OECD issues interim report on tax challenges arising from digitalization

On 16 March 2018, the G20/OECD inclusive framework on base erosion and profit shifting (BEPS) released *Tax Challenges Arising from Digitalisation – Interim Report 2018*, which has been agreed by more than 110 jurisdictions. The interim report follows the work previously undertaken in relation to the final report on BEPS action 1 *Addressing the Tax Challenges of the Digital Economy* and the subsequent request for input in September 2017. The report focuses on new digital business models and considers how to respond to the challenge of determining how taxing rights on income generated from cross-border digital activities should be allocated among jurisdictions.

**Digitalization, business models and value creation**

The Task Force for the Digital Economy, supported by the OECD Secretariat, has undertaken work to understand the main features of digital markets and how these characteristics shape value creation. The following characteristics have been observed in highly digitalized business models:

- Scale without mass. Highly digitalized businesses often are highly involved in the economy of a jurisdiction without any significant physical presence;
- Reliance on intangible assets; and
- Data and user participation, including network effects. This concept of value creation currently is not captured by the existing tax framework.

There is no consensus agreement among countries over the tax implications of scale without mass and a greater reliance on intangibles. There is general agreement that data and user participation are common characteristics of highly digitalized businesses, but there are differences of opinion on whether and the extent to which they represent a contribution to value creation by the business. For example, some jurisdictions consider that the role of user participation allows highly digitalized businesses to collect and monetize information, while others consider that the data is similar to any other input sourced from an independent third party.

**Adapting the international tax system to the digitalization of the economy**

Countries have different views as to whether, and to what extent, changes are needed to the international tax rules, which fall into three broad categories:

1. Targeted changes are needed. Reliance on data and user participation may lead to misalignment between the location in which profits are taxed and the location in which value is created, but this issue is confined to certain digital business models;
2. Changes should apply more broadly. The ongoing digital transformation and globalization of the economy present challenges to the existing international tax framework for business profits, so a broader review is needed; and
3. No significant reform of the international tax rules is needed. The BEPS package has largely addressed the concerns of double nontaxation, although it is still too early to fully assess the impact. The existing tax system generally is satisfactory.

Acknowledging the divergence, there is welcome agreement that it is in the common interest to maintain a single set of relevant and coherent international tax rules to promote economic efficiency and global welfare. Therefore, a review will be undertaken of how taxing rights are allocated between jurisdictions (nexus) and how profits (and, presumably, losses) are allocated to the different activities carried out by multinational enterprises (profit allocation).

This work will include an analysis of the value contribution of certain characteristics of highly digitalized business models, as well as digitalization more broadly, and technical solutions to test the feasibility of different options for nexus and profit attribution rules. Input will be gathered from stakeholders.

**Interim measures**

There is no consensus on the need for, or merit of, interim measures and the interim report does not recommend their introduction.
Jurisdictions that oppose interim measures are concerned about the adverse consequences of a gross-basis tax on grounds including: the impact on investment, innovation and welfare; increases in consumer price; the possibility of over-taxation; and compliance and administrative costs, particularly given the limited time that the measure is intended to be in force. There also is concern that an interim measure may remain in place long term.

Other jurisdictions acknowledge these challenges, but consider that the policy challenge of not acting outweighs the disadvantages. These jurisdictions consider that the current position undermines the sustainability and public acceptability of the system and believe that, pending a global solution, jurisdictions should be compensated for what they consider to be untaxed value created in their jurisdiction. A number of jurisdictions, including the UK, are considering an interim measure in the form of an "excise" or revenue tax on the supply of certain e-services within their jurisdiction. In addition, on 21 March 2018, the European Commission released a proposal that would introduce an interim 3% tax on gross revenue derived from the provision of certain digital services based on where the revenue is generated, rather than where the company is located. This would be followed by longer-term structural changes to the definition of a permanent establishment (PE) that would permit digital services to create a deemed or virtual PE in a country where a service provider does not have a physical presence. See the article in this issue.

Countries have agreed that, where interim measures are introduced, design guidelines are to be followed to mitigate possible adverse consequences and limit divergence. In particular, the measures must:

- Comply with a country’s international obligations, including tax treaties and World Trade Organization, EU and EEA membership. Consideration will be needed as to whether the new tax would be covered by (and creditable under) existing bilateral tax treaties;
- Be temporary in duration. Countries must remain committed to working towards consensus on adapting the international tax system;
- Target the highest risk areas where value is created by user participation and network effects. The online sale of goods and digital content should be excluded. A number of countries maintain that the focus could be on internet advertising and online intermediation services on the basis that these businesses typically operate remotely and rely heavily on intangible property, data, user participation and network effects;
- Minimize over-taxation through a low tax rate and possible exemptions;
- Minimize impact on start-ups, business creation and small business more generally, e.g. thresholds for both global group revenue (potentially in line with the country-by-country reporting threshold of EUR 750 million) and local sales; and
- Minimize cost and complexity by relying on the existing tax collection mechanisms and place of supply rules. For online intermediation services, it is suggested that supply would be based at the location of the customer purchasing the intermediation services.

Next steps

An update on the work in respect of the profit allocation and nexus rules will be provided in 2019, with members working towards a consensus-based solution by 2020. The Task Force for the Digital Economy also will continue to monitor the impact of BEPS measures, US tax reform, unilateral measures and evolving business models in connection with the digitalization of the economy.

Comments

The taxation of sales and other activities in a country by nonresidents depends on rules that are strongly rooted in physical presence requirements and may not always reflect modern business models and technologies. Widespread international agreement is needed for any changes, since the law defining taxable presence is set out in the world’s 3,000 double tax treaties.

Currently, there is no consensus agreement on change among the inclusive framework member countries. Some favor a new allocation of profit model, where part of a group’s profit (or, presumably, loss) is allocated to jurisdictions where users are based. This is intended to reflect the depth of user contribution to the financial results of the digital service provider. The US Treasury indicated in February 2018 that it would be prepared to discuss this issue, but only as part of a wider review of taxable presence rules. Other countries do not consider that any significant reform is required. These are complex technical issues and agreement has been reached that a review is needed of the nexus (taxable
presence) and profit allocation rules, along with further work on value contribution. The OECD has set an ambitious timetable to develop a consensus-based solution by 2020.

New approaches should be aligned as closely as possible with the existing global consensus on international corporate taxation. The locations where new technologies are developed, enhanced and marketed must continue to receive the appropriate share of profit allocation, based on people functions and reward for the control and management of risks and the provision of assets.

While no interim measures are recommended, the pressures on some governments to take more immediate action are recognized. A framework of design considerations has been developed to help mitigate the risks of the unilateral introduction of any interim measures and to limit divergence.

As mentioned above, the European Commission has announced a proposal for interim and long-term approaches. The need to continue to monitor the latest developments in respect of evolving business models and the impact of unilateral action is recognized. It is essential that there is flexibility in taxation models to accommodate new developments, which bring benefits through boosting global economic growth. It also is essential that ultimately governments are able to agree a consensus solution over the framework for countries to tax digital businesses at the profit level to minimize double taxation and potential distortions that could affect businesses’ commercial decisions.

— Bill Dodwell (London)  
Partner  
Deloitte United Kingdom  
biodwell@deloitte.co.uk

— Alison Lobb (London)  
Partner  
Deloitte United Kingdom  
alobb@deloitte.co.uk

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