BUSINESS at OECD
THE BUSINESS AND INDUSTRY ADVISORY COMMITTEE

OECD Interim Report on Tax Challenges Arising From Digitalisation
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Executive Summary

- The goal of the Inclusive Framework is to reach a global, consensus approach to digitalisation by 2020 (with an update in 2019).
- No consensus was reached on either the merit or the need for interim taxation measures related to digital services, as such, the report does not recommend introduction. However, Chapter 6 does outline the views of opponents of short term measures as to their disadvantages, as well as the views of the proponents of such measures as to the possible parameters if such provisions are implemented.
- Consensus was reached by the Inclusive Framework to review two foundational principles of the international tax framework in light of digitalisation – (1) Nexus and (2) Profit Allocation.

Chapter 1: Introduction to the interim report on the tax challenges arising from digitalisation

- The report reflects on the challenges presented by digitalisation and the impact on the broader economy, specifically noting that the impacts on the economy and society have intensified since the Action 1 Report in 2015 and broader challenges are now presented.
- Data collection is doubling every year, and combined with advances in data analytics and technology diffusion, technology is providing the insights necessary to transform and shape the way people behave and organisations operate.
- The future is far from certain and the nature of policy making needs a better framework to respond to it (OECD Going Digital Project).

Chapter 2. Digitalisation, business models and value creation

- The structure of businesses and the process of value creation have significantly evolved over time, especially for some enterprises. This chapter analyses the important characteristics of highly digitalised business models, with the aim of informing the current debate around international taxation.
- The report is the first step in outlining the characteristics, but there is still no consensus on the relevance of key features and their importance to the location of value creation and the identity of the value creator.
- The salient characteristics, which will become common features of an even wider number of businesses as digitalisation continues, include:
    - Cross jurisdictional scale without mass;
    - the heavy reliance on intangible assets, especially intellectual property ("IP"); and
    - the importance of data, user participation and their synergies with IP.
- To analysis the business model, the report addresses three concepts of value creation, widening the discussion from the traditional framework of a "value chain" – where an input is converted into an output.
    - The value chain (the traditional analysis developed my Michael Porter in the 1980s);

    - The value network (where value is often created through the process of "linking" and non-neutral pricing mechanisms are employed); and
    - The value shop (specific types of users, intensive technology applied to solve a specific customer demand or problem).
- There is also significant focus on data and it's important to the business model.
    - Data value cycle includes several interconnected phases:
        - Origination (accelerated by the Internet of Things);
        - Collection leading to "big data" (limited economic value without further manipulation);
        - Data analytics (decoupled from location of storage, analysis, or deployment, and potentially automated);
        - Knowledge base (the basis for economic value); and
        - Data driven decision making (the transformation into economic value).
    - User-generated content is an extremely valuable asset to many businesses, since it attracts traffic, contributes to trust-building, and in some cases, can represent the core of the business. There is a spectrum (from low to high levels of participation):
        - Manufacturing,
        - Cloud,
        - E-Commerce (tangible goods),
        - E-Commerce (intangible goods),
        - Collaborative consumption,
        - Social networks.
- Value of user participation varies from extremes. For social networks it is a central feature (although it is the investment in the platform that attracts users), for vertically integrated the relationship is more transactional.
    - Degrees of user interaction can be characterized as "active" versus "passive"- with varying degrees within such categories (e.g., bookmarking vs. posting in active and opening a web browser vs. downloading an app in passive).
    - A detailed social media example is included in the Business model case study section, focusing on all of the functions and features required to monetise the value network
    - A detailed annex of reviewed business models is included in Annex 2 (building on the social network example).

Chapter 3: Implementation and impact of the BEPS package

- Double non-taxation concerns are being addressed through implementation (direct and indirect taxes).
- Evidence that tax planning practices are changing, and many MNEs are aligning their corporate structures to more closely align with the underlying business activity (e.g., transition from remote sale/commissionaire models to local reseller models and the "on-shoring" of IP to jurisdictions with significant people functions). There's also significant evidence in the indirect (i.e., VAT/GST) area.
- At the same time, it's less evident that broader challenges raised in Final Action 1 Report have been addressed (i.e., nexus, data, and characterisation), likely as BEPS was targeted more to instances of double non-taxation rather than more systematic tax challenges proposed by digitalisation.

Chapter 4: Relevant tax policy developments

- This chapter summarized recent legislative action in this area.
- Several actions can be broken into four buckets – (1) change in nexus rules or alternative applications of the permanent establishment ("PE") threshold, (2) new withholding taxes, (3) turnover taxes on revenue, and (4) general measures targeted erosion of the local tax base by MNEs.
    1. Slovak Republic, India, and Israel have broadened the domestic nexus or PE definitions.
    2. Several jurisdictions have introduced withholding taxes on software and technical services.
    3. Italy, Hungary, France, India and the EU have all introduced various "turnover taxes" based on revenue (versus profit) – with modest expected revenues.
    4. Anti-base erosion measures, which encourage local business activities were introduced in the UK/Australia (Diverted Profits Tax or "DPT") and the U.S. (Base Erosion and Anti-abuse Tax or "BEAT") – with significant expected revenues.

Chapter 5. Adapting the international tax system to the digitalisation of the economy

- While acknowledging the divergences, the Inclusive Framework agree that they share a common interest in maintaining a single set of relevant and coherent international tax rules. Accordingly, they have agreed to undertake a coherent and concurrent review of the two key aspects of the existing tax framework, namely the profit allocation and nexus rules that would consider the impacts of digitalisation on the economy. Both are currently strongly rooted in physical presence, thus challenged by highly digitalised businesses.
- There are different viewpoints by Inclusive Framework countries, which the Interim Report breaks into 3 groups:
    - Group 1 believes that key features (particularly reliance on data and user participation) leads to (non-BEPS) misalignments on allocation of value creation. They do not want broad changes to international tax principles, and instead are in favour of targeted changes focussed on capturing value within certain digital business models.
        - This group also believes that interim, targeted measures are needed in the near term to address the issue – discussed in more detail below in Chapter 6.
    - Group 2 believes digitalisation is changing the entire economy and are therefore prepared to ask fundamental questions about the allocation of taxing rights – but do not believe that ring-fencing the digital economy is either necessary or desirable.
    - Finally, there is a third group of countries that believes that the BEPS package has largely addressed the concerns of double non-taxation, and do not currently see the need for any significant reform of the international tax rules.
- The Inclusive Framework will work towards a consensus based solution by 2020 (with an update in 2019).

Chapter 6: Interim measures to address the tax challenges arising from digitalisation

- There is no recommendation for introduction of interim measures, as the Inclusive Framework could not come to consensus on the merit or need for such measures. However, the chapter goes on to outline parameters, if countries did decide to act.

- A number are considering excise taxes on the supply of certain e-services within their jurisdiction that would apply to the gross consideration paid for the supply of such e-services by a registered e-services supplier – i.e., a turnover tax on gross revenue.
- The report warns that there are several risks of interim measures attempting to ring-fence digital, including:
    - Impact on investment, innovation, and growth (i.e., a reduction in incentive to invest);
    - Impact on welfare (i.e., distortion of firm choices leading to inefficiency in production/resources);
    - Potential economic incidence of taxation on consumers and business (i.e., higher prices for consumers);
    - Possible over-taxation (i.e., application of a gross tax in addition to existing income taxes, which is aggravated if the business has low margins or is loss-making);
    - Possible difficulties in implementing as only interim measures (i.e., a new set of rules and administrative procedures); and
    - Compliance and administration costs (i.e., increase in costs for governments and businesses to comply).
- Certain guidelines are provided should such countries enact measures:
    - Must comply with international obligations (e.g., double tax treaties, WTO obligations, etc.);
    - Temporary (should expire upon a comprehensive global solution);
    - Target specific e-services (e.g., internet advertising, intermediation services);
        - However, the Interim Report acknowledges that drawing a line is difficult and the attempt to ring-fence could have corresponding impacts outside of targeted sector.
    - Minimisation of over-taxation (i.e., avoid double taxation, cascading results at multi-levels, etc.);
    - Impact on start-ups, business creation, and small businesses (i.e., scope with a threshold); and
    - Cost and complexity (e.g., utilize existing measures with simplification to reduce the burden).

Chapter 7: Special feature: Beyond the international tax rules: The impact of digitalisation on other aspects of the tax system

- Online platforms also impact the formal and informal economy through P2P transactions and the gig and sharing economies, which are not currently well measured.
- Impact can be positive (e.g., shifting informal to formal economy increases revenues), however, such will also provide challenges (e.g., fair competition, consumer protection, social protections).
- A lack of information for tax administrations due to these changes may result in a lack of compliance. Work is needed to improve taxpayer education and self-reporting to assess the best way forward.
- Platforms will typically have some, but not all, relevant information. A collaborative and multilateral approach is recommended.
- Technology also impacts tax compliance and administration, including improving taxpayer services and reducing compliance burdens.

Chapter: 8 Conclusion

- The final chapter confirms and summarizes the prior chapters and reinforces the goal of coming to an international consensus by 2020.