

OECD Releases Discussion Draft on Tax Challenges of the Digital Economy

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In July 2013, the Organisation for Economic Co-operation and Development (OECD) released its [Action Plan on Base Erosion and Profit Shifting \[PDF\]](#) (the [BEPS Action Plan](#)). The BEPS Action Plan identified the spread of the digital economy as a source of multiple challenges for international taxation (Action 1). (For further details, see our [Update on the BEPS Action Plan, "OECD/G20 International Tax Reform: Potential Impact on Canadian Companies,"](#) July 19, 2013; our [Update on Action 6, "OECD Proposes Revisions to Tax Treaties to Prevent 'Treaty Abuse,'"](#) March 17, 2014; and our [Update on Action 2, "OECD Releases Discussion Drafts on Hybrid Mismatch Arrangements,"](#) March 20, 2014.)

On March 24, 2014, the OECD released a discussion draft identifying the major tax challenges raised by the rapidly developing digital economy and summarizing several possible options to address these challenges. Comments on the discussion draft are being accepted by the OECD until April 14, 2014. A final report is expected in September 2014.

Background

The OECD recognized in the BEPS Action Plan that rapid developments in information and communication technology (ICT) are creating new ways of doing business, leading governments to consider whether new rules of taxation may be required or whether the old rules need to be modernized to better address evolving business models. The BEPS Action Plan noted that the digital economy is characterized by a high degree of reliance on intangible assets, the use of personal and other data, the development of new business models to create value from "free" information and content, and the difficulty of determining the jurisdictions in which value is created.

The OECD notes that these characteristics threaten conventional thinking on how digital businesses add value and make profits, how digitally derived income should be characterized for tax purposes, and how the concepts of source and residence taxation should be understood in the context of virtual businesses. Action 1 of the BEPS Action Plan is aimed at addressing some of these challenges by examining how and where the value created from the sale and use of digital products and services should be taxed and how new rules should be enforced to ensure such taxes are collected.

The OECD established a Task Force on the Digital Economy in September 2013 and charged it with identifying issues raised by the digital economy and possible actions to address them. The discussion draft released on March 24, 2014 reflects the work of the Task Force as well as input from stakeholders.

The Information and Communication Economy

The discussion draft contains an overview of the way ICT has evolved and also identifies

emerging and future developments in the digital sector. Technological advances and falling prices for hardware and many digital services, combined with pressure for constant innovation, have contributed to the growth of the digital economy. Emerging developments in mobile computing, cloud-based processes, virtual currencies, 3D printing and decentralized data collection through the “Internet of Things” are also indications that digital commodities and sources of value will continue to expand.

New business models identified by the discussion draft include the explosion of e-commerce and digital advertising, the development of app stores for digital distribution of software and content and the expansion of cloud-based services. Diverse business models in the digital economy have created a number of revenue models, such as subscriptions for digital delivery of news, music and video-streaming; sales of user data and customized market research; and sales of digitally delivered services such as e-trading, payment processing and content hosting. These new business models and sources of revenue challenge conventional tax models and policy.

Tax Challenges in the Digital Economy

Key features of the digital economy identified by the discussion draft include volatility as a result of rapidly evolving technology, reliance on “big data” and the increasing mobility of suppliers, business functions and consumers. The discussion draft notes some of the key characteristics of the digital economy that may exacerbate the risks of base erosion and profit-shifting in both direct and indirect taxation:

- Taxation in the “market” country (where customers are located) may be minimized by avoiding a taxable presence or by shifting profits through structures that, for example, maximize deductions in higher-tax jurisdictions;
- Withholding tax at source may be minimized or reduced;
- Using exempt businesses (i.e., in jurisdictions that do not require the recipient of a service acquired from abroad to self-assess value-added tax [VAT] on the service) to purchase and then re-sell digital supplies to minimize VAT.

Additional challenges for international tax measures arise from the importance of intangibles and mobility to the digital economy. Intangibles themselves are increasingly mobile, making direct taxation difficult, while the mobility of users and customers creates substantial challenges and risks for VAT. These circumstances expand opportunities for base erosion, which the BEPS Action Plan is expected to address.

In general terms, the discussion draft identifies four main categories of tax policy challenges raised by the digital economy:

1. **Nexus:** Are the current rules appropriate, given the reduced need for an enterprise to have a physical presence in order to carry on business?
2. **Data:** How should value created from creating, collecting or manipulating data be characterized and attributed for tax purposes?
3. **Characterization:** How should payments for new services such as cloud-computing or software-as-a service be taxed? Do these payments represent sales income or royalties or something else?
4. **VAT:** How should VAT be reported and collected when goods and services are acquired from suppliers in distant jurisdictions, particularly when the value of each transaction

(such as a download of a music track) is minimal or the supplier is a small enterprise?

In addition to these policy challenges, administrative issues may also arise from the borderless nature of the digital economy. Tax administrations may have difficulty identifying the suppliers who are providing digital goods and services in their own jurisdictions as well as the extent and nature of the activities conducted by offshore sellers. Requiring customers or payment intermediaries to provide this information to tax authorities may also engage privacy and financial regulation laws. Similarly, the tax administration in the supplier's jurisdiction may have difficulty identifying the residence of customers in different jurisdictions, which may differ from the place in which consumption occurs.

Potential Options

The final report in September 2014 is expected to analyze a number of possible options to address some of the tax challenges of the digital economy, including the five options set out in the discussion draft (discussed below) and those proposed by stakeholders in response to the discussion draft.

Potential options will be evaluated with reference to the fundamental principles of electronic commerce taxation first formulated by the OECD in 1998. The discussion draft emphasizes that equity between the taxation of electronic and conventional forms of commerce is an important governing principle, as is the need to minimize the administrative burden on taxpayers and tax administrations. Flexibility will also be needed to ensure that new tax systems are able to keep pace with ever-advancing new technologies.

The Task Force seeks input from the public on the following five preliminary options to address the tax challenges outlined above:

1. **Modify the exemptions from permanent establishment (PE) status:** Paragraph 4 of Article 5 of the OECD Model Tax Convention currently provides a series of exemptions that may cause an enterprise's facilities or a fixed place of business in a jurisdiction not to be a PE under certain circumstances. The exemptions listed cover preparatory or auxiliary activities, such as maintaining a fixed place of business solely for the purpose of collecting information for the enterprise. The discussion draft proposes to eliminate the listed exemptions or make them subject to the overall condition that the character of the activity conducted be preparatory or auxiliary in nature rather than one of the enterprise's core business activities.
2. **Establish a new nexus rule for digital business:** An enterprise engaged in "fully dematerialized digital activities" could be considered have a PE in another jurisdiction if it maintains a significant digital presence there. Factors indicating a significant digital presence would include sales of digital goods and services that are widely used or consumed in that jurisdiction or the presence of a branch offering marketing, consulting or other secondary services. The discussion draft recognizes that a new nexus rule would also require parallel consideration of the manner in which profits may appropriately be attributed to such PEs and whether profit attribution provisions in existing treaties should be modified.
3. **Create a new rule for "virtual PEs":** A virtual PE might be established where an enterprise maintains a website on the server of another business located in that

jurisdiction and carries on business through that website. Alternatively, the existing dependent agent PE concept could be extended to apply when contracts are habitually completed through technological means in another jurisdiction, rather than through a person.

4. **Create a withholding tax on digital transactions:** Payments made by a resident of one country for digital goods or services provided by a foreign e-commerce provider could be subject to withholding tax. This measure might be enforced by requiring the purchaser's financial institution to withhold tax on credit card payments or electronic transfers.
5. **Require non-resident vendors to collect VAT:** Technological advancements could also assist tax administrations to simplify the registration and compliance mechanisms for VAT collection, making it more feasible to require a non-resident supplier of low-value goods or other cross-border transaction to charge, collect and remit VAT. Enforcing compliance from non-resident suppliers will be challenging for tax administrations, but may be improved through expanded mutual assistance and exchange of information agreements between taxing jurisdictions.

Conclusion

The discussion draft provides an overview of the way BEPS strategies will relate to the digital economy and summarizes the potential options initially discussed by the Task Force to address some of the broader tax challenges raised by the digital economy. It also provides an overview of the many concerns raised by member states and tax authorities with respect to capturing cross-border e-commerce and cloud-based service transactions that presently go untaxed.

Although its work is at a preliminary stage, the Task Force is proceeding quickly toward its final report in September 2014 and it appears that it intends its recommendations to be sufficiently flexible and adaptable to the ever-evolving flow of new digital goods and services between businesses and users in different jurisdictions. While flexibility is desirable, however, care will need to be taken to ensure that new measures or treaty revisions do not widen the tax net excessively or create disincentives for innovation or uncertainty with respect to reporting and collection mechanisms. Given the ubiquity of electronic commerce, the OECD's ultimate proposals will have a serious impact on enterprises across a wide range of sectors. In addition, it will ultimately be up to each country individually to decide whether and to what extent the OECD's recommendations may be adopted into its domestic law and bilateral tax treaties.

For further information or for advice on how these proposals may affect you, please contact any member of [Osler's national tax group](#).