Chapter 6

Tackling BEPS in the digital economy

This chapter discusses how work on the actions of the base erosion and profit shifting (BEPS) Action Plan and in the area of indirect taxation will address BEPS issues arising in the digital economy. It also highlights the particular characteristics of the digital economy that must be taken into account to ensure that the measures developed effectively address BEPS in the digital economy.

6.1 Introduction

Many of the key features of the digital economy, particularly those related to mobility, generate BEPS concerns in relation to both direct and indirect taxes. For example, the importance of intangibles in the context of the digital economy, combined with the mobility of intangibles for tax purposes under existing tax rules, generates substantial BEPS opportunities in the area of direct taxes. The mobility of users creates substantial challenges and risks in the context of the imposition of value added tax (VAT). The ability to centralise infrastructure at a distance from a market jurisdiction and conduct substantial sales into that market from a remote location, combined with increasing ability to conduct substantial activity with minimal use of personnel, generates potential opportunities to achieve BEPS by fragmenting physical operations to avoid taxation.

Work on the actions of the BEPS Action Plan (OECD, 2013) should take into account these key features in order to ensure that the proposed solutions fully address BEPS in the digital economy. The following sections describe how the work on the implementation of the BEPS Action Plan, as well as the work on consumption taxes, is expected to address these BEPS concerns.

6.2 Restoring taxation on stateless income

Structures aimed at artificially shifting profits to locations where they are taxed at more favourable rates, or not taxed at all, will be rendered ineffective by ongoing work in the context of the BEPS Project. At the same time, the work on BEPS will increase transparency between taxpayers and tax administrations and among tax administrations themselves. Risk assessment processes at the level of the competent tax administration will be enhanced by measures such as the mandatory disclosure of aggressive tax planning arrangements and uniform transfer pricing documentation requirements, coupled with a template for country-by-country (CBC) reporting. The comprehensiveness of the BEPS Action Plan will ensure that, once the different measures are implemented in a co-ordinated manner, taxation is more aligned with where economic activities take place. This will restore taxing rights at the level of both the market jurisdiction and the jurisdiction of the ultimate parent company, with the aim to put an end to the phenomenon of so-called stateless income.

6.2.1 Measures that will restore taxation in the market jurisdiction

A number of measures of the BEPS Action Plan will in effect restore source taxation, in particular Action 6 (prevent treaty abuse) and Action 7 (prevent the artificial avoidance of PE status).

6.2.1.1 Prevent treaty abuse (Action 6)

Effective rules to tackle the abuse of tax treaties are under development and model provisions will be delivered by September 2014. These rules will first address treaty shopping arrangements through which companies are set up in a country in order to take advantage of the treaty network of that country rather than for carrying on business activities in that country. They will also prevent the use of structures involving the use of companies that claim to be resident of two treaty countries to achieve double non-taxation. Further, it will address unintended cases of non-taxation that result from tax treaties, in particular where countries eliminate double taxation through the exemption method.

The denial of treaty benefits in cases that could otherwise result in double non-taxation will ensure that the market country will be able to apply its domestic law unconstrained by treaty rules aimed at preventing double taxation. This is of relevance both in cases where the foreign company has claimed not to have a taxable presence in that country in the form of a permanent establishment (PE) or when there is indeed a taxable presence in the form of a PE or a group company, but the relevant taxable income is reduced by deductible payments. In cases where such deductible payments would be subject to a withholding tax under domestic law, the market country will be able to apply such a withholding tax without any treaty limitation.

6.2.1.2 Prevent the artificial avoidance of PE Status (Action 7)

The treaty definition of PE may limit the application of domestic law rules applicable to the taxation of the business profits of non-resident companies derived from sources in the market country. The work done with respect to Action 7 aims at preventing the artificial avoidance of the treaty threshold below which the market country may not tax. The objective of the work is to develop changes to the definition of PE to ensure that the intended scope of the definition and, therefore, domestic taxing rights, are not circumvented through artificial arrangements. This work is due to be delivered by September 2015.

The work would consider whether and how the definition of PE may need to be modified to address circumstances in which artificial arrangements relating to the sales of goods or services of one company in a multinational group effectively result in the conclusion of contracts, such that the sales should be treated as if they had been made by that company. This will be relevant where, for instance, an online seller of tangible products or an online provider of advertising services uses the sales force of a local subsidiary to negotiate and effectively conclude sales with prospective large clients.

The work should also address the need to ensure that where essential business activities of an enterprise are carried on at a given location in a country, the enterprise cannot benefit from the list of exceptions usually found in the definition of PE (see e.g. Art. 5(4) of the OECD Model Tax Convention). It will also ensure that it is not possible to benefit from these exceptions through the fragmentation of business activities. In this context, the work should consider whether certain activities that were previously considered auxiliary for the purposes of these exceptions may be increasingly significant components of businesses in the digital economy. For example, if proximity to customers and the need for quick delivery to clients are key components of the business model of an online seller of physical products, the maintenance of a local warehouse could constitute a core activity of that seller. In addition to broader tax challenges (see Chapter 8), this raises BEPS issues when the lack of taxation in the market country is coupled with techniques that reduce or eliminate tax in the country of the recipient or of the ultimate parent.

6.2.2 Measures that will restore taxation in both market and ultimate parent jurisdictions

A number of measures in the BEPS Action Plan will contribute to restore taxation both at the level of the market jurisdiction and at the level of the parent company jurisdiction. These measures include the ones being developed in the course of the work on Action 2 (neutralise the effects of hybrid mismatch arrangements), Action 4 (limit base erosion via interest deductions and other financial payments), Action 5 (counter harmful tax practices more effectively), and Actions 8-10 (assure that transfer pricing outcomes are in line with value creation).

6.2.2.1 Neutralise the effects of hybrid mismatch arrangements (Action 2)

The BEPS Action Plan notes that hybrid mismatch arrangements can be used to achieve unintended double non-taxation or long-term tax deferral by, for example, creating two deductions for a single borrowing, generating deductions in one jurisdiction without corresponding income inclusions in another, or misusing foreign tax credit or participation exemption regimes. Existing structures within the digital economy take advantage of hybrid mismatch arrangements to achieve BEPS by stripping income from a market or intermediate jurisdiction or by avoiding application of controlled foreign company (CFC) rules or other anti-abuse regimes. The work done with respect to Action 2, which will be delivered by September 2014, will therefore, in effect, reduce opportunities for BEPS in the digital economy.

6.2.2.2 Limit base erosion via interest deductions and other financial payments (Action 4 and 9)

The innovation that is key to success in the digital economy must be financed. Many large and well-established digital economy players are cash rich and they often finance new ventures, the acquisition of start-ups, or other assets with intra-group debt. It is often the case that taxpayers will establish and capitalise entities in low-tax environments that are then able to engage in transactions with associated enterprises that have the effect of eroding the tax base. For example, an affiliate in a low-tax environment might be established to lend to high-tax operating entities or to purchase intangibles and license them to affiliates. Excessive interest deductions on such loans, or excessive deductions for royalties paid to such low-tax entities can present BEPS concerns in countries where business operations take place. Where the capital contributed to the low-tax entity to fund these activities is borrowed from third party lenders, the base erosion effect of these arrangements may be exacerbated. The same effects can be created by the retention of earnings in low-tax entities that own intangibles or assume risk, where such retained earnings are loaned to other operating entities.

In other words, the existing rules allow affiliate entities in a low-tax environment to fund the profit generating activities of the group with intercompany debt, even though the MNE group as a whole may be much less heavily leveraged. This ultimately reduces tax at the level of the market jurisdiction and at the level of the parent company jurisdiction, with the interest often going untaxed anywhere for a number of reasons (such as the availability of preferential regimes, the use of hybrid instruments, and the availability of generous deductions). Existing tax planning arrangements within the integrated global businesses that characterise the digital economy take advantage of this type of structuring to achieve BEPS.

The work done with respect to Action 4 will make recommendations regarding best practices in the design of domestic rules, in order to reduce opportunities for BEPS via deductibility of interest and other financial payments. This work will address BEPS opportunities with respect to both interest paid to related parties and to third parties, and will address both inbound and outbound investment scenarios. In co-ordination with this work, the work under Action 9 of the BEPS Action Plan will consider whether these behaviours have any transfer pricing implications and, as necessary, identify mechanisms to address those implications, within or beyond the arm's length principle. Similarly, more detailed guidance on the application of transfer pricing principles to loans, guarantees, captive insurance and other financial transactions will be developed. In this respect, a formulary type of approach which ties the deductible interest payments to external debt payments may lead to results that better reflect the business reality of multinational enterprise (MNE) groups. Other approaches to address excessive interest deductions will also be analysed. The output of this work will be delivered by September 2015.

6.2.2.3 Counter harmful tax practices more effectively (Action 5)

Digital economy companies heavily rely on intangible assets to create value and produce income. Intangible assets, and income arising from the exploitation of intangibles, are by definition geographically mobile. Over the last decade, a number of OECD and non-OECD countries have introduced intangible regimes which provide for a preferential tax treatment for certain income arising from the exploitation of Internet Protocol (IP), generally through a 50% to 80 % deduction or exemption of qualified IP income.

The work in the context of the BEPS Action Plan examines intangible regimes of the type described to determine whether they constitute harmful preferential tax regimes within the meaning of the OECD's 1998 Report "Harmful Tax Competition: An Emerging Global Issue". Action 5 of the BEPS Action Plan specifically requires substantial activity for any preferential regime and mandates that the existing substance factor to assess regimes be elaborated in the context of BEPS. IP regimes will be assessed against the elaborated substance factor and the other factors in the 1998 Report. The work on substantial activity and its application to IP regimes, as well as other preferential regimes, is under way. If any of the IP regimes under review were to be found harmful, the relevant country would be given the opportunity to abolish the regime or remove the features that create the harmful effect, as the case may be.

6.2.2.4 Assure that transfer pricing outcomes are in line with value creation (Actions 8-10)

The BEPS work on transfer pricing is intended to address BEPS issues that commonly arise among companies active in the digital economy as well as other taxpayers. Many of the structures involve separating business functions between different legal entities in the group, treating some of those entities as low-risk / low-profit entities, and others as high-risk / high-profit ones, making certain that the high-risk / high-profit entities do not conduct activities that trigger taxation in high-tax jurisdictions. Taken together, the overall objective of the transfer pricing actions is to bring the allocation of income within a multinational group of companies more directly in line with the location of the economic activity that gives rise to that income. This objective is pursued by focusing on key issues such as *(i)* intangibles, *(ii)* business risks, *(iii)* re-characterisation of transactions, *(iv)* base eroding payments, and *(v)* global value chains and profit splits.

i. Intangibles, including hard-to-value intangibles, and cost contribution arrangements

A key feature of many BEPS structures adopted by participants in the digital economy involves the transfer of intangibles or rights to intangibles to tax advantaged locations. Digital economy companies rely heavily on intangibles in creating value and producing income. Depending on the local law, below value transfers of intangibles can be facilitated through licensing arrangements, cost contribution arrangements or tax structures that separate deductions relevant to the development of the intangible from the income associated with it. Below value transfers of intangibles can occur *(i)* because of difficulties in valuing transferred intangibles at the time they are transferred; *(ii)* because of unequal access to information relating to value between taxpayers and tax administrations; and *(iii)* because some arrangements result in the transfer of hidden or unidentified intangibles without payment.

The BEPS work on intangibles will address these issues by taking several steps. First, the work will make it clear that the term intangibles should be defined broadly and clearly, and that any intangible item for which unrelated parties would provide compensation upon transfer must be compensated in transfers between associated enterprises. This will help ensure that transfers of hidden intangibles are not used to shift income. Second, the work will ensure that entities within an MNE group that contribute value to intangibles either by performing or managing development functions or by bearing and controlling risks are appropriately rewarded for doing so. It will also make clear that valuation techniques can be used when comparable transfers of intangibles cannot be identified. This first phase of the work will be delivered by September 2014. Third, in situations where partially developed intangibles or other hard-to-value intangibles are transferred, the work will consider whether the post-transfer profitability of intangibles should be taken into account in the valuation in specified circumstances in order to balance the availability of information between taxpayers and tax administrations. This second phase of the work on intangibles will be delivered by September 2015.

ii. Business risks

BEPS structures aimed at shifting income into low-tax environments often feature a contractual allocation of business risk into a low-tax affiliate. It is then often argued that these contractual allocations, together with legal ownership of intangibles, justify large allocations of income to the entity allocated the risk. Often this is accomplished by arguing that other entities in the group are contractually insulated from risk so that a low-tax affiliate is entitled to all residual income after compensating other low risk group members for their functions. The work will address questions related to contractual risk allocation by requiring control of risk, financial capacity to bear risk, and management of risk to be more closely aligned. The guidance will also identify risks that, by their nature, are borne by the MNE group as a whole and which therefore cannot be readily assigned to a single group entity. The output of this work will be delivered by September 2015.

iii. Recharacterisation of transactions

The existing transfer pricing guidelines require an analysis that takes as its starting point the transactions entered into by the taxpayer. The guidelines permit recharacterising or disregarding the taxpayer's transactional form in only some exceptional circumstances, the exact boundaries of which are not fully clear. Consideration is being given to whether the scope of current guidance on recharacterising taxpayer transactions should be revisited to reframe or clarify the guidance, and in what particular circumstances those rules may require modification. It is worth noting that there are significant complexities associated with disregarding taxpayer transactional forms. A broad scope for dispute and double taxation could arise if the scope for recharacterisation were expanded significantly, especially if this expansion is based on principles that cannot be limited to transactions with entities in low-tax environments. This means that careful weighing is required regarding the particular circumstances where taxpayer designed transactions may make transfer pricing analyses so uncertain as to become unreliable, thereby opening opportunities for BEPS. The work will provide clearer guidance on the difference between appropriately identifying the specific nature of transactions undertaken based both on actual conduct and contracts, on the one hand, and disregarding or recharacterising a transaction on the other hand. Because an unlimited authority in the hands of tax authorities to recharacterise transactions may lead to unwanted double taxation and increased levels of controversy, guidance will make clear that understanding precisely what business activities individual entities undertake is a critical element in the process of analysing transfer pricing matters. The output of this work will be delivered by September 2015.

iv. Base eroding payments

Excessive cross-border payments to related parties in low-tax jurisdictions can erode the tax base of the countries from which such payments are made. While transfer pricing rules based on the arm's length principle are theoretically equipped to address the proper amount of such payments, in some circumstances a combination of inadequate data on comparable transactions, a lack of tax administration enforcement resources, complex fact patterns, and questionable assumptions about the attribution of risk can create conditions in which excessive payments are made. This can result in such payments not being subjected to tax either in the low-tax recipient country or the home country of the MNE group, while they still give rise to base eroding tax deductions in the payor country. Certain targeted measures could potentially be helpful in addressing this type of BEPS. Depending on the way they are designed, such measures could preserve a measure of reliance on the arm's length approach but depart from a strict adherence to the arm's length principle in targeted circumstances. Examples of such approaches could include caps on certain payments, or formula based allocations. It would therefore be necessary to evaluate the effectiveness of these types of provisions, the areas in which they might be applied, whether they would ease administrative burdens, and mechanisms that could be used to avoid or relieve double taxation in situations where it might otherwise arise. The output of this work will be delivered by December 2015.

v. Global value chains and profit methods

When the arm's length principle was initially devised, it was common that each country in which an MNE group did business had its own fully integrated subsidiary to carry on the group's business in that country. This structure was dictated by a number of factors, including slow communications, currency exchange rules, customs duties, and relatively high transportation costs that made integrated global supply chains difficult to operate. With the advent of the development in information and communication technology (ICT), reductions in many currency and custom barriers, and the move to digital products and a service based economy, these barriers to integration broke down and MNE groups began to operate much more as single global firms. Corporate legal structures and individual legal entities became less important and MNE groups moved closer to the economist's conception of a single firm operating in a co-ordinated fashion to maximise opportunities in a global economy. Attention should therefore be devoted to the implications of this increased integration in MNEs and evaluate the need for greater reliance on value chain analyses and profit split methods. This work should also address situations where comparables are not available because of the structures designed by taxpayers and could also include simpler and clearer guidance on the use of profit methods, including profit splits along the lines that have been successfully applied in connection with global trading and other integrated financial services businesses. The output of this work will be delivered by September 2015.

6.2.3 Measures that will restore taxation in the jurisdiction of the ultimate parent

In addition to measures mentioned in Chapter 2, the work on strengthening CFC rules may also contribute to restoring taxation in the jurisdiction of the ultimate parent company. As noted in the BEPS Action Plan, one source of

BEPS concerns is the possibility of creating affiliated non-resident taxpayers and routing income of resident enterprises through that non-resident affiliate. Although CFC rules have been introduced in many countries to address this, there remain many jurisdictions that lack CFC rules. Where CFC rules do exist, they do not always address BEPS in a comprehensive manner. The work on CFC rules will encourage more countries to adopt CFC rules and develop recommendations regarding their design. The work will also consider the need for anti-inversion rules and to ensure that CFC rules have appropriate provisions to prevent double taxation. The output of this work will be delivered by September 2015. This measure will seek to counteract profit-shifting by restoring residence state taxation and may also have spill-over effects and hence at the same time protect the tax base of source countries. This is because effective CFC rules mean that taxpayers will have less of an incentive to shift profits from a source country into a low-tax jurisdiction.

To address BEPS issues within the digital economy, CFC rules must effectively address the taxation of mobile income typically earned in the digital economy. Although CFC rules vary significantly from jurisdiction to jurisdiction, income from digital products and services provided remotely is frequently not subject to current taxation under CFC rules. Accordingly, a multinational enterprise in a digital business can earn income in a CFC in a low-tax jurisdiction by locating key intangibles there and using those intangibles to sell digital goods and services without that income being subject to current tax, even without the CFC itself performing significant activities in its jurisdiction. As a result, a digital economy company may pay little or no tax in the CFC jurisdiction while also avoiding tax in the source country and the country of ultimate residence.

To address this situation, consideration should be given to CFC rules that target income typically earned in the digital economy, such as income earned from the remote sale of digital goods and services. Such income may be particularly mobile due to the importance of intangibles in the provision of such goods and services and the relatively few people required to carry out online sales activities. A CFC rule along these lines could include an exception for situations where the CFC, through its own employees, makes a substantial contribution to the value of the goods and services sold.

6.3 Addressing BEPS issues in the area of consumption taxes

The digitisation of the economy has greatly facilitated the ability of businesses to acquire a wide range of services and intangibles from suppliers in other jurisdictions around the world and to structure their operations in a truly global manner. These developments have allowed exempt businesses to avoid and minimise the amount of unrecoverable VAT they pay on their inputs. Section 5.3 of Chapter 5 outlined the BEPS concerns that may arise from the opportunity for businesses to structure their affairs in such a way that no or an inappropriately low amount of VAT is borne by exempt businesses on remotely delivered services and intangibles.

The implementation of Guidelines 2 and 4 of the OECD's "Guidelines on place of taxation for business-to-business (B2B) supplies of services and intangibles" would minimise BEPS opportunities for supplies of remotely delivered services and intangibles made to exempt businesses, including exempt entities that operate through establishments (branches) in multiple jurisdictions (multiple location entities (MLEs)).

Guideline 2 recommends that the taxing rights on cross-border supplies of services and intangibles between businesses be allocated to the jurisdiction where the customer has located its business establishment and that business customers be required to self-assess VAT on remotely delivered services or intangibles acquired from offshore suppliers according to the rules of the jurisdiction in which they are located.

Guideline 4 provides that when a supply is made to a business that is established in more than one jurisdiction, taxation should accrue to the jurisdiction where the customer's establishment (branch) using the service or intangible is located. These Guidelines set out the possible mechanisms for tax authorities to achieve the desired result in practice, which is allocation of the right to levy VAT on B2B services and intangibles to the jurisdiction where these services are used for business purposes irrespective of how the supply and acquisition of these services and intangibles were structured.

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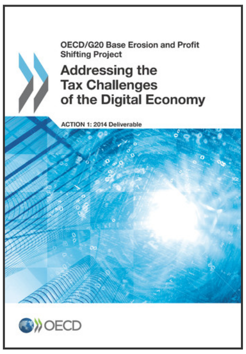
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