Does the Action 1 Report Tell Us re Direct Taxes?
- How Do the “Alternative Options” Measure Up Against Treaty Obligations?
- Other Domestic Law Actions
- Foreign Tax Credit Available?
- Broader Policy Discussion

## Background -- Earlier Efforts to Address

- Report of the Indian High-Powered Committee on Electronic Commerce (2001)
  - Proposal of withholding tax on deductible payments (can be viewed as expansion of fees for technical services)
- OECD E-commerce project in 1997-2005 resulted in various reports including:
  - Working Party No. 1, Concept of Permanent Establishment in Electronic Commerce, leading to Comm. art. 5 par 42.1-42.10
  - TAG Report, Treaty Characterization of Electronic Commerce Payments (2001)
  - TAG Report, Attribution of Profit to a Permanent Establishment Involved in Electronic Commerce Transactions (2001)
  - TAG Report Are the Current Treaty Rules for Taxing Business Profits Appropriate for E-Commerce? (2005)

## Background – TAG to OECD BEPS Project and EC Project

- **TAG Reports** unsurprisingly concluded that fundamental changes should be adopted only if clearly superior
  - Found **no evidence of** significant tax **revenue loss**
  - No resulting action except “service PE” (physical world)
- Task Force on Digital Economy created by OECD Feb 2013
- Interim OECD BEPS Action 1 Report Sept 2014
- **Final OECD BEPS Action 1 Report** – 5 Oct 2015  
“Addressing the Tax Challenges of the Digital Economy”
- Note also **EC** Dec. of 22 Oct 2013 set up Commission Expert Group on Taxation of the Digital Economy

## Breadth of Inquiry of Oct 2015 Final Report

- Final BEPS Action 1 Report – negotiated document
- **DE business models “highlight opportunities to achieve BEPS”** across the supply chain and pose “challenges”
  - Just highlight? Or rather create.
- Also raises “**questions regarding the paradigm** used to determine where economic activities are carried out and value is generated for tax purposes.”
  - Formulation presupposes a negative answer to direct taxation based on use by consumer, since physical presence of vendor is lacking
- “Because **the digital economy is increasingly becoming the economy itself**, it would be difficult, if not impossible, to ring-fence....”
  - First clause is key--question remains how to address

# Economic Developments Creating Pressures to Revisit Paradigms of Taxation

- Factors contributing to BEPS challenges include:
  - IP = the assets of most **value + mobile** tax ownership
  - ICT (Info + commun. tech) enables MNE to “centralise infrastructure”/**conduct sales away** from the market
  - “**Minimal** use of **personnel/footprint** by digital MNEs
  - **Concentration** of perceived value in a few KERT personnel
  - **Resulting loss of revenues**
  - **Traditionally, W/T tax** used where these factors present
    - **But** digital income can be bus profits and/or foreign source; and IP embedded in tangible assets or in services
      - Fees for included/tech services (**FIS/FTS**)? Not enough

## Pressures to Not Revisit Basic Paradigms

- On the other hand, **pressures** from business and certain countries **for no/lesser change**
- Argue **indirect taxes** (VAT etc.) are available
- Regarding direct taxes:
  - Importance of **PE standard** to taxpayers
  - Importance of **services character** to taxpayers
  - Importance of **source at place of performance**
- As reflected in TAG reports



# Action 1 Report and VAT/GST Guidelines: Indirect Taxes

- **Clear progress here.** Collecting tax in country of consumption (**destination principle**) now **proceeding from B2B to B2C**
  - Destination principle for digital in EU's Sixth Directive (2003)
- OECD's International VAT/GST Guidelines (G/L) seek neutrality for tangible, services and digital
- For B2B, nonregistration of foreign vendor typically addressed via reverse charge (self-assessment by local purchaser)
- For B2C, would not be effective, so foreign vendors/suppliers of digital services should register locally and account for VAT
  - Or, possibly, intermediary may collect for them.
  - Covers eg downloads of music, videos etc

# Action 1 Report and VAT/GST Guidelines: Indirect Taxation

- Consolidated draft G/L, with Chapter 3 on services and intangibles including B2C
  - Approved by CFA July 2015 and at Third Global Forum on VAT 6 Nov 2015 (G/L for B2C had been approved 2014).
  - Projected 2016 approval by OECD Planning Council, for same status as TP Guidelines and Model Treaty
  - G/L project dated since 2006 but impetus from and cross-impetus with BEPS
  - B2C got late start due to higher implementation hurdles and underestimates of volume of purchases
    - \$1.4 trillion in 2013, project to be \$2.4 trillion by 2018

# Direct Taxation: Current Int'l Norms/Model Treaties

## •Nexus of digital provider

- Generally not if not physical: internet advertising—e.g. *Telmark Global Solutions* (Mumbai ITAT 2010); cf. radio advertising – e.g., *Piedro Negras* (US 1941)
- Server issue

## •Classification of income

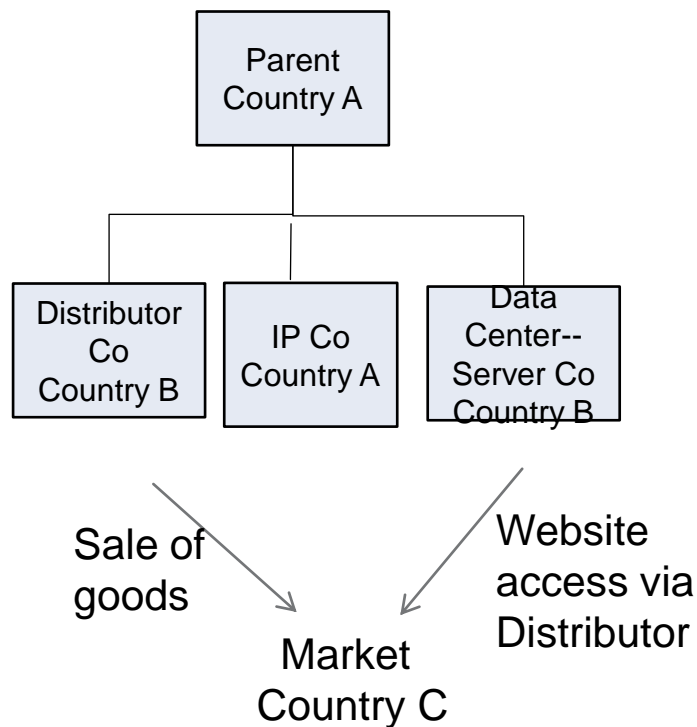
- **Sale income:** rights in software for use w/o distribution (but *Microsoft Corp. v. DIT* (2010) - royalties)
- **Royalties:** for use of knowhow; or for right to modify or reproduce and distribute a copyright (infringement test)
  - Source typically local if royalty, so may be W/H tax

## Current Int'l Norms/Model Treaties (Cont'd)

### • Classification of income (cont'd)

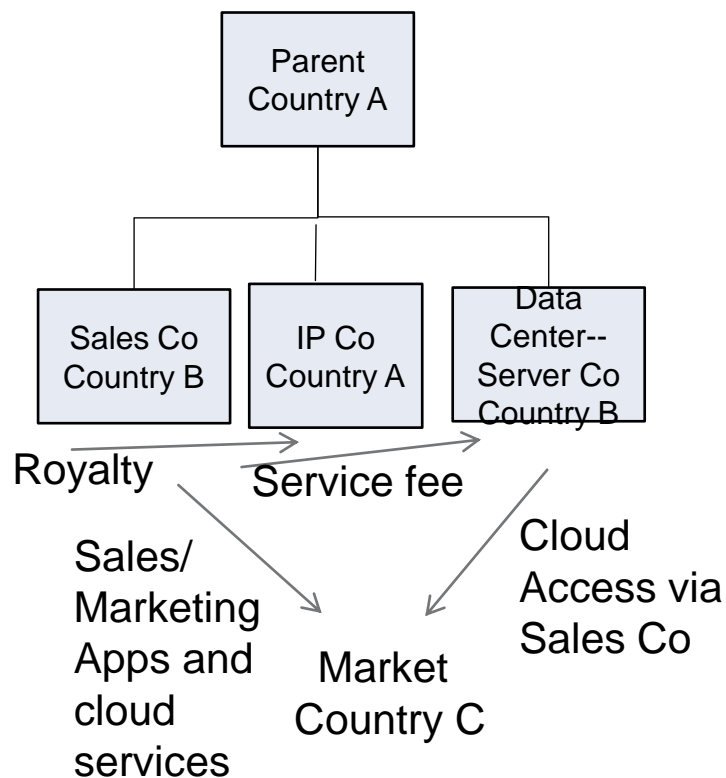
- **Service income:** eg, software used by subscriber for monthly subscription fee and various hosted products.
  - IRC 7701(e): factors for lease vs. services contract (eg, control, property right, etc); cited by OECD in 2001 TAG report on Treaty Characterization; relevance?
- Service income = (generally) “**business profits**”
  - Eg, *Infrasoft Ltd. v. ADIT* (ITAT/DEL 2008) (fees for voice and data services)
- But may be W/H tax if **FIS/FTS** (if technical or consultancy services and technical skill or knowledge made available to client)

# Illustration of eTailer



- Separate legal entities for functions
- Distributor Co operates a warehouse, performs marketing, and buys and resells the goods to Country C customers
- Data Center/Server Co provides website access to customers, for which Distributor Co pays a fee
- Distributor Co pays a royalty to IP Co for TM/TN, and contracts for services with Parent

# Illustration of Seller of Cloud Services



- Separate legal entities for functions
- Sales Co performs sales and marketing of the cloud services/apps to Country C customers for a fee
- Data Center/Server Co provides cloud access to the customers
- Sales Co subcontracts for Apps and cloud services from IP Co for fees
- Sales Co subcontracts for services on a cost plus basis with Parent

# BEPS Action 1 Report: Recommendations re Direct Taxes

- No specific new direct tax digital rules are recommended. Instead focus on:
  - BEPS Action 7 – Permanent Establishment
    - Effect in certain cases.
  - BEPS Actions 8 -10 – Transfer Pricing
    - But ALS allows legal entities/contracts to minimize presence
  - BEPS Action 3 – CFC Rules:
    - But digital income may not be passive and so may remain outside scope; and doesn't address revenue allocation; just nowhere income

## Solution in BEPS Action 7 (art 5(5))?

An important addition to Art 5(5) is the phrase:

- “habitually plays **the principal role leading to the conclusion of **contracts**** that are routinely concluded **without material modification** by the enterprise.”
- Based on this broader definition, perhaps different result in:
  - *eBay International v. ADIT* (2012) (Indian subs of eBay engaged in promotion exclusively for its Swiss affiliate were not PEs thereof).
  - LDR (limited risk distributor) solution may not work: redistribution of C/R is not buy-sell
    - The owner of the IP remains the group principal company or IP owner



## **Solution in BEPS Action 7 (Art 5(4) or Anti-Fragmentation)?**

- Excepted “preparatory or auxiliary” activities might (if so negotiated) be subject to **overriding prep/aux requirement**
- Eg, is warehouse of digital vendor prep/aux? Value?
- **Anti-fragmentation** rule (art. 5(4.1)), to override Art. 5 (4) where complementary functions that are part of a cohesive business operation are carried on by the same or a closely related enterprise.
  - Typically, servers, sales offices and data centers are owned by different legal entities
  - No issue for vendor unless it has “fixed place of business”

## Solution in Actions 8-10: Transfer Pricing?

- TP principles are largely rational vs. cliff effect or subjectivity.
  - E.g., *DIT v. Morgan Stanley* (Sup. Ct. 2008)
- But TP rules work against local income attribution of residual profit, as they typically **start from a fragmented business**:
  - TP for **services often cost plus** with safe harbors for low value services
  - TP for IP allows residual to attach to KERT personnel (TNMM (one-sided) or, now favored, Profit Split (each side justifies relative contributions))
- Also, no real comparables for attribution of profits in various cases: eg, how allocate to a server?

# BEPS Action 1 Report – Alternative Options

- The Report, however, presents “**alternative options**”:
  - (1) Significant economic presence nexus
  - (2) W/H taxes on digital income from goods or services ordered online (a final tax or to enforce net-basis taxation)
  - (3) Equalization levy
- These are **not recommended** as an international standard.
- They, however, could be imposed **through domestic legislation “provided they respect existing treaty obligations.”**
- Discussed later.

## BEPS Action 1 Report – Other Open Issues

Also, **disagreement on** premises for alternative options--  
especially **classification of income**

- WP 1 of CFA will clarify this issue, especially for cloud computing (e.g., IaaS, SaaS and PaaS) payments--
  - “with the Associates in the BEPS Project participating on an equal footing with the OECD countries.”
- And **uncertainty re data harvested** via search engine or online advertising, w/o physical presence
  - Where is value created in the chain and where tax it?
- Task Force on the Digital Economy will continue its work by monitoring with objective of a **further report in 2020**

# Jumping the Gun on Alternative Options: DPT and MAAL

- **UK Diverted Profits Tax** and Australia **Multilateral Anti-Avoidance Law** cut from the same cloth
- **Common target:** large N/R MNE avoids PE, minimizes local tax
- **Only large companies affected**
  - Large sales relating to local activity (UK); or large company by sales or activity (Australia)
- **Physical presence of affiliate** or agent in related activity
- **Avoidance purpose can be inferred**
  - Designed to avoid UK trade via a support company (UK); or
  - Reasonable to conclude designed to avoid PE; PPT of tax benefit; related activities in no-substance tax haven (Australia)

# Foreign Tax Credit Relief for Alternative Options

- Given new tax approaches, what standard to allow a credit?
  - Credit per domestic law – **how much leeway** to go beyond traditional norms? Sourcing where customer ok?
  - If treaty exists, require that tax be **permitted under treaty** even to claim credit under domestic law if both routes exist, as in the US?
    - If not a covered tax, does that per se mean no credit?
- **Policy issues**
  - Not encourage aggressive taxation abroad
  - But need easily applied standard
- Current consideration of issues by US

# Why Are Certain Countries Chasing an Alternative Option?

- The **world has changed** in terms of how income is generated.
  - So fair to ask, how would allocation rights for an income tax being designed today be allocated?
  - Consider source of value (**populace/market as an asset** like natural resources)
    - Not new concept—see, eg, 1923 League of Nations Report (formula including sales was considered)
- **Can reliance be placed on VAT** or other consumption taxes?
  - For most countries, consumption taxes are in addition to, not in lieu of, income taxes—need parity of tax burden with nondigital
  - Direct incidence of the tax is different than for an income tax, though consumer may bear part of latter as well

# (1) A Viable Alternative Substantial Nexus Option?

- Potential nexus based on digital and nondigital sales of goods or services into the country **above a threshold amount**
- **Then, other factors** mentioned in Action 1 Report:
  - Local domain names, localized websites, local currency payment options, number of active users in a country, online contracting and data collection
- Presumably for this purpose affiliates aggregated even if not under Art 5(4.1)



# (1) A Viable Alternative Substantial Nexus Option (Cont'd)?

- **Absent a PE, issue** under OECD-Model treaties.
  - **But** not treaty violation if not “**substantially similar** ...[and] imposed ... **in addition to, or in place of**, the existing [listed] taxes.” Art. 2(4).
    - Reaches persons not covered, so **not** in addition to/in place of. And “extraordinary.” See Comm., Art 2, par. 5
    - And consider DPT/MAAL as precedent (“cover”).
- How determine **attributable profit**?
- E.g., **deemed** profit margins, by industry; likely only rebuttable presumption
- How collect, absent some W/H obligation? In which case it becomes in effect like alternative option 2

## And (2) a Viable W/H Tax Option?

- W/H tax approach may be justified if treaty doesn't block
  - Theory of services being deemed performed (in part) where the user/customer is located.
  - **Customers can be a basis for source** (Graetz 2001)
  - Payment for software for internal use is **not a royalty** under OECD Model. Comm., Art. 12, par. 13.1, 14.
- Under OECD-Model treaties, **issue where no PE**
  - Might be **FFIS** (regardless of source) for certain amounts under e.g. India treaties
  - And could **argue** as above, **not a covered tax**, and also use DPT/MAAL as precedent ("cover").

## And (2) a Viable W/H Tax Option (Cont'd)?

- Additional issue: Action 1 Report says **GAAT/GATS and EU nondiscrimination issues**, if both not permitted under treaty (FIS/FTS or royalty) and not net basis
  - Solution (if not FIS/FTS or royalty): impose as **collection for ultimate net-basis tax** (leaving aside potential tax treaty violation issue).
    - Same issues re attributable profit as for nexus basis net-basis tax.
- Consider **local registration** for foreign vendors, like B2C VAT
- Italian Prime Minister Renzi was reported Sept 2015 to seek a 25% W/H tax on internet companies, eff. 2017.

## And (3) a Viable Excise (Equalisation) Tax Option?

- **Levy** to address disparity between the tax burden on remote and domestic suppliers (unfair completion). Cf. insurance excise tax.
- **Scope choices** (eg. all remote sales, or only if contract concluded through a platform, or based on monthly average users or on data collected
  - Amount based on gross revenues, volume of data, etc.
- Not treaty violation if **not “substantially similar ...[and] imposed ... in addition to, or in place of, the existing [listed] taxes.”** Art. 2(4).
  - Reaches persons not covered, so **not** in addition to/in place of, as described above.

## And (3) a Viable Excise (Equalisation) Tax Option (Cont'd)?

- Additional issue: Same **nondiscrimination issues under GATT/GATS and EU**, if both not permitted by a treaty and not net basis tax
  - Solution: Impose on residents and nonresidents but allow the levy to be **credited against CIT**.
- Likely no foreign tax credit in home country
- **Require** foreign vendors to **register**, to permit collection of tax

# Concluding Remarks

- **Other approaches** still on the table
- Fundamental change would affect most enterprises
  - Need for certainty and simplicity
  - Double tax relief should be made available even in credit countries
- Unlike most other areas the BEPS initiative, this would directly involve a change in **allocation of taxing rights**
  - Therefore, support for change will be at most uneven (e.g., US is publicly opposed) and no right theoretical answer.
- Nevertheless, other taxing authorities may continue to **fill the vacuum** of perceived double nontaxation