E-commerce: Tax in the digital domain

2013 EMA TAX SUMMIT
E-commerce: Tax in the digital domain

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Are the international standards for corporate income taxation appropriate for e-commerce? 1/3

The OECD is monitoring the appropriateness of international tax standards for the challenges of the digitalised e-commerce business for more than fifteen years – with a shifting attitude


Stresses the economic potential of e-commerce

• “Electronic commerce has the potential to be one of the greatest economic developments of the 21st Century”

States the principle of tax neutrality in relation to traditional businesses

• “The taxation principles which guide governments in relation to conventional commerce should also guide them in relation to electronic commerce.”

Judges existing taxation principles as appropriate for e-commerce

• “The CFA believes that at this stage of development in the technological and commercial environment, existing taxation rules can implement these principles.”
Are the international standards for corporate income taxation appropriate for e-commerce? 2/3


Developed a set of criteria to facilitate existing treaty rules, identified alternatives to current treaty rules and assessed them on the basis of the evaluation criteria.

Concluded that it would not be appropriate to embark fundamental changes to current rules at this stage, i.a. based on the assumption that there is no evidence for base erosion.

“[…] there does not seem to be actual evidence that the communications efficiencies of the internet have caused any significant decrease to the tax revenues of capital importing countries.”

Stated that fundamental changes to current rules should only be undertaken if one particular alternative was clearly superior to existing rules – which none of the analysed alternatives was.

Proposed a close monitoring, how direct tax revenues are affected by changes to digital business models.
Are the international standards for corporate income taxation appropriate for e-commerce? 3/3

July 2013- OECD Action Plan on Base Erosion and Profit Shifting

States “BEPS is a concern in the context of the digital economy”

Action Point No. 1: Address the tax challenges of 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.”

The Action Plan names certain issues to be analysed:

- Companies having a significant digital presence in a country without being liable to taxation because of a lack of nexus
- The attribution of value creation from the creation of location-relevant data
- The characterisation of income derived from digital business models
- The application of related source rules
- Effective Collection of VAT/GST

Tight timeline until September 2015 to take concrete actions
What has changed?

Digital business models have seen an exponential growth since 2005

Recent empiric studies seem to prove that base erosion actually is a real phenomenon

In its 2005 final report, TAG stated, that consumer retail business (B2C) represents only a fraction of the e-commerce between businesses (B2B). This assumption is surely outdated

The TAG further assumed, that also e-commerce business models where in need of a physical local presence”[…] to maintain a competitive advantage and to provide the desired product or service to the recipient in the quickest and most cost-effective manner.”

Finally, the political landscape has dramatically changed.

■ Base erosion reached its place on the agenda of political leadership (G8, G20)
■ A growing number of countries, including France and Australia, are examining ways to enforce the taxation of digital businesses carried out in their frontiers by unilateral measures

As the OECD conceded in their BEPS report, those unilateral measures expose a significant threat of double taxation to the taxpayers if treaty rules are not aligned with those unilateral measures
The political momentum of the BEPS-Initiative and the focus on the digital economy

19.06.2012 G20 “BEPS-Declaration”, Los Cabos, Mexico
17.01.2013 Collin-Colin-Report
12.02.2013 OECD “Addressing BEPS” Paper
29.05.2013 OECD “Ministerial Declaration on BEPS”
05.09.2013 OECD “SG BEPS-Report to the G20”, St. Petersburg
The Beps-action plan is spearheaded by a notion to crackdown on the digital economy. Why is this the case?

Classical means of tax planning are enormously effective in the digitized economy:

The organisational architecture is pliable compared to traditional businesses

Comprising the entire scale: Residence, Subsidiaries, PEs, and especially even Non-PE-Schemes

Comprising the organisation of the chain of value-creation because of the importance of mobile factors

Turning the dependence on IP into an asset, efficiently exploiting their high value contribution and mobility

Resulting in structures such as (i) the Irish-Dutch-Sandwich and (ii) the IP-Holding-Scheme, used by many industries
Losses in corporate tax revenues (CTR) remain speculative and differ from source to source

US-Senator Carl Levin estimated USD 1.7 trillion of corporate earnings being currently stockpiled in tax havens

ZEW “Profit shift”:
- Quotes some other examples of estimated annual losses in tax revenues (UK GBP 12bn, Germany € 90bn, Developing Countries USD 50bn) but concludes: “Methodological flaws underlying the estimations prevent them from being very reliable”
- Nonetheless states: “Evidence exists that profit shifting takes places”

OECD “Addressing BEPS”, Chapter 2:
- Enormous amounts received and invested by recognised tax havens
- Enormous amounts inward and outward stock investment into/from Netherlands and Luxembourg (80% via SPEs)
- Concludes: “BEPS is indeed taking place, and it poses a threat in terms of tax sovereignty and tax revenue”
The upcoming debate should consider three questions

Is there a need to change the systematic approach OECD’s TAG took in its evaluation performed between 1999 and 2005?

What are the significant changes to the fact pattern or other consideration that the TAG based its 2005 conclusions on?

What alternative solutions have been discussed within the tax community since then and what is their evaluation against the set of criteria to be defined?
The set of criteria to measure the eligibility of tax reforms

1/2

Consistency with the conceptual base for sharing the tax base (TAG)
Forge consistency with the theoretical arguments on allocating taxing rights between states:
In what circumstances should a country have a claim to tax business profits (Nexus Issue)
What is the appropriate basis for dividing accrued business profits (Measurement-of-profits Issue)

Neutrality (Ottawa)
Taxation should seek to be neutral and equitable between forms of E-Commerce and between conventional and electronic forms of commerce. Business decisions should be motivated by economic rather than tax considerations

Efficiency (Ottawa)
Compliance costs for taxpayers and administrative costs for the tax authorities should be minimised as far as possible

Certainty and Simplicity (Ottawa)
Tax rules should be clear and simple to understand so that taxpayers can anticipate the tax consequences in advance of a transaction
The set of criteria to measure the eligibility of tax reforms

Effectiveness and Fairness (Ottawa)
Taxation should produce the right amount of tax at the right time. The potential for tax evasion should be minimised while keeping counter-acting measures proportionate to the risks involved.

Flexibility (Ottawa)
Tax rules should be flexible and dynamic enough to ensure that they keep pace with technological and business developments.

Compatibility with International Trade Rules (TAG)
Tax rules must be fully compatible with existing international trade rules.

The Need to Have Universally Agreed Rules (TAG)
Any set of rules to allocate taxing rights needs to be agreed to by as many countries as possible in order to avoid double taxation and double non-taxation.
### Overview of the considered measures 1/2

#### What measures are currently being discussed to counter perceived excessive MNE tax planning?

**Extension of residence taxation**

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<thead>
<tr>
<th>Pro</th>
<th>Contra</th>
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<tbody>
<tr>
<td>International mismatches in entity characterisation especially CFC-Rules enable creative usage</td>
<td>Currently, much dispute arises in the source states, which would not be solved</td>
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**Extension of source taxation**

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<tr>
<td>Disputed lack of appropriate source taxation could be alleviated</td>
<td>Gains and losses of the parties involved in a re-allocation of rights to tax at source remain unclear (Zero-sum-game)</td>
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**Destination Based Cash Flow Tax**

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<td>Very little leeway to artificially shift profits between entities</td>
<td>Effects hypothetic, digress from the bipolarity residence-source unrealistic, appropriateness questionable</td>
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### Common Consolidated Corporate Tax Base (CCCTB)

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<td>Group as subject to tax reflects economic reality, intra-MNE tax planning in the current form extinct (within EU)</td>
<td>Details and pertinence very unclear, formula apportionment questionable, EU-extern transactions not solved</td>
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### Transparency rules and exchange of information

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<td>Easily doable, enforcing tax laws facilitated</td>
<td>Systematic inconsistencies remain totally unsolved</td>
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Much emphasis is placed on the necessity of reforming the allocation of taxing rights to source countries. What are possibilities?

Implementation of deduction restriction rules:

- Thin-capitalisation rules/Earnings-stripping rules are broadly applied on debt financing
- Comparable deduction restrictions for intra-group royalties could be introduced

**Possible**

Non-deductibility of intra-group royalties

**Drawbacks**

1. Does not only affect avoidance arrangements
2. Reduces the consistency of income tax laws regarding taxation of financial capability
3. Often might cause double taxation
Imposition of withholding taxes on interest and royalty payments

- As long as full credibility in the state of residence, no double taxation would arise
- Currently for intra-EU transactions impossible to implement (conflicting with “EU Interest and royalty Directive”)

**Drawbacks**

1. Thus necessitates changes to: EU-Law, Tax Treaty Law, and various National Laws
2. Digital economy businesses typically have no subsidiary or PE in the source state

Implementation of general anti-avoidance rules

- Disallow the deductibility of payments (such as royalties and interest) to tax havens under certain conditions

**Drawbacks**

1. Difficult to delineate artificial and sound business structures by laws
2. Might thus be easy to circumvent and a potential subject to dispute over application
In Detail: The potential to extend taxation at source 3/3

Adequate valuation of IP and Royalty payments

- Overhauling Transfer Pricing Concepts with regard to IP usage and transfer
- Implementing national adjustment clauses if payments are revealed to be flawed in hindsight

Drawbacks

1. Application of Arm’s Length Principle to IP notoriously difficult
2. Necessitates taxable presence in source country, which could be avoided in digital economy

Imposition of a new PE-Threshold (Revision Art. 5 and Art 7 OECD-MC)

- Adaptation of the historical notion of significant connection to source state to new commercial realities
- Shift from physical presence to economic presence in terms of necessary nexus
- Shift from production to consumption as basis for allocating tax revenue
- Adaptation of the concepts of the measurements of PE-profits to new realities of value-creation

Drawbacks

1. Due to the variety of concepts each has its strengths and weaknesses
### Virtual Fixed Place of Business PE

**Concept**
Maintenance of a web-site on a server of another enterprise located in a source state and undertaking of business activities through that web-site. The place of business is the web-site itself.

**Remarks**
The criterion of a server located in the source state does not remove currently recognised pitfalls (i.e. it has deficiencies with regard to “Effectiveness & Fairness” and “Flexibility”).

### Virtual Agency PE

**Concept**
To extend the notion of the dependent agent PE to other circumstances (e.g. a web-site) where contracts are habitually concluded on behalf of the enterprise with persons located in the source state.

**Remarks**
More "Flexible" because underlying business structures are irrelevant, but to narrow a scope of application to cover “Effective” all business models of the digital economy and thus “Neutrality” questionable, albeit “Neutrality” in comparison with traditional business models increased.
In Detail: The imposition of a new PE-Threshold 2/3

### On-Site Business PE

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<td>Economic presence of an enterprise in a country where the business provides on-site services or other business interface. To determine the significance of the activities, a quantitative or qualitative threshold should be defined</td>
<td>The virtualised presence in the source state renders certain “Flexibility”, but the application of the Arm's Length Principle in the current form might be “Ineffective”, separate accountancy for each on-site service is “Inefficient”</td>
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### Access to Market Proxy PE

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<td>Economic presence in a jurisdiction is dependent on a sufficient access to the source country’s market. A sufficient access to the market is indicated e.g. by a certain volume of sales or bit rates being transmitted</td>
<td>The bit-access approach is “Flexible” and “Simple” but raises questions regarding “Effectiveness”, “Efficiency”, “Neutrality” and the “Consistency” for the supply-demand approach to source taxation was (historically) in minority</td>
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### Sales Volume PE

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<th>Concept</th>
<th>The volume of sales by itself trigger source taxation if a certain threshold is reached (e.g. $1m)</th>
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<tr>
<td>Remarks</td>
<td>Sales are only one business model in the digital economy, thus “Effectiveness” and “Neutrality” are questionable</td>
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### Data Collection via Free Labour PE (Collin-Colin)

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<th>Concept</th>
<th>Capture the notion of the digital economy to create value by systematically collecting personal data of the users of the provided web applications. Defining the data drill as origin of value-creation, taking place where users are located. The collected data itself as an equivalent to an asset is attributed to the web-service provided</th>
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<td>Remarks</td>
<td>Data collection is only one model of Non-PE business structures, thus it is not a “Neutral” concept. For the amount of data and their respective value might be the basis for allocating profits, intricate administration of amount and valuation of collected data will likely cause “Inefficiencies”</td>
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VAT Impacts – An evolving landscape

- **2003**: 1 July 2003 - ESS – Impact on Non-EU suppliers
- **2007**: 5 Jun 2007 - Agreement to bring in VAT Package
- **2010**: 1 Jan 2010 - Main VAT Package comes into force
- **2011**: 1 Jan 2011 - New place of supply rules came into force
- **15 Mar 2011**: Council Implementing Regulation 282/2011
- **2012**: 16 Jan 2012 - Commission Proposal
- **18 Jun 2012**: Proposal for a Council Regulation
- **9 Oct 2012**: ECOFIN adopt Council Regulation 967/2012
- **2013**: 1 Jan 2013 - New place of supply rules came into force
- **July 2013**: Final amendments to Implementing Regulation 282/2011 publicly released by EU Commission
- **31 Dec 2013**: Deadline for Council to adopt Council Regulation
- **2014**: 1 Oct 2014 - Submission of information from this date for MOSS registration
- **2015**: 1 Jan 2015 - New place of supply rules will come into force
Indirect Tax – challenges 1/2

Problem – VAT rates are not uniform in origin or system (within EU)

Solution – Tax where the consumer is … But...

VAT is a tax based on transactions

Who is the customer?

Where is the customer?

What is the customer?
Indirect Tax – challenges 2/2

Analogous to BEPS issue - “the seat of the economic activity”

Case law on “establishment” has not moved on substantially since early 2000’s – “human and technical resources” test is outdated

FS – Branch-to-Branch – Separate legal reality?

“Intervening in a supply” – broadly untested, but could be very wide ranging

Blurred lines of Agent v. Principal – especially ESS and Travel

Legal v. fiscal – conflict in how parties interpret contracts

Enforcement is difficult/impossible – especially where there isn’t any nexus

Double-taxation/non-taxation

2015 Changes – EU

Elsewhere: Norway, CH, Iceland, South Africa etc.
Thank you