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Taxation of Digital Economy: Challenges & Response

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1. Taxation of Digital Economy

Introduction

The traditional way of doing business with human presence has undergone a significant change due to revolutionary improvements in communication and technology. The expansion of the communication and technology network has made rapid inroads into the supply chain network of every organisation. The supply chain network, which involves procuring and distribution of goods and services, has undergone significant change due to the rapid advancement of technology and communication. The expansion of the communication and technology network has brought in “invisible” players who did not exist earlier and hence, the rules of doing business are totally new, making every businessman adapt to changes in technology.

Digital Economy – An Outlook

The European Commission, in its report dated September 9, 2017,² has provided details on digital business. Some excerpts are given below:

- The growth of the digital economy is leading to a revolution in everyday life and business models, which not only affect traditional economic, political, governance, enforcement and business models but also tax and customs administration.
- Digitalisation changes the nature of exchange by blurring the lines between goods and services, transforming products to their digital representation, such as e-books or using the least material possible, for example: 3D printing.
- The digitalisation of the global economy is happening at a fast pace and on a large scale, permeating all areas of society.
- Close to a third of the growth of the overall industrial output in Europe is already due to the uptake of digital technologies. In 2006, only one technology company was among the top 20, accounting for only 7 per cent of the market capitalisation. In 2017, nine out of the top 20 companies by market capitalisation were technology companies, accounting for 54 per cent of market capitalisation of the total top 20 companies. Between 2008 and 2016, the revenue of the top five e-commerce retailers grew on average by 32 per cent per year. During the same time period, revenue in the entire EU retail sector grew on average by 1 per cent per year. New advances will rapidly arise from a new generation of information technologies, such as the internet of things, artificial intelligence, robotics and virtual reality. Digital solutions are being increasingly used and open up new opportunities for people, businesses, investors and public administrations.

Organisation for Economic Co-operation and Development (OECD), in its report on Action 1 of BEPS Action Plan – “Addressing the Tax Challenges of the Digital Economy”,

²European Commission Report- Communication from the Commission to the European Parliament and the Council- dated September 9, 2017

has summarised the outlook for the digital economy, A few excerpts on the impact of the digital economy are summarised below:

- The digital economy is the result of a transformative process brought about by information and communication technology (ICT). The ICT revolution has made technologies cheaper, more powerful, and widely standardised, improving business processes and bolstering innovation across all sectors of the economy. For example, retailers allow customers to place online orders and are able to gather and analyse customer data to provide personalised service and advertising; the logistics sector has been transformed by the ability to track vehicles and cargo across continents; financial services providers increasingly enable customers to manage their finances, conduct transactions and access new products online; in manufacturing, the digital economy has enhanced the ability to remotely monitor production processes and to control and use robots; in the education sector, universities, tutoring services and other education service providers are able to provide courses remotely, which enables them to tap into global demand; in the healthcare sector, the digital economy is enabling remote diagnosis and the use of health records to enhance system efficiencies and patient experience. The broadcasting and media industry has been revolutionised, expanding the role of non-traditional sources in news media, and expanding user participation in media through user-generated content and social networking.
- The developments in ICT have been characterised by rapid technological progress that has brought the prices of ICT products down rapidly, ensuring that technology can be applied throughout the economy at low cost. In many cases, the drop in prices caused by advances in technology and the pressure for constant innovation have been bolstered by a constant cycle of commoditisation that has affected many of the key technologies that have led to the growth of the digital economy. As products become successful and reach a greater market, their features have a tendency to solidify, making it more difficult for original producers to change those features easily. When features become more stable, it becomes easier for products to be copied by competitors. This is stimulated further by the process of standardisation that is characteristic of the ICT sector, which makes components interoperable, making it more difficult for individual producers to distinguish their products from others. Unless the original producer can differentiate its product from the copies (for example, by bundling its product with services or other features that are not easily duplicated), or otherwise find a way to maintain a dominant position in the market, it will be forced to compete solely on price or move to other market segments. This process tends to cause prices of the commoditised goods or services to fall, and innovation to move elsewhere in the value chain. This does not necessarily mean that every single component of the commoditised product becomes a commodity. A producer of a component of the overall product can maintain or create a proprietary advantage by enhancing some elements or subsystems of that component. This can “decommoditise” those elements or subsystems of the commoditised product, creating new opportunities at a different stage of the value chain.

- The rapid technological progress that has characterised the development of ICT has led to a number of emerging trends and potential developments that may prove influential in the near future. Although this rapid change makes it difficult to predict future developments with any degree of reliability, OECD expects several developments as outlined below:
 - Internet: The number of devices connected to the Internet is expanding rapidly, but substantial room for expansion remains. While Cisco has estimated that between 10 and 15 billion devices are currently connected to the Internet, that figure represents less than 1 per cent of the total devices and things that could ultimately be connected (Evans, 2012). Within the area of the OECD, households alone currently have approximately 1.8 billion connected devices. This figure could reach as many as 5.8 billion by 2017 and as many as 14 billion by 2022 (OECD, 2013). As increasing numbers of connected devices are developed and sold, the expansion of machine-to-machine communication appears likely to dramatically expand and improve the ability of businesses to collect and analyse relevant data.
 - Virtual Currencies: Recent years have been marked by the appearance and development of “virtual currencies”, meaning digital units of exchange that are not backed by government-issued legal tender. These currencies have taken various forms. Some virtual currencies are specific to a single virtual economy, such as an online game, where they are used to purchase in-game assets and services. In some cases, these economy-specific virtual currencies can be exchanged for real currencies or used to purchase real goods and services, through exchanges which may be operated by the creators of the game or by third parties. Other virtual currencies were developed primarily to allow the purchase of real goods and services. The most prominent examples of this type are various “cryptocurrencies”, including in particular “Bitcoins”, which rely on cryptography and peer-to-peer verification to secure and verify transactions. Many private operators have chosen to accept payment in Bitcoins.
 - Advanced robotics: The development of new connected and smart robots is changing manufacturing profoundly. The increased productivity of new automated factories is already making it possible for some multinational enterprises that had previously moved manufacturing offshore to take advantage of lower labour costs to consider moving their manufacturing activities back to where most of their customers are.
 - 3D Printing: Advances in 3D printing have the potential to bring manufacturing closer to the customer, with direct interaction with consumers influencing the design of product features. As a result, manufacturing could gradually move away

from mass production of standardised products, and instead focus on shorter product lifecycles by adopting a strategy of constant experimentation at scale.

Digital Economy and Business Models³

Examples of new ways of doing business

First, there is the online retailer model, in which goods are sold on online platforms or platforms that connect buyers and sellers in return for a transaction or placement fee or a commission. Examples of such businesses include Amazon, Zalando and Alibaba.

Second, there is the social media model, in which network owners rely on advertising revenues by delivering targeted marketing messages to consumers. Examples include Facebook, Xing and Qzone.

Third is the subscription model, in which platforms charge a subscription fee for continued access to a digital service (e.g. music or videos). Examples include Netflix and Spotify.

Finally, there is the collaborative platform model, in which digital platforms connect spare capacity and demand, use reputational currency mechanisms to underpin consumption, and enable individuals to share “access” to assets rather than own them outright. Platforms charge a fixed or variable fee on each transaction. Examples of such businesses include Airbnb, Blablacar and Didi Chuxing.

OECD has also explained the new business models under a digital economy.⁴ This has been summarized below:

Electronic commerce: Electronic commerce, or e-commerce, has been defined broadly by the OECD Working Party on Indicators for the Information Society as “*the sale or purchase of goods or services, conducted over computer networks by methods specifically designed for the purpose of receiving or placing of orders. The goods or services are ordered by those methods, but the payment and the ultimate delivery of the goods or service do not have to be conducted online. An e-commerce transaction can be between enterprises, households, individuals, governments, and other public or private organisations*” (OECD, 2011). E-commerce can be used either to facilitate the ordering of goods or services that are then delivered through conventional channels (indirect or offline e-commerce) or to order and deliver goods or services completely electronically (direct or on-line e-commerce).

Although e-commerce covers a broad array of businesses, the below paragraphs provides an illustration of some of the more prominent types.

- **Business-to-business models (B2B):** Involves transactions in which a business sells products or services to another business. These models accounts for vast majority of e-commerce. This can include online versions of traditional transactions in which a wholesaler purchases consignments of goods online, which it then sells to consumers from retail outlets. It can also include the provision of goods or services to support other businesses, including, among others: (i) logistics services such as transportation, warehousing, and distribution; (ii) application service providers offering deployment, hosting, and management of packaged software from a central facility; (iii) outsourcing of support functions for e-commerce, such as web-hosting, security, and customer care solutions; (iv) auction solutions services for the operation and maintenance of real-time

³Page 124 and 125 of OECD Report on Action 1

⁴Page 55 and 56 of OECD Report on Action 1.

auctions via the Internet; (v) content management services, for the facilitation of website content management and delivery; and (vi) web-based commerce enablers that provide automated online purchasing capabilities.

- Business-to-consumer models (B2C): These models were among the earliest forms of e-commerce and involves a transaction in which business sells goods or services to individuals acting outside the scope of their profession. B2C models fall into several categories, including, for example, so-called “pureplay” online vendors with no physical stores or offline presence, “click-and-mortar” businesses that supplemented existing consumer-facing business with online sales, and manufacturers that use online business to allow customers to order and customise directly.

The goods or services sold by a B2C business can be tangible (such as a CD of music) or intangible (i.e., received by consumers in an electronic format). Through digitisation of information, including text, sound, and visual images, an increasing number of goods and services can be delivered digitally to customers increasingly remote from the location of the seller. B2C e-commerce can in many cases dramatically shorten supply chains by eliminating the need for many of the wholesalers, distributors, retailers, and other intermediaries that were traditionally used in businesses involving tangible goods. Partly because of this disintermediation, B2C businesses typically involve high investment in advertising and customer care, as well as in logistics. B2C reduces transaction costs (particularly search costs) by increasing consumer access to information. It also reduces market entry barriers, as the cost of maintaining a website is generally cheaper than installing a traditional brick-and-mortar retail shop.

- Consumer-to-consumer models: Consumer-to-consumer (C2C) transactions are becoming more and more common. Businesses involved in C2C e-commerce play the role of intermediaries, helping individual consumers to sell or rent their assets (such as residential property, cars, motorcycles, etc.) by publishing their information on the website and facilitating transactions. These businesses may or may not charge the consumer for these services, depending on their revenue model. This type of e-commerce comes in several forms, including, but not limited to: (i) auctions facilitated at a portal that allows online bidding on the items being sold; (ii) peer-to-peer systems allowing sharing of files between users; and (iii) classified ads portals providing an interactive, online marketplace allowing negotiation between buyers and sellers.

Growth of e-commerce: The Internet facilitates transactions such as ordering goods and services. This means that many transactions that would have taken place without the Internet can be conducted more efficiently and at less expense. In addition, the Internet has expanded the reach of smaller businesses, enabling them to reach markets that would not have been possible to reach without its existence. As a result, the number of firms carrying out business transactions over the Internet has increased dramatically over the last decade.

Diversity of Revenue Models

The diversity of businesses in the current digital economy is illustrated by the variety of ways in which businesses turn value into revenue. OECD in its report has explained some of the common revenue models which is summarised below⁵:

- i. Advertising-based revenues. There are a few versions of this model. One version offers free or discounted digital content to users in exchange for requiring viewing of paid-for advertisements. Other models rely on providing advertising through mobile devices based on location or other factors. A third type concerns social media websites or platforms which typically build up a large online user community before monetising their captive audience through advertising opportunities.
- ii. Digital content purchases or rentals. Users pay per item of download – for instance, e-books, videos, apps, games and music would fall into this category.
- iii. Selling of goods (including virtual items). This category, which overlaps to a degree with (i), would include online retailers of tangible goods but could also cover online gaming, where users are offered a free or discounted introductory product but are also offered purchasable access to additional content or virtual items to enhance the experience.
- iv. Subscription-based revenues. Examples include annual payments for “premium delivery” with online retailers, monthly payments for digital content including news, music, video-streaming, etc. It could also include regular payments for software services and maintenance such as antivirus software, data storage, customer “help” services for operating systems, and payment for access to the Internet itself.
- v. Selling of services. This category overlaps with (iv) but would include traditional services which can be delivered online such as legal services (e.g. e-conveyancing), financial services (e.g. brokerage), consultancy services, travel agent services, etc. It would also include a large range of B2B services linked to enterprises who provide core Internet access and act as Internet intermediaries (web hosting, domain registration, payment processing, platform access, etc.).
- vi. Licensing content and technology. Again, this category overlaps with (iv) and (v) but might typically include access to specialist online content (e.g. publications and journals), algorithms, software, cloud based operating systems, etc., or specialist technology such as artificial intelligence systems.
- vii. Selling of user data and customised market research. Examples include Internet service providers (ISPs), data brokers, data analytics firms, telemetrics and data gained from non-personal sources.
- viii. Hidden” fees and loss leaders. There may be instances in integrated businesses where profits or losses may be attributable to online operations but because of the nature of the business, cross-subsidy with physical operations occurs and it is difficult to separate and identify what should be designated as ‘online revenue’. An example might include online banking, which is offered “free” but is subsidised through other banking operations and fees.”

⁵Page 64 of OECD Report on Action 1

Taxation Challenges of a Digital Economy

The emergence of the digital economy and new business models has created new taxation challenges. These include

- Identifying significant economic and digital presence
- Creation and Avoiding PE status
- Attribution of profits to significant economic presence or PE
- Application of Transfer Pricing to new business models
- Collection of tax

The next chapter deal with the challenges of taxing the digital economy and response of some countries as well as OECD to the challenges identified.

2. Taxation of the Digital Economy- Challenges and Response

Introduction

This chapter deals with taxation challenges and how some countries have responded to taxation issues relating to the digital economy. This chapter also deals with OECD's response.

OECD Response

Background:

In response to the BEPS issues, the OECD had identified 15 actions in its BEPS Action Plan released in July 2013. The very first action identified was in relation to taxation issues of digital economy. The BEPS Action Plan envisaged the following description of the work to be undertaken in relation to the digital economy:

*“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 cross-border supply of digital goods and services. Such work will require a thorough analysis of the various business models in this sector”.*⁶

The Task Force on the Digital Economy (TFDE), a subsidiary body of the Committee on Fiscal Affairs (CFA) was established in September 2013 to carry out the work of identifying issues raised by the digital economy and possible actions to address them by September 2014. The TFDE held its first Meeting on October 29-31, 2013, during which delegates discussed the scope of the work and heard presentations from experts on the digital economy. The Task Force also discussed the relevance of the work done in the past on this topic. In particular, the Task Force discussed the outcomes of the 1998 Ottawa Ministerial Conference on Electronic Commerce where ministers welcomed the 1998 CFA

⁶Page 16 of OECD Report on Action 1

Report “Electronic Commerce: Taxation Framework Conditions” setting out the following taxation principles that should apply to electronic commerce.

Neutrality: Taxation should seek to be neutral and equitable between forms of electronic commerce and between conventional and electronic forms of commerce. Business decisions should be motivated by economic rather than tax considerations. Taxpayers in similar situations carrying out similar transactions should be subject to similar levels of taxation.

Efficiency: Compliance costs for taxpayers and administrative costs for the tax authorities should be minimised as far as possible.

Certainty and Simplicity: Tax rules should be clear and simple to understand so that taxpayers can anticipate the tax consequences of a transaction, including knowing when, where and how the tax is to be accounted.

Effectiveness and Fairness: Taxation should produce the right amount of tax at the right time. The potential for tax evasion and avoidance should be minimised while keeping counteracting measures proportionate to the risks involved.

Flexibility: The systems for taxation should be flexible and dynamic to ensure that they keep pace with technological and commercial developments.⁷

Tax Challenges of Digital Economy

The growth of the digital economy and the growth of ICT services create a challenge for taxation rules as most countries and double taxation conventions have framed taxation rules to tax profits from traditional business models. The principles relating to taxation based on sourcing principles is always based on the rules meant for traditional businesses and not for businesses conducted through the digital means. Hence, the first issue that needs to be addressed is whether a digital economy should be segmented from rest of the economy. It is important to note in this context that as per the BEPS report, India’s export of ICT services is around US\$13.5 billion and ranks number 1. The BEPS action plan concluded that segmenting the digital economy from the rest of the economy is increasingly difficult. It observed that: *“As digital technology is adopted across the economy, segmenting the digital economy is increasingly difficult. In other words, because the digital economy is increasingly becoming the economy itself, it would be difficult, if not impossible, to ring-fence the digital economy from the rest of the economy. Attempting to isolate the digital economy as a separate sector would inevitably require arbitrary lines to be drawn between what is digital and what is not. As a result, the tax challenges and BEPS concerns raised by the digital economy are better identified and addressed by analysing existing structures adopted by MNEs together with new business models and by focusing on the key features of the digital economy and determining which of those features raise or exacerbate tax challenges or BEPS concerns, and developing approaches to address those challenges or concerns.”*

It is very relevant to observe that changes in the rules of taxation aimed to tax income arising from the digital economy may prove to be a challenge because rules under domestic law or the OECD model convention are primarily meant to tax profits arising from traditional routes of business. Therefore, any attempt to change the rules may pose challenges not only for the digital economy but may also lead to the dilution of rules meant for traditional businesses. Hence, care should be taken to ensure that rules for taxing the

⁷Page 17 of OECD Report on Action 1

profits from the digital economy should be segmented from rules for taxing traditional profits although it is accepted that the digital economy cannot be ring fenced from the rest of the economy.

OECD, in its report on Action 1, outlines the tax challenges posed by the digital economy⁸ as follows:

“The evolution of business models in general, and the growth of the digital economy in particular, have resulted in non-resident companies operating in a market jurisdiction in a fundamentally different manner today than at the time international tax rules were designed. For example, while a non-resident company has always been able to sell into a jurisdiction without a physical presence there, advances in information and communication technology (ICT) have dramatically expanded the scale at which such activity is now possible. In addition, traditionally for companies to expand opportunities in a market jurisdiction, a local physical presence in the form of manufacturing, marketing, and distribution was very often required. These in-country operations would have engaged in potential high-value operations such as procurement, inventory management, local marketing, branding and other activities that earned a local return subject to tax in the market country. Advances in business practices, coupled with advances in ICT and liberalisation of trade policy, have allowed businesses to centrally manage many functions that previously required local presence, rendering the traditional model of doing business in market economies obsolete. The fact that existing thresholds for taxation rely on physical presence is partly due to the need in many traditional businesses for a local physical presence in order to conduct substantial sales of goods and services into a market jurisdiction formed. It is also due in part to the need to ensure that the source country has the administrative capability of enforcing its taxing rights over a non-resident enterprise. The fact that less physical presence is required in market economies in typical business structures today – an effect that can be amplified in certain types of businesses in the ICT sector – therefore raises challenges for international taxation.”

OECD in its report has highlighted⁹ the following policy related challenges to taxing the digital economy.

- **Nexus:** The continual increase in the potential of digital technologies and the reduced need in many cases for extensive physical presence in order to carry on business, combined with the increasing role of network effects generated by customer interactions, can raise questions as to whether the current rules to determine nexus with a jurisdiction for tax purposes are appropriate.
- **Data:** The growth in sophistication of information technologies has permitted companies in the digital economy to gather and use information across borders to an unprecedented degree. This raises the issues of how to attribute value created from the generation of data through digital products and services, and of how to characterise for tax purposes a person or entity’s supply of data in a transaction, for example, as a free supply of a good, as a barter transaction, or some other way.

⁸Page 98 of OECD Report on Action 1

⁹Page 99 of OECD Report on Action 1

- **Characterisation:** The development of new digital products or means of delivering services creates uncertainties in relation to the proper characterisation of payments made in the context of new business models, particularly in relation to cloud computing.

VAT Challenges in Digital Economy

OECD in its report highlighted the challenges on VAT collection in a digital economy which is reproduced below:¹⁰

“Cross-border trade in goods, services and intangibles (which include for VAT purposes digital downloads) creates challenges for VAT systems, particularly where such products are acquired by private consumers from suppliers abroad. The digital economy magnifies these challenges, as the evolution of technology has dramatically increased the capability of private consumers to shop online and the capability of businesses to sell to consumers around the world without the need to be present physically or otherwise in the consumer’s country. This often results in no VAT being levied at all on these flows, with adverse effects on countries’ VAT revenues and on the level playing field between resident and non-resident vendors. The main tax challenges related to VAT in the digital economy relate to (i) imports of low value parcels from online sales which are treated as VAT-exempt in many jurisdictions, and (ii) the strong growth in the trade of services and intangibles, particularly sales to private consumers, on which often no or an inappropriately low amount of VAT is levied due to the complexity of enforcing VAT-payment on such supplies.”

OECD in its report also highlighted¹¹ administrative challenges on taxation of the digital economy.

“There is a pressing need to consider how investment in skills, technologies and data management can help tax administrations keep up with the ways in which technology is transforming business operations. The borderless nature of digital economy produces specific administrative issues around identification of businesses, determination of the extent of activities, information collection and verification, and identification of customers. These issues are outlined below.... Further, operational work is underway within the Forum on Tax Administration to develop a strong voluntary compliance culture and expand the use of modern technology for self-service delivery purposes (OECD, 2014).

- *Identification:* While global business structures in the digital economy involve traditional identification challenges, these challenges are magnified in the digital economy. For example, the market jurisdiction may not require registration or other identification when overseas businesses sell remotely to customers in the jurisdiction, or may have issues with implementing registration requirements, as it is often difficult for tax authorities to know that activities are taking place, to identify remote sellers and to ensure compliance with domestic rules. Difficulties in identifying remote sellers may also make ultimate collection of tax difficult.

¹⁰Page 120 of OECD Report on Action 1

¹¹ Page 105 of OECD Report on Action 1

- *Determining the extent of activities: Even if the identity and role of the parties involved can be determined, it may be impossible to ascertain the extent of sales or other activities without information from the offshore seller, as there may be no sales or other accounting records held in the local jurisdiction or otherwise accessible by the local revenue authority. It may be possible to obtain this information from third parties such as the customers or payment intermediaries, but this may be dependent on privacy or financial regulation laws.*
- *Information collection and verification: To verify local activity, the market jurisdiction's tax administration may need to seek information from parties that have no operations in the jurisdiction and are not subject to regulation therein. While exchange of information can be a very useful tool where the proper legal basis is in place, this is predicated on knowledge of where the offshore entity is tax resident and information retained or accessible by the reciprocating tax authority. This can create challenges for a market jurisdiction revenue authority seeking to independently verify any information provided by the offshore entity.*
- *Identification of customers: There are in principle a number of ways in which a business can identify the country of residence of its client and/or the country in which consumption occurs. These could include freight forwarders or other customs documentation or tracking of Internet Protocol (IP) and card billing addresses. However, this could be burdensome for the business and would not work where customers are able to disguise their location."*

Options proposed by OECD in its Action Report 1

The task force on BEPS Action plan 1 identified the following options to address issues relating to direct taxation on digitised businesses. The options are:

- Modifying the rules of exemption from Permanent Establishment
- Creating new rules based on Significant Digital Presence
- Virtual Permanent Establishment
- Creation of WHT on digital transactions

Modifying the rules of exemption from PE

The Action Plan report suggest that exemption contained in Paragraph 4¹² of Article 5 of the OECD Model Convention relating to preparatory and auxiliary services in connection to the PE should not be available. The action plan report contemplates multiple variations, which include the elimination altogether of Paragraph 4 or to consider the activities as PE for enterprises whose core business is some of the activities described in Paragraph 4.

The elimination altogether of Paragraph 4 will certainly affect business conducted through traditional methods and hence, it is not advisable to eliminate the exemption from Paragraph 4. Although the distinction between core and non-core business activities may

¹²Paragraph 4 of Article 5 of the OECD Model Tax Convention provides a list of functions that are specifically excluded from the definition of a PE such as use of facilities or stock maintenance solely for storage, display or delivery purpose, carrying on activity of a preparatory or auxiliary character, etc.

be appropriate under the circumstances, it is essential that more precise rules should be framed for this purpose. The entire intent of the BEPS strategy is to have rules for allocation of profits for different jurisdictions as business conducted through the digital economy spans across regions and each country will seek to exercise its right to tax profits based on sourcing principles. Therefore, it is essential that rules distinguishing between core and non-core should be clear.

New Nexus based on Significant Digital Presence

The Action Plan 1 report also discusses the option of establishing an alternative nexus to address situations in which businesses are conducted wholly digitally. Under this option, an enterprise engaged in certain “fully dematerialised digital activities” would have a permanent establishment if it maintained a “significant digital presence” in the economy of another country.

The present rules on PE are primarily related to creation of PE through physical presence and not due to virtual presence. The action plan report has suggested various tests to determine the creation of virtual PE and the test are based on

- Whether a significant number of contracts for the provision of fully dematerialised goods or services are remotely signed between the enterprise and a customer that is resident for tax purposes;
- Digital goods or services of the enterprises are widely used or consumed in the country;
- Substantial payments are made from clients in the country to the enterprise in connection with contractual obligations arising from the provision of digital goods or services as part of the enterprise’s core business; or
- An existing branch of the enterprise in the country offers secondary functions such as marketing and consulting functions targeted at clients resident in the country that are strongly related to the core business of the enterprise;

The creation of new rules in this context requires fundamental changes in existing rules of PE under Article 5 of the OECD Model Convention and also calls for changes in rules relating to attribution of profits under Article 7 of the OECD Model Convention. The context of fixed place PE, agency PE or an equipment PE or preparatory or auxiliary services may undergo drastic change if the existing Article 5 or 7 is modified to give effect to the rules relating to the digital economy. As said earlier, it is important to frame rules to tax profits arising from the digital economy but it should not change, extend or dilute the rules relating to traditional businesses. Hence, the task force, instead of changing the rules relating to Article 5 and Article 7, should consider a new article relating to PE and attribution of profits to address tax challenges arising due to the digital economy.

Virtual PE

The report considers the following options while discussing the creation of a virtual PE in the context of a digital economy.

- A “virtual fixed place of business PE”, which would create a permanent establishment when the enterprise maintains a website on a server of another enterprise located in a jurisdiction and carries on business through that website;
- A “virtual agency PE”, which would seek to extend the existing dependent agent PE concept to circumstances in which contracts are habitually concluded on behalf of an enterprise with persons located in the jurisdiction through technological means, rather than through a person; and
- An “on-site business presence PE”, which would look at the economic presence of an enterprise within a jurisdiction in circumstances in which the foreign enterprise provides on-site services or other business interface at the customer’s location.

Again, in the context of a digital economy, although the parameters listed may be valid and acceptable, the methodology of creation of PE and consequent attribution of profits under Article 7 is more critical. Further the option of altogether eliminating preparatory and auxiliary services under Paragraph 4 of Article 5 should not be considered if the concept of virtual PE is proposed. Any rules relating to the creation of physical PE or virtual PE should have exemptions and “preparatory and auxiliary services” are one of the important tools to consider the exemption.

Withholding of tax on Digital Transactions

The report considers the option of imposing a final withholding tax on certain payments made by residents of a country for digital goods or services provided by a foreign e-commerce provider. This proposal is intended to address the concern that it may be possible to maintain substantial economic activity in a market without being taxable in that market under current permanent establishment rules due to the lack of physical presence in that market.

This option is intended to eliminate the subjective test on PE and consequent subjective test on attribution of profits; this option should be used only as a means of tax collection in cases where a primary liability to tax exists on the foreign e-commerce provider. This option may pose a challenge as most payments are done through credit cards or online credit. Hence, the practical issue of imposing a WHT obligation and ensuring compliance with WHT may be difficult. The report suggests that the financial institutions involved with those payments would be required to comply with WHT. Further, the rules relating to foreign tax credit under the current tax treaties and under domestic tax law needs to be modified to give effect to WHT on digital transactions.

Introducing a bandwidth or “Bit” tax

Another potential option proposed in public comments would be to tax websites’ bandwidth use. Such a tax would be based on the number of bytes used by the website, although in order to introduce an element of progressivity, different tax levels would apply depending on the enterprise size or the turnover. For administrative purposes, such a tax would apply only to businesses that exceed a minimum threshold of annual bandwidth used. In order to maintain equity between digital businesses and traditional businesses, the proposed bandwidth tax would be creditable against corporate income tax.

UK Response

In November 2017, HMRC UK released a position paper on “Corporate Tax and Taxation of Digital Economy”.¹³ The position paper explains the international framework of the taxation including digital economy, challenges to the international framework, the government’s approach and important considerations.

Challenges to Current International framework

In its position paper, HMRC details the challenges of the digital economy to the current international framework. The challenges are summarised below:

- The significance of the BEPS project should not be underestimated. There is clear evidence that its recommendations, along with the unilateral action undertaken by the UK through the Diverted Profits Tax, are having a discernible impact on multinational groups' behaviour and the viability of complex tax planning structures that unfairly reduce UK tax receipts.
- However, the government believes that important weaknesses remain in the detailed application of the international tax framework which necessitate continued multilateral action. Specifically, there is a need to consider, and respond to, the challenges that remain with the transfer pricing rules.
- That includes:
 - the challenges for businesses and tax authorities in administering those rules. For example, the potential difficulties in applying the arm’s length concept to intra-group arrangements where no comparable arrangements exist between unrelated parties
 - the extent to which the changes made to the transfer pricing guidelines as part of the BEPS project are being administered in a consistent manner by countries in a way that: (i) prevents residual profits being realised in low-tax entities that own assets and risks in the absence of true economic substance; and (ii) prevents groups from being able to transfer valuable assets into low-tax entities without triggering appropriate tax charges at the level of the transferee
 - to the extent to which tax authorities have the requisite information on a multinational group’s global value chain, as opposed to just the group’s local activities, in order to support transfer pricing judgements
 - the situations in which the transfer pricing rules might leave countries exposed to risks of manufactured tax outcomes. For example, where the attribution of a large amount of profit is determined by the location of a small number of mobile and replaceable individuals taking decisions regarding the deployment of capital or the management of risk within a group.

¹³ Source: <https://www.gov.uk/government/consultations/corporate-tax-and-the-digital-economy-position-paper>

- This user-generated value is not captured under the existing international tax framework, which focuses exclusively on the physical activities of a business itself in determining where profits should be allocated for corporate tax purposes. This means that the businesses outlined above can generate significant value from a market like the UK without the profits they derive from that value being subject to UK corporation tax.

HMRC in its position paper explains that the challenges posed by the digital economy can be addressed only through sustained and long term reforms¹⁴. The paper explains that the reform would need to:

- ensure that the rules for determining the profits of companies within a group, or perhaps groups undertaking certain narrowly defined activities, reward the value that those companies might generate from user participation.
- give countries a right to tax the profits of foreign companies that derive value from a material and active user base within their jurisdiction, even in the absence of those companies having a permanent establishment.
- allocate an amount of profit of those foreign companies to the countries in which they have such a user base, based on a metric that approximates the value that the user base generates e.g. monthly active users.

Further, this paper explains the approach proposed to be adopted by the UK.

Of the options that have been put forward in this area, the UK government thinks the most attractive is a tax on the revenues that businesses generate from the provision of digital services to the UK market. There are a number of important design decisions, however, that need careful consideration:

- *Scope*: The UK government believes that the scope of such a tax should align with the specific concern raised about user participation not being given sufficient recognition by the international tax framework. That concern seems relevant to businesses that generate revenues through intermediation and the provision of online advertising. The concern seems less relevant to businesses that generate revenue through selling self-developed goods to customers through an online platform, selling acquired goods on an online platform, charging customers for the provision of digital content, or charging customers for the provision of digital software and digital services.
- *Nexus*: It would be important to consider what revenues the UK would have a right to tax, given the lack of a typical consumer in these businesses models and the possibility of users being located in a different country from consumers (or the users of an intermediation platform being located in different countries). For example, a social media platform may generate revenue from a non-UK business in relation to advertisements targeted at UK users.

¹⁴ Page 11 of the position paper

- *Rate*: The rate would need to be set at a level that raises material revenue in a way that is nonetheless fair, non-distortive and applicable to business models with different profit margins.
- *Collection* mechanism: There are different ways such a tax could be collected. There are potential benefits to collecting the tax directly from the relevant companies, to ensure more efficient compliance and to avoid placing new obligations on financial intermediaries, as may be the case under a withholding model.
- *Detailed* design: It would need to be considered how possible distortions with a revenue-based tax could be minimised, for example, through the provision of double tax relief, de minimis thresholds and mitigating provisions for loss-making and early-stage businesses.

Extension of WHT

The position paper clarifies that the UK government proposes to extend WHT on all payments to a multinational group which has zero or no WHT due to a treaty network and proposes to amend the tax treaties it has entered into with various countries. The paper clarifies that the government will introduce legislation seeking to tax profits that multinational groups make from selling products and services to UK customers, where those profits have been transferred to an entity in a low-tax country which has been awarded ownership of the group's intangible assets. This is not a comprehensive response to all of the challenges posed by the digital economy, but it's one that maximises what can be done without overriding the UK's treaties, raises material revenue from businesses primarily in the digital sector, and demonstrates that the government is serious about achieving reform of the international tax system to ensure that it produces fairer and more sustainable outcomes.

While the position paper acknowledges that the challenges that remain with the transfer pricing rules and any challenges created by business centralisation are not unique to businesses in the digital economy, even if those challenges might be exacerbated within a highly dematerialised digital group, it, however, does identify a specific concern, which is the tax rules' failure to recognise the reliance that certain digital businesses place on a sustained relationship with an active user base.

Update to the position paper:

In March 2018, the HMRC released an update to the position paper. The updated paper sets out the government's view that:

- the participation and engagement of users is an important aspect of value creation for certain digital business models, and is likely to be reflected through several channels, such as the provision of content or as a contribution to certain intangibles such as brand.
- the preferred and most sustainable solution to this challenge is reform of the international corporate tax framework to reflect the value of user participation. It is important that the members of the OECD's Inclusive Framework make progress in

developing multilateral solutions, and to assist this process the updated paper sets out some of the government’s initial considerations on what this could include.

- as set out at Autumn Budget, in the absence of such reform, there is a need to consider interim measures such as revenue-based taxes. The updated paper explores some of the important considerations regarding the scope and design of an interim measure, and the steps that could be taken to ensure that it is well-targeted and protects start-ups and growth companies. The government still thinks there are benefits to implementing an interim measure on a multilateral basis and it intends to work closely with the EU and international partners on this issue.

The updated paper does not look to set out the government’s final position on these issues. It instead sets out the government’s updated thinking, with a view to engaging further with businesses and other stakeholders to better understand and resolve some of the outstanding questions.

The government is nonetheless clear that there is a challenge that needs to be solved. The current misalignment between where digital businesses are taxed and where they create value threatens to undermine the fairness, sustainability and public acceptability of the corporate tax system.

The government hopes to find a multilateral solution to this challenge, and believes that the upcoming OECD report and G20 summit in Argentina will be important in setting out a programme of work for achieving that. The government thinks that the updated paper can help to inform that work, and help to achieve a coherent, proportionate and sustainable long-term solution.

The government welcomes the submissions and business engagement it has received since the publication of the original position paper, as it considers it useful in drawing out further considerations that need to be explored as part of its work.

International discussions on this issue have now reached an important point, with both the EU and OECD due to shortly present the outputs of their work.

The government therefore intends to continue engaging with businesses, the Inclusive Framework and the EU, to discuss their reaction to these outputs and its own policy development, as it works towards developing a proportionate and effective policy solution.

European Proposals on Action Point 1

The EU’s proposals relating to taxing the digital economy offer both a short term and long term solution. In its detailed study “Tax Challenges in Digital Economy” released in 2016,¹⁵ the EU Parliament expressed that although specific measures for the digital sector are not desirable, some out-of-the-box thinking might be needed to shape tax policies, suggested the following.

“In the short term, priority should be given to the question of the Permanent Establishment status mentioned below. In the long-term far-reaching reforms such as the conception of a single firm, modification of source and residence and deemed PE should be considered. Fractional apportionment, withholding tax on digital transactions and equalisation levy, which was already introduced in India, could be evaluated as possible measures in this

¹⁵TAX CHALLENGES IN THE DIGITAL ECONOMY- European Parliament- DIRECTORATE GENERAL FOR INTERNAL POLICIES POLICY DEPARTMENT A: ECONOMIC AND SCIENTIFIC POLICY

area. In our view, immediate action is needed to advance the so called ‘Beyond BEPS’ strategy and to make it happen sooner than later, as some of the reforms may take 5 or more years. By doing so, one shall keep a careful eye on measures on taxation introduced in other countries such as the reform process in the US. The current EU investigations against digital tech giants are commendable but they are temporary and a time-costly step in addition to being limited to the four fundamental freedoms and the EU case law. Hence, Member States shall also assume responsibility in tackling this issue by adapting existing tax laws. For instance, as a result of the UKs new tax laws aimed at forcing companies to pay more tax on revenue generated in the UK, Facebook changed its tax structure. One shall consider the possibility of the introduction of deadlines to make the investigation processes more efficient.

While the current legislative process in the EU on the VAT marks a shift towards the destination principle, some EU Member States such as the UK make it a propaganda by complaining about the omni-present EU. Having a say on VAT matters is important for the EU as its budget is mainly supplied by those payments. In our opinion, the VAT Action Plan Agenda, proposed under the Better Regulation Agenda by the Commission on 7 April 2016, is a significant step towards a single EU VAT area. The EU shall address the problem of its VAT gap but this should not come at the expense of giving up the right to have an influence over VAT rates of goods and products circulating to ensure the good functioning of its Single Market in order to please one or more Member State(s).”

European Commission Recommendations¹⁶

In its communication, the European Parliament describes the way-ahead on challenges in taxing the digital economy. The way-ahead as explained in the report is reproduced below:

Way-ahead

“EU citizens and governments are increasingly concerned by the perceived imbalances in the levels of taxation of the new digitalised business models. Failure to agree on a meaningful solution in adequate time will exacerbate the pressure to act at national level and will undermine the Single Market.

One solution is to embed the taxation of the digital economy in the general international corporate tax framework. Fundamental reform of the international corporate tax framework currently applicable to the digital economy would ensure the consistency and coherence of tax rules worldwide, and ensure stability and certainty for businesses. The EU expects a high level of ambition as regards the interim report on the taxation of the digital economy that the OECD will present to the G20. It is essential that the report comes forward with meaningful policy options to address the issues at stake.

In particular, new international rules specific to the challenges raised by digital economy are needed to determine where the value of businesses is created and how it should be attributed for tax purposes. This would entail reform of international tax rules on permanent establishment, transfer pricing and profit attribution applicable to digital technologies.

¹⁶COMMUNICATION FROM THE COMMISSION TO THE EUROPEAN PARLIAMENT AND THE COUNCIL

A Fair and Efficient Tax System in the European Union for the Digital Single Market –Dated September 21, 2017.

The permanent establishment rules are used to determine the threshold of activity that needs to be carried out in a country in order for a business to be taxable in that country, and are largely based on physical presence. However, thanks to digital technologies, businesses are now able to have a significant economic presence in a market jurisdiction without necessarily having a substantial physical presence. Alternative indicators for significant economic presence are therefore required in order to establish and protect taxing rights in relation to the new digitalised business models.

Once the business is taxable in the country, the profits generated by this business still need to be determined and allocated to this country. The transfer pricing rules are used to attribute the profit of multinational groups to the different countries based on an analysis of the functions, assets and risks within the value chain of the group. However, these rules were developed for traditional business models and economic environment. The digital economy relies heavily on intangible assets, which are becoming more and more the value drivers within multinational groups and which are difficult to value. The challenge of identifying and valuing intangible assets as well as determining their contribution to value creation requires alternative methods for attributing profit that better capture value creation in the new business models, which should therefore be considered alongside changes to the permanent establishment rules. Furthermore, as profits can be shifted across countries through misuse of permanent establishment and transfer pricing rules, anti-abuse rules could be considered to enforce compliance and ensure that profits earned in the EU are taxed in the EU.

At EU level, the Common Consolidated Corporate Tax Base proposal offers a basis to address these key challenges. The Commission continues to believe that the CCCTB provides an EU framework for revised permanent establishment rules and for allocating the profit of large multinational groups using the formula apportionment approach based on assets, labour and sales that should better reflect where the value is created. There is scope within the current CCCTB proposal to examine further enhancements to ensure that it effectively captures digital activities. Discussions are already underway on this in the Council under the Estonian Presidency and in the European Parliament. The Commission stands ready to work with Member States in examining these options within the ongoing CCCTB negotiations, to find an ambitious and EU-law compatible approach for the Single Market.

Arriving at a meaningful solution to capture and allocate the value created in the digital economy across countries can take time. This is further complicated by the multidimensional nature of this challenge, to the constantly changing nature of the digital economy, and the diversity of the business models and the complexity of ecosystems in which they create value. However, the longer it takes to find a solution, the bigger the losses in tax revenues will be. Therefore, unilateral initiatives in the EU and internationally will continue to develop. Since 2016, countries such as India and Israel have already been testing alternative approaches to ensure effective taxation of the digital economy.

Alongside the work on this longer-term strategy, there are also more immediate, supplementary and short-term measures that should be considered to protect the direct and indirect tax bases of Member States. Different ideas have been presented in the EU and internationally to capture the digital activity in an alternative way to the international corporate tax framework, and to ensure equal treatment and a level playing field for all businesses.

Some alternative options for shorter-term solutions

- *Equalisation tax on turnover of digitalised companies - A tax on all untaxed or insufficiently taxed income generated from all internet-based business activities, including business-to-business and business-to-consumer, creditable against the corporate income tax or as a separate tax.*
- *Withholding tax on digital transactions - A standalone gross-basis final withholding tax on certain payments made to non-resident providers of goods and services ordered online.*
- *Levy on revenues generated from the provision of digital services or advertising activity - A separate levy could be applied to all transactions concluded remotely with in-country customers where a non-resident entity has a significant economic presence.*

All short-term options have pros and cons, and further work is needed on the detailed approach to find a workable solution for the Single Market and the global economy as a whole. Questions about the compatibility of such approaches with the double-taxation treaties, State aid rules, fundamental freedoms, and international commitments under the free trade agreements and WTO rules would need to be examined. Yet something has to be done. The Commission remains convinced that the appropriate level of action is the EU. Only a coordinated EU approach will ensure that the solution is fit for the Digital Single Market and can deliver on our objectives of fairness, competitiveness and sustainability.

Conclusion

This Communication calls for a strong and ambitious EU position on taxing the digital economy, which should feed into ongoing international work on the issue. It also aims to provide a basis for further political discussions amongst Member States at the Tallinn Digital Summit of 29 September, so as to reach a common position in the international discussions.

The Commission will support the Estonian Presidency in its work on these issues with a view to stabilise by the end of the year Council conclusions setting out a coordinated EU approach. These conclusions would form the common basis that EU and its Member States would use to put forward proposals in the international discussions.

The EU expects meaningful progress in the global agenda and should push for this to be reflected in the OECD report to the G20 Finance Ministers at their meeting in April 2018. The Commission will contribute to a successful conclusion of the on-going global discussions at the G20.

In the absence of adequate global progress, EU solutions should be advanced within the Single Market and the Commission stands ready to present the appropriate legislative proposals. The Commission will continue to analyse the policy options and consult with relevant stakeholders and industry representatives on this important and pressing issue ahead of a possible proposal by spring 2018.”

The EU has proposed new rules in March 2018 to ensure that digital business activities are taxed in a fair and growth-friendly way in the EU. The measures would make the EU a global leader in designing tax laws fit for the modern economy and the digital age. This press release is appended as ***Annexure 1***.

Response of other countries on Action 1-

Most countries have responded by introducing cross border tax through VAT/GST. The summary of each country response on Action 1 is appended as *Annexure 2*¹⁷.

The next chapter sets out a brief analysis of certain judicial precedents in the context of taxation of digital economy.

¹⁷ Deloitte report on Action Point 1- Countries response.