

Chapter 7

Broader tax challenges raised by the digital economy

This chapter discusses the challenges that the digital economy raises for direct taxation, with respect to nexus, the tax treatment of data, and characterisation of payments made under new business models. It also discusses the indirect tax challenges raised by the digital economy with respect to exemptions for imports of low-valued goods, and remote digital supplies to consumers. Finally, it lists certain administrative challenges faced by tax administrations in applying the current rules.

7.1 The digital economy and the challenges for policy makers

The spread of the digital economy brings about many benefits, for example in terms of growth, employment and well-being more generally. At the same time it gives rise to a number of challenges for policy makers. These challenges extend well beyond domestic and international tax policy and touch upon areas such as international privacy law and data protection, as well as accounting and regulation.

From a strategic tax policy perspective, the uptake of digital technologies may potentially constrain the options available to policymakers in relation to the overall tax mix. For decades, companies have contributed to public expenses via a broad range of taxes in addition to corporate income tax. These taxes include employment taxes, environmental taxes, property and land taxes. The development of digital technologies has the potential to enable economic actors to operate in ways that avoid, remove, or significantly reduce, their tax liability within these bases. This may increase the pressure on a smaller number of taxpayers to compensate for the related loss of revenues. It also highlights the importance of designing corporate income and consumption tax systems that promote growth and investment, while reducing inequality and establishing a level playing field among economic actors.

The following sections examine a number of the tax challenges raised by the digital economy in relation to corporate income tax and consumption taxation.

7.2 An overview of the tax challenges raised by the digital economy

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.

Other elements of the digital economy have also raised challenges for policy makers. As noted above, growing reliance in certain new business models on data may raise tax challenges in terms of characterisation of and attribution of value from data. Further, new revenue streams adopted in particular due to the spread of multi-sided business models or the use of massive computing power and broadband connection trigger questions regarding the appropriate characterisation of certain transactions and payments for tax purposes. Finally, digital technologies make it easier to do business across jurisdictions, as well as enabling consumers to access products and services from anywhere in the world, generating challenges in terms of collecting the appropriate amounts of consumption tax.

In general terms, in the area of direct taxation, the main policy challenges raised by the digital economy fall into three broad categories:

- **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.
- **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.

These challenges raise questions as to whether the current international tax framework continues to be appropriate to deal with the changes brought about by the digital economy and the business models that it makes possible, and also relate to the allocation of taxing rights between source and residence jurisdictions. These challenges also raise questions regarding the paradigm used to determine where economic activities are carried out and value is created for tax purposes, which is based on an analysis of the functions performed, assets used and risks assumed. At the same time, when these challenges create opportunities for achieving double non-taxation, for example due to the lack of nexus in the market country under current rules coupled with lack of taxation in the jurisdiction of the income recipient and of that of the ultimate parent company, they also generate BEPS issues.

Although the challenges related to corporate income tax (nexus, data and character) are distinct in nature, they may overlap with each other. For example, the characterisation of payments may trigger taxation in the jurisdiction where the payor is resident or established and hence overlap with the issue of nexus. Similarly, the collection of data from users located in a jurisdiction may trigger questions regarding whether it should give rise to nexus with that jurisdiction, and if so, whether and how the income generated from the use of these data should be attributed to that nexus. It also raises questions regarding how income from transactions involving data should be characterised for tax purposes.

The digital economy also creates challenges for value added tax (VAT) systems, particularly where goods, services and intangibles are acquired by private consumers from suppliers abroad. This is partly due to the absence of an effective international framework to ensure VAT collection in the jurisdiction of consumption. For economic actors, and in particular small and medium enterprises, the absence of an international standard for charging, collecting and remitting the tax to a potentially large number of tax authorities, creates difficulties and high compliance costs. From a government viewpoint, there is a risk of loss of revenue and trade distortion, as well as the challenge of managing tax liabilities generated by a high volume of low value transactions, which can create a significant administrative burden but marginal revenues.

In addition to these policy challenges, which are further discussed below, the Task Force has also identified a number of administrative issues raised by the digital economy. These latter issues are outlined in the box at the end of this chapter.

7.3 Nexus and the ability to have a significant presence without being liable to tax

Advances in digital technology have not changed the fundamental nature of the core activities that businesses carry out as part of a business model to generate profits. To generate income, businesses still need to source and acquire inputs, create or add value, and sell to customers. To support their sales activities, businesses have always needed to carry out activities such as market research, marketing and advertising, and customer support. Digital technology has, however, had significant impact on how these activities are carried out, for example by enhancing the ability to carry out activities remotely, increasing the speed at which information can be processed, analysed and utilised, and, because distance forms less of a barrier to trade, expanding the number of potential customers that can be targeted and reached. Digital infrastructure and the investments that support it can be leveraged today in many businesses to access far more customers than before. As a result, certain processes previously carried out by local personnel can now be performed cross-border by automated equipment, changing the nature and scope of activities to be performed by staff. Thus, the growth of a customer base in a country does not always need the level of local infrastructure and personnel that would have been needed in a “pre-digital” age.

This increases the flexibility of businesses to choose where substantial business activities take place, or to move existing functions to a new location, even if those locations may be removed both from the ultimate market jurisdiction and from the jurisdictions in which other related business functions may take place. As a result, it is increasingly possible for a business’s personnel, IT infrastructure (e.g. servers), and customers each to be spread among multiple jurisdictions, away from the market jurisdiction. Advances in computing power have also meant that certain functions, including decision-making capabilities, can now be carried out by increasingly sophisticated software programmes and algorithms. For example, contracts can in some cases be automatically accepted by software programmes, so that no intervention of local staff is necessary. As discussed below, this is also true in relation to functions such as data collection, which can be done automatically, without direct intervention of the employees of the enterprise.

Despite this increased flexibility, in many cases large multinational enterprises (MNEs) will indeed have a taxable presence in the country where their customers are located. As noted in Chapter 4, there are often compelling reasons for businesses to ensure that core resources are placed as close as possible to key markets. This may be because the enterprise wants to ensure a high quality of service and have a direct relationship with key clients. It may

also be because minimising latency is essential in certain types of business, or because in certain industries regulatory constraints limit choices about where to locate key infrastructure, capital, and personnel. It is therefore important not to overstate the issue of nexus. Nevertheless, the fact that it is possible to generate a large quantity of sales without a taxable presence should not be understated either and it raises questions about whether the current rules continue to be appropriate in the digital economy.

These questions relate in particular to the definition of permanent establishment (PE) for treaty purposes, and the related profit attribution rules. It had already been recognised in the past that the concept of PE referred not only to a substantial physical presence in the country concerned, but also to situations where the non-resident carried on business in the country concerned via a dependent agent (hence the rules contained in paragraphs 5 and 6 of Article 5 of the OECD Model). As nowadays it is possible to be heavily involved in the economic life of another country without having a fixed place of business or a dependent agent therein, concerns are raised regarding whether the existing definition of PE remains consistent with the underlying principles on which it was based. For example, the ability to conclude contracts remotely through technological means, with no involvement of individual employees or dependent agents, raises questions about whether the focus of the existing rules on conclusion of contracts by persons other than agents of an independent status remains appropriate in all cases.

These concerns are exacerbated in some instances by the fact that in certain business models, customers are more frequently entering into ongoing relationships with providers of services that extend beyond the point of sale. This ongoing interaction with customers generates network effects that can increase the value of a particular business to other potential customers. For example, in the case of a retail business operated via a website that provides a platform for customers to review and tag products, the interactions of those customers with the website can increase the value of the website to other customers, by enabling them to make more informed choices about products and to find products more relevant to their interests.

Similarly, users of a participative networked platform contribute user-created content, with the result that the value of the platform to existing users is enhanced as new users join and contribute. In most cases, the users are not directly remunerated for the content they contribute, although the business may monetise that content via advertising revenues (as described in relation to multi-sided business models below), subscription sales, or licensing of content to third parties. Alternatively, the value generated by user contributions may be reflected in the value of business itself, which is monetised via the sale price when the business is sold by its owners. Concerns that the changing nature of customer and user interaction allows greater participation in the

economic life of countries without physical presence are further exacerbated in markets in which customer choices compounded by network effects have resulted in a monopoly or oligopoly.

Another specific issue raised by the changing ways in which businesses are conducted is whether certain activities that were previously considered preparatory or auxiliary (and hence benefit from the exceptions to the definition of PE) may be increasingly significant components of businesses in the digital economy. For example, as indicated in Chapter 6, 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. Similarly, where the success of a high-frequency trading company depends so heavily on the ability to be faster than competitors that the server must be located close to the relevant exchange, questions may be raised regarding whether the automated processes carried out by that server can be considered mere preparatory or auxiliary activities.

Although it is true that tax treaties do not permit the taxation of business profits of a non-resident enterprise in the absence of a PE to which these profits are attributable, the issue of nexus goes beyond questions of PE under tax treaties. In fact, even in the absence of the limitations imposed by tax treaties, it appears that many jurisdictions would not in any case consider this nexus to exist under their domestic laws. For example, many jurisdictions would not tax income derived by a non-resident enterprise from remote sales to customers located in that jurisdiction unless the enterprise maintained some degree of physical presence in that jurisdiction. As a result, the issue of nexus also relates to the domestic rules for the taxation of non-resident enterprises.

7.4 Data and the attribution of value created from the generation of marketable location-relevant data through the use of digital products and services

Digital technologies enable the collection, storage and use of data, and also enable data to be gathered remotely and from a greater distance from the market than previously. Data can be gathered directly from users, consumers or other sources of information, or indirectly via third parties. Data can also be gathered through a range of transactional relationships with users, or based on other explicit or implicit forms of agreement with users. Companies collect data through different methods. These can be proactive, requesting or requiring users to provide data and using data analytics, or primarily reactive, with the quantity and nature of the information provided largely within the control of users e.g. social networking and cloud computing. As set

out in Chapter 3, data gathered from various sources is often a primary input into the process of value creation in the digital economy. Leveraging data can create value for businesses in a variety of ways, including by allowing businesses to segment populations in order to tailor offerings, to improve the development of products and services, to better understand variability in performance, and to improve decision making. The expanding role of data raises questions about whether current nexus rules continue to be appropriate or whether any profits attributable to the remote gathering of data by an enterprise should be taxable in the State from which the data is gathered, as well as questions about whether data is being appropriately characterised and valued for tax purposes.

While it is clear that many businesses have developed ways to collect, analyse, and ultimately monetise data, it may be challenging for purposes of an analysis of functions, assets, and risks, to assign an objective value to the raw data itself, as distinct from the processes used to collect, analyse, and use that data (OECD, 2013). For accounting purposes, the value of data collected by a business, like other self-created intangibles, would generally not appear on the balance sheet of the business, and would therefore not generally be relevant for determining profits for tax purposes. Although data purchased from another related or unrelated business would be treated as an asset in the hands of the buyer (and its subsequent sale would generate tax consequences), outright sale of data is only one of many ways in which collection and analysis of data can be monetised. For example, as with other user contributions, the value of data may be reflected in the value of the business itself, and may be monetised when the business is sold. Even where data itself is sold, the value of that data may vary widely depending on the capacity of the purchaser to analyse and make use of that data. The issue of valuing data as an asset is further complicated by existing legal questions about the ownership of personal data. Many jurisdictions have passed data protection and privacy legislation to ensure that the personal data of consumers is closely protected. Under most such legislation, this information is considered to be the property of the individual from which it is derived, rather than an asset owned by a company or a public good. Economic literature analysing intangible capital, in contrast, has tended to embrace modern business realities and value also assets whose ownership may not be protected by legal rules (Corrado et al., 2012).

The value of data, and the difficulties associated with determining that value, is also relevant for tax purposes in the cross-border context and triggers questions regarding whether the remote collection of data should give rise to nexus for tax purposes even in the absence of a physical presence, and if so (or in the case of an existing taxable presence) what impact this would have on the application of transfer pricing and profit attribution principles, which in turn require an analysis of the functions performed, assets used

and risks assumed. The fact that the value of data can impact tax results places pressure on the valuation of data. Further, the fact that the value of data can impact tax results if attributable to a PE or if held by a local subsidiary and sold to a foreign enterprise, but not if collected directly by a foreign enterprise with no PE, places pressure on the nexus issues and raises questions regarding the location of data collection.

In addition, data, including location-specific data, may be collected from customers or devices in one country using technology developed in a second country. It may then be processed in the second country and used to improve product offerings or target advertisements to customers in the first country. Determining whether profit is attributable to each of these functions and the appropriate allocation of that profit between the first country and the second country raises tax challenges. These challenges may be exacerbated by the fact that in practice a range of data may be gathered from different sources and for different purposes by businesses and combined in various ways to create value, making tracing the source of data challenging. This data may be stored and processed using cloud computing, making the determination of the location where the processing takes place similarly challenging.

Additional challenges are presented by the increasing prominence in the digital economy of multi-sided business models. A key feature of two-sided business models is that the ability of a company to attract one group of customers often depends on the company's ability to attract a second group of customers or users. For example, a company may develop valuable services, which it offers to companies and individuals for free or at a price below the cost of providing the service, in order to build a user base and to collect data from those companies and individuals. This data can then be used by the business to generate revenues by selling services to a second group of customers interested in the data itself or in access to the first group. For example, in the context of internet advertising data collected from a group of users or customers can be used to offer a second group of customers the opportunity to tailor advertisements based on those data. Where the two groups of customers are spread among multiple countries, challenges arise regarding the issue of nexus mentioned above and in determining the appropriate allocation of profits among those countries. Questions may also arise about the appropriate characterisation of transactions involving data, including assessing the extent to which data and transactions based on data exchange can be considered free goods or barter transactions, and how they should be treated for tax and accounting purposes.

The changing relationship of businesses with users/customers in the digital economy may raise other challenges as well. The current tax rules for allocating income among different parts of the same MNE require an analysis of functions performed, assets used, and risks assumed. This raises questions

in relation to some digital economy business models where part of the value creation may lie in the contributions of users or customers in a jurisdiction. As noted above, the increased importance of users/customers therefore relates to the core question of how to determine where economic activities are carried out and value is created for tax purposes.

7.5 Characterisation of income derived from new business models

Products and services can be provided to customers in new ways through digital technology. The digital economy has enabled monetisation in new ways, as discussed in Chapters 3 and 4, and this raises questions regarding both the rationale behind existing categorisations of income and consistency of treatment of similar types of transactions.

Prior work by the Treaty Characterisation Technical Advisory Group (TAG), discussed further in Annex A, examined many characterisation issues related to e-commerce. Although this work remains relevant, new business models raise new questions about how to characterise certain transactions and payments for domestic and tax treaty law purposes.¹ For example, although the TAG considered the treatment of application hosting, cloud computing has developed significantly since that work, and the character of payments for cloud computing is not specifically addressed in the existing Commentary to the OECD Model Tax Convention. The question for tax treaty purposes is often whether such payments should be treated as royalties (particularly under treaties in which the definition of royalties includes payments for rentals of commercial, industrial, or scientific equipment), fees for technical services (under treaties that contain specific provisions in that respect), or business profits. More specifically, questions arise regarding whether infrastructure-as-a-service transactions should be treated as services (and hence payments characterised as business profits for treaty purposes), as rentals of space on the cloud service provider's servers by others (and hence be characterised as royalties for purposes of treaties that include in the definition of royalties payments for rentals of commercial, industrial, or scientific equipment), or as the provision of technical services. The same questions arise regarding payments for software-as-a-service or platform-as-a-service transactions.

In the future, development and increasing use of 3D printing may also raise character questions. For example, if direct manufacturing for delivery evolves into a license of designs for remote printing directly by purchasers, questions may arise as to whether and under what circumstances payments by purchasers may be classified as royalties rather than as business profits, or may be treated as fees for technical services.

Under most tax treaties, business profits would be taxable in a country only if attributable to a PE located therein. In contrast, certain other types of income,

such as royalties, may be subject to withholding tax in the country of the payer, depending on the terms of any applicable treaty. Whether a transaction is characterised as business profits or as another type of income, therefore, can result in a different treatment for tax treaty purposes. There is therefore a need to clarify the application of existing rules to some new business models.

At the same time, when considering questions regarding the characterisation of income derived from new business models it may be necessary to examine the rationale behind existing rules, in order to determine whether those rules produce appropriate results in the digital economy and whether differences in treatment of substantially similar transactions are justified in policy terms. In this respect, characterisation has broader implications for the allocation of taxing rights. For example, if a new type of business is able to interact extensively with customers in a market jurisdiction and generate business profits without physical presence that would rise to the level of a PE, and it were determined that the market jurisdiction should be able to tax such income, modifying the PE threshold could permit such taxation. Source taxation could also be ensured by creating a new category of income that is subject to withholding tax. As a result, the issue of characterisation has significant implications for the issue of nexus.

7.6 Collection of VAT in the digital economy

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.

7.6.1 Exemptions for imports of low valued goods

The first challenge regarding collection of VAT arises from the growth that has occurred in e-commerce and in particular, online purchases of physical goods made by consumers from suppliers in another jurisdiction.

Countries with a VAT collect tax on imports of goods from the importer at the time the goods are imported using customs collection mechanisms. Many VAT jurisdictions apply an exemption from VAT for imports of low value goods as the administrative costs associated with collecting the VAT on the goods is likely to outweigh the VAT that would be paid on those goods. The value at which the exemption threshold is set varies considerably from country to country but regardless of the threshold value, many VAT countries have seen a significant growth in the volume of low value imports on which VAT is not collected.

Challenges arise from the ability of businesses to deliberately structure their affairs to take advantage of a country's low value thresholds and sell goods to consumers without the payment of VAT. For example, a domestic business selling low value goods online to consumers in its jurisdiction would be required to collect and remit that jurisdiction's VAT on its sales. The business could restructure its affairs so that the low value goods are instead shipped to its consumers from an offshore jurisdiction and therefore qualify under that VAT jurisdiction's exemption for low value importations. Similarly, a business starting up could structure its operations to deliberately take advantage of the low value exemption and locate offshore rather than in the jurisdiction in which its customers are located.

The exemption for low value imports results in decreased VAT revenues and the possibility of unfair competitive pressures on domestic retailers who are required to charge VAT on their sales to domestic consumers. As a consequence, the concern is not only this immediate loss of revenue and potential competitive pressures on domestic suppliers, but also the incentive that is created for domestic suppliers to locate or relocate to an offshore jurisdiction in order to sell their low value goods free of VAT. It should also be noted that such relocations by domestic businesses would have added negative impacts on domestic employment and direct tax revenues.

The exemptions for low value imports have therefore become increasingly controversial in the context of the growing digital economy. The difficulty lies in finding the balance between the need for appropriate revenue protection and avoidance of distortions of competition, which tend to favour a lower threshold and the need to keep the cost of collection proportionate to the relatively small level of VAT collected, which favours a higher threshold. At the time when most current low value import reliefs were introduced, internet shopping did not exist and the level of imports benefitting from the relief was relatively small. Over recent years, many VAT countries have seen a significant and rapid growth in the volume of low value imports of physical goods on which VAT is not collected resulting in decreased VAT revenues and potentially unfair competitive pressures on domestic retailers who are required to charge VAT on their sales to domestic consumers.

7.6.2 Remote digital supplies to consumers

The second challenge regarding collection of VAT arises from the strong growth in cross-border B2C supplies of remotely delivered services and intangibles. The digital economy has increasingly allowed the delivery of such products by businesses from a remote location to consumers around the world without any direct or indirect physical presence of the supplier in the consumer's jurisdiction. Such remote supplies of services and intangibles present challenges to VAT systems, as they often result in no or an inappropriately low amount of VAT being collected and create potential competitive pressures on domestic suppliers.

Consider an example of an online supplier of streaming digital content such as movies and television shows. The supplies are made mainly to consumers who can access the digital content through their computers, mobile devices and televisions that are connected to the Internet. If the supplier is resident in the same jurisdiction as its customers, it would be required to collect and remit that jurisdiction's VAT on the supplies. However, if the supplier is a non-resident in the consumer's jurisdiction, issues may arise.

As noted in Chapter 2, broadly two approaches are used by countries for applying VAT to such cross-border supplies of services or intangibles: the first approach allocates the taxing rights to the jurisdiction where the supplier is resident whereas the second approach allocates the taxing rights to the jurisdiction where the customer is resident. If the first approach is applied to the supply of digital content in the example, then this supply will be subject to VAT in the supplier's jurisdiction at the rate that is applicable in that jurisdiction. If the jurisdiction of the supplier of the digital content in the example has no VAT or a VAT with a lower rate than that of the consumer's jurisdiction, then no or an inappropriately low amount of VAT would be collected on this supply and none of the VAT revenue would accrue to the jurisdiction where the final consumption takes place.

The approach that allocates the taxing rights to the jurisdiction where the customer is resident would, in principle, result in taxation in the jurisdiction of consumption. However, under this approach, it is challenging for the private consumers' jurisdictions to ensure an effective collection of the VAT on services and intangibles acquired by such consumers abroad. One option is to require the private consumer to remit, or "self-assess", the VAT in its jurisdiction at the rate applicable in this jurisdiction. However, such consumer self-assessment mechanism has proven to be largely ineffective and as result, it is highly likely that no VAT would be paid by the consumer in this scenario. The OECD's E-commerce Guidelines (OECD, 2003) therefore recommend a mechanism that requires the non-resident supplier to register, collect and remit VAT according to the rules of the jurisdiction in which the consumer is resident. This results in the correct amount of VAT being paid in

the jurisdiction of consumption. This approach, however, is dependent on the non-resident supplier complying with the requirement to register, collect and remit the VAT. In other words, if taxing rights are allocated to the jurisdiction of consumer residence without implementing a suitable mechanism to collect the tax in this jurisdiction, no VAT would be paid.²

The example illustrates how domestic suppliers of competing services could face potential competitive pressures from non-resident suppliers. Domestic suppliers are required to collect and remit VAT on their supplies of services and intangibles to their domestic consumers while the non-resident supplier, depending on the scenario, could structure its affairs so that it collects and remits no or an inappropriately low amount of tax. The example also illustrates how an incentive could arise for domestic suppliers to restructure their affairs so that their supplies of services and intangibles are made from an offshore location, which could allow them to make the supplies with no or an inappropriately low amount of VAT. This incentive could arise as a response to competition from non-resident suppliers who are collecting no or an inappropriately low amount of VAT or as part of a strategy to gain a potential competitive advantage over domestic suppliers who are charging VAT. Such relocations by domestic businesses are likely to have a negative impact on domestic employment and direct tax revenues.

Against this background, jurisdictions are increasingly looking at ways to ensure the effective collection of VAT on services and intangible acquired by resident consumers from suppliers abroad, in line with the destination principle, relying primarily on a requirement for non-resident suppliers to register and collect and remit the tax. Compliance with these requirements is essentially voluntary as the consumers' jurisdictions have limited means to enforce compliance by non-resident non-established suppliers. The experience in countries that have implemented such an approach suggests that a significant number of suppliers comply by either registering in the VAT jurisdiction and collecting and remitting tax on their remotely delivered services or by choosing to establish a physical presence in the jurisdiction and effectively becoming a "domestic" supplier. It has been suggested that particularly the high-profile operators, which occupy a considerable part of the market, wish to be seen to be tax-compliant notably for reputational reasons.

However, it is difficult to assess compliance levels as data on the volume of taxable digital services to consumers are often not readily available. Some have suggested that it is currently impossible to track the supplies by non-resident vendors to private consumers on which VAT should be paid under a vendor collection mechanism in the consumer's jurisdiction. As a consequence, it is suggested that many non-resident suppliers are likely to fail to register and remit the VAT in the consumer's jurisdiction, without any real possibility for tax authorities to audit and sanction them (Lamensch, 2012).

As a result, there is a loss of VAT revenue to these jurisdiction and potentially unfair competitive pressures on domestic suppliers.

It should also be noted that some VAT regimes that allocate taxing rights to the jurisdiction of the residence or the actual location of the consumer, have not implemented a mechanism for collecting the VAT on services acquired by private consumers from non-resident suppliers. This has notably been based on the consideration that it would be overly burdensome on tax administrations to operate such a collection mechanism. As a result, no VAT is paid on digital supplies imported in these jurisdictions by private consumers. The strong growth of the digital economy, particularly the growing scale of B2C trade in digital products, may render this approach increasingly unsustainable.

Box 7.1. Administrative challenges in the digital economy

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. 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. Operational work is underway with respect to these administrative issues within the Forum on Tax Administration.

- **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.
- **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.

Box 7.1. Administrative challenges in the digital economy
(continued)

- **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.

Notes

1. In addition, the conclusions drawn in the TAG Report have not been accepted by all countries participating in the BEPS Project.
2. While the example deals with streaming movies and TV shows, the same issues arise with most, if not all supplies of remotely delivered services to consumers, such as cloud computing, gaming, software downloads.

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