At the intersection of international tax and digital transformation

Digital economy tax spotlight sweeps across BEPS, state aid and patent boxes

Building a better working world

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EY is a regular contributor to CCH's *Global Tax Weekly*. As tax and technology professionals, from member firms around the world, we share our insight and technology perspective on topics of interest to executives faced with taxation issues resulting from disruptive innovation and technology enabled digital transformation. The content contained in this document was first published in *Global Tax Weekly* – and is being reprinted with full knowledge and permission from Wolters Kluwer, copyright 2015 CCH.

In this edition

These local country and international dynamics present fundamental considerations for tax practitioners and international finance executives, who must:

1. Understand the level of uncertainty you face in monitoring and preparing for ongoing change in digital economy taxation worldwide.
2. Always keep in mind the current context of potentially varying tax treatment from country to country.
3. Map the tax treatment of IP, transfer pricing, research and development (R&D) and other issues related to your digital business models from the very outset, as you first develop your strategies, and build in flexibility for the long term.

Overview

October may well be remembered by taxpayers for the publication of highly anticipated multinational tax guidelines, but there was much more in store for the digital economy.

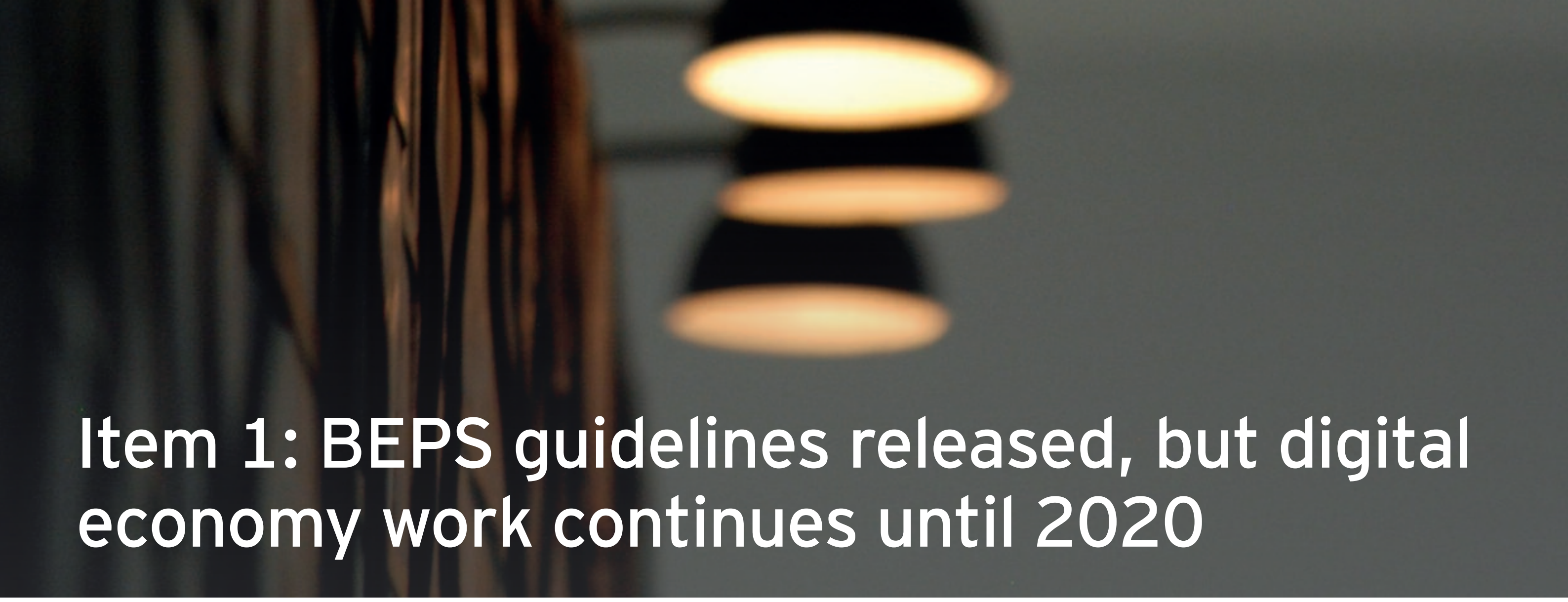
Some of the month's biggest headlines were reserved for charges of state aid, focusing on advance APAs between tax authorities and multinationals. And attention turned toward new developments in the evolution of tax regimes for IP development.

All of this October news is related, but each development also has a life of its own and will reverberate for some time to come. In this edition of our regular column, we analyze the implications for multinational companies and the digital business models that all industries are deploying today to serve global markets.

We also invite you to explore EY's new website devoted to digital economy taxation, at ey.com/digitaltax. There, you will find our newest reports — *3D printing taxation issues and impacts* and *Global digital tax developments review* — two important additions to a growing analytical resource that can help you operate with greater confidence in today's increasingly digital world.

Highlights and takeaways

Tax update	Technology impact	Ask yourself
The OECD releases the final package of tax guidelines from BEPS Project.	Work will continue on some of the most difficult digital economy tax questions, with more guidelines coming in 2020.	Where can you find new certainty in this year's guidelines, and how can you act with confidence in the areas left unresolved?
The EC finds that two countries' tax treatment of multinationals constituted state aid.	Both cases revolve around APAs in an era of digitally enabled global operations.	What is the most prudent approach to gaining advance tax rulings from national authorities?
Ireland's Knowledge Development Box is unveiled while the proposed US innovation box undergoes review.	Attention turns toward new developments in the evolution of tax regimes for IP development.	How and where could your company benefit most?
A court in Japan and a new BEPS guideline both reconsider how warehouses are taxed.	E-commerce warehouses could face PE status.	How might new interpretations of "preparatory or auxiliary functions" apply to your global supply chain?
Latin America trends toward more online taxes.	In Brazil, Colombia and Uruguay, scrutiny is increasing on cross-border transactions flowing from servers located overseas.	How can you ensure the desired returns on investment amid such fluid tax policy developments?
A European court invalidates US-EU Safe Harbor principles on personal data.	US multinationals are reconsidering how to protect the personal data of EU citizens as replacement principles are negotiated.	Have you considered the full range of alternative mechanisms to replace Safe Harbor certification?



Item 1: BEPS guidelines released, but digital economy work continues until 2020

October was indeed the month when the OECD released the final package of tax guidelines from the BEPS Project and its 15 action plan reports. It did not, however, mark the end of the OECD's digital economy tax deliberations.

Rather, the final report on Action 1: *Addressing the Tax Challenges of the Digital Economy* (the *Digital Economy Report)* projects that work will continue on some of the most difficult questions — even as the digital economy itself continues to evolve — with the OECD's Task Force on the Digital Economy announcing more guidelines in 2020.

That's not to say that nothing has changed on the global digital tax front. "Once the new measures become applicable, it is expected that profits will be reported where the economic activities that generate them are carried out and where value is created," the OECD wrote in its report. And so, for example, some companies are reviewing and confirming their arrangements and documentation surrounding IP ownership, development and commercialization.

BEPS has also focused on value-added tax (VAT)-like consumption taxes on digital services, as discussed in the last edition of this column.

What is in the final report on Action 1: *Addressing the Tax Challenges of the Digital Economy* (the *Digital Economy Report*)?

Overall, the report does not make detailed recommendations specific to the digital economy itself, instead reaffirming the task force's earlier conclusions that the digital economy is the economy and that the associated challenges should be addressed primarily by working groups addressing other BEPS action items. In fact, the final report largely follows the September 2014 draft of the *Digital Economy Report* in this and other regards. However, there are four specific areas where recommendations were made or indicated as needed.

They are:

- Modifying the list of exceptions to the definition of PE regarding preparatory or auxiliary activities as they relate to a digital environment and introducing new anti-fragmentation rules to deny benefits from these exceptions through the fragmentation of certain business activities
- Modifying the definition of a PE to address artificial arrangements through certain "conclusion of contracts" arrangements
- Making a correlative update to the transfer pricing guidelines
- Making changes to the controlled foreign company (CFC) rules addressing identified challenges of the digital economy.

Detailed analysis of these points and more insight on the *Digital Economy Report* are available in an *EY Global Tax Alert*.[1]

What did not make the final recommendations?

To the relief of many in the industry, certain options considered by the task force for addressing broader tax challenges raised by the digital economy (i.e., beyond BEPS) did not become recommendations. They are:

- A new nexus test in the form of a significant economic presence requirement
- A withholding tax on certain types of digital transactions
- An equalization levy addressing a digital business's ability to operate in a country without being physically present

The final report states that continued monitoring will enable the task force to assess the broader direct tax challenges and determine whether future work on these three additional options should be carried out. Meanwhile, the final report also states that countries could introduce any of the options in their domestic laws as additional safeguards against BEPS, provided they respect existing treaty obligations or include them in their bilateral tax treaties.

US Treasury reacts

The US Treasury Department responded to the final BEPS package in line with its recent expressions of opposition to certain of the practices addressed by the recommendations. Robert Stack, the Treasury's Deputy Assistant Secretary for International Tax Affairs, commented that the current US rules are largely consistent with the BEPS recommendations. The essence of Stack's comments seems to be that the US will support the project overall but does not anticipate making wholesale changes to its existing laws. Specifically, Stack said he does not anticipate significant changes to US transfer pricing regulations. The Treasury also claims that there is still much work to be done in certain areas, namely the PE definitions/attribution rules, CFC rules, and transfer pricing related to "cash boxes" and entities that only control investment risk but not operational risk.

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Considerations

The G20 leaders approved the full BEPS package on November 15, 2015.[2] As such – and also in anticipation of future BEPS recommendations – companies should review their existing digital supply chains and examine new or existing business models in line with the issues outlined in the *Digital Economy Report*.

Companies should also consider whether they have sufficient transfer pricing documentation to support their positions on digital intragroup/intercompany transactions because historical functional analysis may not provide enough detail about their digital supply chains. Finally, depending on a company's facts and circumstances, upfront dialogue with local tax authorities to discuss the implications of digital transactions may be useful where issues are particularly challenging.

Meanwhile, the OECD task force agreed that follow-up work will be carried out in consultation with stakeholders and on the basis of a detailed mandate that will be developed during 2016 in the context of designing a globally inclusive post-BEPS monitoring process. We encourage participation by interested companies, as both the digital economy and digital tax policy evolve.

You are invited to view, on demand, our recent webcast on the final *Digital Economy Report* and its implications for business worldwide.[3]

Item 2: State aid cases reflect on transfer pricing, advance tax rulings

The EC decided in October that Luxembourg and the Netherlands had granted selective tax advantages to local branches of multinational companies, effectively constituting illegal state aid. These two cases — and another two that are pending — have revolved around aspects of intragroup/intercompany transfer pricing of assets, functions and risks, as well as APAs between national tax authorities and multinationals. Several more investigations related to fiscal state aid are still at the informal stage, in that the Commission has not yet decided whether to open formal investigations.

In the first cases, the Commission decided that APAs applied methods that did not reflect economic reality arguing that prices set for goods and services sold between companies of each multinational group did not correspond to market conditions. The Commission held that in one case, profits were shifted abroad, where they also were not taxed, whereas in the other case, the company paid taxes on underestimated profits. The Commission ordered Luxembourg and the Netherlands each to recover the unpaid tax, estimated to be EUR20–30m (USD22–33m) for each company.

One takeaway of these decisions is that the Commission generally recognizes APAs as legal, as long as they reflect a proper application of tax laws. During a press conference, EU Commissioner for Competition Margarethe Vestager expressed that tax rulings are not in themselves problematic and that they are a useful tool to grant certainty to businesses. As for transfer pricing, she left it unclear whether new guidelines would be issued. Legal appeals to the approaches used in the two cases are expected.

Considerations

"EU state aid enforcement is just one part of a wider package that needs to come together to effectively address corporate tax avoidance and tax evasion," said Vestager. "But it also means that there is a big team that can get to work — here in the Commission, and together with the European Parliament, EU member states, the OECD and other international partners as well as businesses." However, observers are already questioning the alignment between the Commission's approach and the final BEPS guidelines — which, combined with the expected appeals, could perpetuate or even aggravate uncertainty surrounding transfer pricing and advance tax rulings. For more insight, please read the EY *Global Tax Alert* on the cases.[4]

Digitally enabled multinationals today can operate with unprecedented mobility and agility in the location and allocation of assets, functions and risks. They should, however, maintain a rigorous end-to-end tax view and assessment of their value chains. Advance tax rulings can help multinationals act with greater confidence, but caution is always required to avoid even the appearance of selective tax advantage.

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Item 3: Nations look to evolve IP tax regimes

Ireland's new IP regime is about to arrive on the global tax scene as more governments evolve their tax regimes for IP development.

In this column, we analyze Ireland's latest IP offering (with an effective tax rate of 6.25%) and a legislative proposal in the US (projected at 10.15%). The UK has been evolving its patent box since it was put in place in 2013 (at 10%). Italy, Luxembourg and Switzerland are also in the growing group of nations promoting patent box regimes.

Ireland publishes details on its new IP regime

The Irish Government recently published Finance Bill 2015 which included draft legislation on Ireland's new IP regime, the Knowledge Development Box (KDB). The KDB provides for an effective corporation tax rate of 6.25% on income arising from qualifying assets, where some, or all, of the related R&D is undertaken by an Irish company. The assets qualifying for the regime include patented inventions, copyrighted software and other specified forms of IP, including patents pending.

However, the regime does not extend to marketing intangibles such as trademarks, brands and image rights. The relief will be given by way of a tax deduction and will apply for accounting periods commencing on or after January 1, 2016, and will initially run to January 1, 2021. The KDB follows the nexus approach and is said to be the first OECD-compliant patent box. The nexus approach seeks to link the relief under the KDB to the proportion of qualifying R&D expenditure being carried on by the company on that innovation.

The KDB is the latest enhancement to Ireland's existing portfolio of tax incentives to encourage innovation in Ireland; these also include a 12.5% corporate tax rate for trading activities, a 25% R&D tax credit regime and tax amortization for specified intangible assets.

In US, public scrutiny of "innovation box" proposal continues

Since the July release of a discussion draft of the Innovation Promotion Act of 2015 (IPA), the House Committee on Ways and Means has been receiving a steady stream of feedback from companies and other stakeholders on this most recent legislative proposal to institute an "innovation box" in the US.

The proposal would tax certain income derived from IP at an effective tax rate of 10.15%. While the income that is attributed to IP under the proposal would be very broad, the amount of income that actually would be eligible for the reduced tax rate is reduced significantly by a factor that compares research costs incurred in the US to overall costs incurred worldwide (excluding costs of goods sold, interest and taxes). In addition, the proposal would not apply to income derived from the provision of services that involve the use of IP, nor would the proposal apply to LLCs, partnerships or other pass-through entities. A separate part of the proposal would reduce the US tax barriers for companies that on-shore their IP into the US.

Anemic benefit for the technology sector

Patent boxes are generally thought of as tax policy tools to encourage companies to locate IP (and the associated activities and jobs) in the country offering the patent box, so it stands to reason that technology, pharmaceutical, biotechnology and other research-driven sectors would be particular beneficiaries of a well-designed patent box. Yet, many technology companies (as well as companies in some of these other sectors) that have modeled the IPA against their income have discovered that the IPA provides surprisingly little tax savings, particularly as compared with patent boxes in other countries. Why? Companies have pointed to two principal features of the IPA that together diminish its benefits.

First, by not covering income from services, the proposal would exclude the rapidly growing portion of the technology sector that no longer licenses or sells IP or products that use IP — think of companies that deliver software as a service. Second, the reduction in eligible income based on the comparison of US research spending with worldwide costs is problematic for companies that spend substantial amounts in the US on research but have a global presence — even those companies that conduct all of their research activities in the US.

Tech groups weigh in

Groups representing the technology industry have suggested several changes to the IPA — first and foremost that the proposal be expanded to include income from services that involve the use of IP. In addition, these groups have argued that US research spending should be compared with worldwide research spending — not overall worldwide costs — in determining the reduction in income that is eligible for the reduced effective tax rate. Furthermore, the dilutive effects of low-margin operations should be addressed by including a floor to the benefit such that the reduced tax rate would apply to the greater of the eligible income determined under the proposal or 50% of a company's US research costs during the year. Another suggestion would actually shrink the innovation box by excluding routine returns and marketing intangibles.

Where to from here?

When the IPA was released in July, then-Ways and Means Chairman (now House Speaker) Paul Ryan (R-Wisconsin) stated that the proposal would be incorporated into a broader international tax reform package that he was negotiating with Senate Democrats to provide funding for a federal highway spending program. However, Speaker Ryan and Senator Charles Schumer (D-New York) jointly announced in October that the negotiations had reached a stalemate for the time being. Although this means we are unlikely to see a revised version of the IPA any time soon (either standing alone or as part of broader international tax reform legislation), technology companies and others will have more time to further review the IPA and provide their reactions to Capitol Hill.

Considerations

Companies making location decisions need to do careful, 360-degree, global analyses of competitive IP tax regimes, including all the devilish details and the sum total of all applicable taxes, as well as the operational costs and benefits of each particular location. To that end, we refer you to *EY Global Tax Alerts* on Ireland's KDB[5] and on the US innovation box.[6] Companies should also weigh in with policymakers as such programs are being developed and evolved, to advance the most favorable outcome. With all that said, competition among nations to attract multinationals' intangible asset ownership, development and commercialization should be viewed as good tax news (for a change).

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Item 4: E-commerce warehouses in the crosshairs

Foreign-owned warehouses shipping products purchased online have not typically been deemed as PEs subject to taxation in any given nation. A Japanese court earlier this year ruled otherwise. The ruling, and a subsequently released OECD BEPS guideline, raises concerns among e-commerce companies worldwide. It all has to do with what is and what is not a "preparatory or auxiliary" function — in other words, one that is remote from the actual realization of profits.

Japanese court rules warehouse is a PE
The Tokyo District Court rendered its decision in May in a dispute over the existence of a PE of a US-resident entity retailing auto parts and accessories to Japanese customers online. The entity used an apartment and warehouse in Japan for storage and delivery, as well as the receipt of returned products. Part-time Japanese employees packed orders, included product instructions, arranged for delivery, and handled product returns.

The court held that such activities should only be treated as exceptions to the general definition of PE if they are preparatory and auxiliary in character. It noted, in particular, that a warehouse located in Japan for quick delivery to customers and efficient handling of returned products was involved in important elements of the online retail business. Because these activities and other activities performed in Japan as a whole were in fact "significant" for an online retail business, the court upheld the existence of a PE in Japan.

Furthermore, the court held that substantially all of the sales income from the business activity should be attributed to the PE, without any deductions, due to both: (1) the functional significance of the activities in Japan, and (2) the fact that the taxpayer did not cooperate in the tax audit process and did not disclose its accounting books, which creates a rebuttable presumption for income calculation under the Japan–US Double Tax Treaty.

In legal terms, the court interpreted that under Article 5(4) of the Japan–US Double Tax Treaty, which is equivalent to Article 5(4) of the OECD Model Convention, the activities are not automatically deemed to be "preparatory or auxiliary."

OECD BEPS guidelines open to interpretation

The new OECD BEPS guidelines modify the list of Article 5(4) exceptions to the definition of PE to ensure that each of the exceptions included therein is restricted to activities that are of a "preparatory or auxiliary" character, and to introduce a new anti-fragmentation rule to ensure that it is not possible to benefit from these exceptions through the fragmentation of business activities among closely related enterprises.

The OECD *Digital Economy Report* singles out warehouses as an example, describing how the maintenance of a very large local warehouse, in which a significant number of employees work for purposes of storing and delivering goods sold online to customers by an online retailer of physical products (whose business model relies on the proximity to customers and the need for quick delivery to clients), could constitute a PE for that seller.

This would recognize that such warehousing and delivery activities should no longer be preparatory or auxiliary but instead have become an essential part of the retailer's business. Some countries, however, believe that there is no need to modify Article 5(4) and that the list of exceptions in subparagraphs (a) to (d) of Article 5(4) should not be subject to the condition that the activities referred to in those subparagraphs be of a preparatory or auxiliary character. Those countries may adopt a different version of Article 5(4) as long as they include the new anti-fragmentation rule. The extent to which the revised Article 5(4) would be implemented in each tax treaty will also depend on the outcome of BEPS Action 15's multilateral instrument negotiation.

Considerations

This is another area in which tax professionals should consider where they might face new risks of establishing one or many more additional PEs around the world, along with the taxes and administrative burdens associated with each.

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Item 5: Latin America trending toward more online taxes

Electronically delivered software, online services and streaming media are facing new taxes in parts of Latin America. In this column, we outline developments in Brazil, Colombia and Uruguay. In each case, scrutiny is increasing on cross-border transactions flowing from servers located overseas.

Brazil sorts through tax policies on software

Tax certainty continues to elude technology companies doing business in Brazil as they weigh the sometimes conflicting implications of state and federal rulings on VAT for software downloaded from the internet.

In September, the São Paulo State Government issued a substantial tax change (Decree 61,522) regarding the sale of software to Brazilian customers, particularly in the calculation of the *Imposto Sobre Operações Relativas à Circulação de Mercadorias e Serviços de Transporte Interestadual de Intermunicipal e de Comunicações* (ICMS, the state's VAT).

Starting in January 2016, the sale of software will be subject to the ICMS based on the total sales price, which includes the value of the software plus the electronic media and any other values charged to customers. Under prior rules in the state of São Paulo, the ICMS on software was calculated on an amount equivalent to twice the value of the carrier media only (e.g., CDs, flash drives).

The change opens a new chapter in the judicial discussion about whether it is legal to impose ICMS on the sale of software. Several software companies have argued that the ICMS should not be triggered on the sale of software to local customers, to the extent that the software itself should not technically be classified as a "good." In some cases, tax authorities have accepted that ICMS should only be triggered on the value of the carrier media, which qualify as goods under Brazilian law.

In the past, the Supremo Tribunal Federal (STF, Brazil's Supreme Court) had taken the position that software should be considered as an intangible asset, therefore not subject to ICMS. According to this interpretation, only the sale of off-the-shelf software, supported by physical media and without any customization, would be subject to ICMS. In a more recent case, however, the STF appeared to have changed its interpretation in a way that would legitimize ICMS on downloaded software. A final judgment is pending.

Also unclear is whether the ICMS would apply to cross-border software downloads. Theoretically, the ICMS on imported goods is paid at customs, a concept that has not been clarified for digital transactions. São Paulo state tax authorities are expected to develop a mechanism to include cross-border software sales under their new ICMS tax.

One more complication: it is important to note that software license agreements are also considered to be services, subject to the municipal *Imposto Sobre Serviços* (ISS), and in this context the discussion continues over the taxation of software sales by ICMS or ISS. In this matter, to avoid double taxation, the STF is also analyzing the constitutionality of ISS charging by municipalities.

Changes expected in Colombian taxation of foreign digital services

Colombia today generally provides a non-taxation environment for many multinationals' digital economy businesses when activities are carried out from data servers located abroad. However, recent signs indicate this could change in the near future.

Under current tax rules, foreign companies (even if they have a PE in the country) are subject to direct taxation only on Colombian source income. On the question of online services provided to Colombian customers via servers located abroad — and in the absence of other specific regulation — Colombian tax authorities have remained consistent since 2005. Their opinion has been that services such as streaming, cloud hosting and automated back-office activities, among others, should be considered as non-specialized/non-technical services rendered outside Colombia that generate foreign-source income and therefore, should not be subject to taxation in Colombia.

Lately, however, the local press has called attention to foreign companies conducting business in Colombia that are not subject to the same tax laws and other regulatory requirements as local companies. Current legislative proposals aim to create a new legal regulatory framework for television service, for example, that would also cover streaming media via the internet. Even though the proposals are not tax-driven, they could have some tax impact. Indeed, some of the proposals would require foreign entities to establish a legal presence in Colombia in order to provide the services and pay some contributions; this may end up subjecting the activity in Colombia to taxation at the level of a local entity, based on the function, risks, assets and employees that exist in Colombia.

At the same time, the OECD's BEPS Project is expected to exert an important influence in future Colombian tax policy. Now in the accession process to become an OECD member, Colombia participated in the BEPS discussion and has the political impetus to align with other OECD members.

In Uruguay, streaming services attract government, media attention

The taxation of streaming services has also become a focus of attention by the Uruguayan Government and media. Tax authorities have been asked to review foreign companies providing such services in Uruguay — usually without any requirement to pay taxes. Some local interests argue that foreign companies should be assessed with both income tax and VAT on the services.

Income tax in Uruguay is generally applicable on local source income, and VAT applies on services performed inside the country. It is not clear how the taxable amounts could be determined on streaming services from abroad. Nor is it clear which mechanism could be used for assessing and collecting the taxes. At the moment, there are no specific regulations or rulings establishing tax authorities' positions on such matters, but they are expected in the short term.

Considerations

Developments in Brazil, Colombia and Uruguay show a growing trend toward taxing cross-border streaming media, online services and downloadable software — even if political and practical details remain to be resolved. Such fluid tax developments again underscore how real-time monitoring of the policy environment and planning for a range of possible outcomes are critical to business strategy and planning, to ensure the desired returns on investment.

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Item 6: Data protection issue roils EU–US flows

As this column went to press, EU and US negotiators were racing to agree on new principles for the protection of Europeans' personal data – and US multinationals were reviewing their policies, procedures and systems for handling such data – after the European Court of Justice (ECJ) invalidated the US–EU Safe Harbor principles in effect since 2001.

What the court has ruled

The EU Data Protection Directive provides that the transfer of personal data to a non-EU country may, in principle, take place only if that country ensures an adequate level of data protection approved by the EC. Even though the US does not have a comprehensive data protection law, the EU and the US negotiated the Safe Harbor principles, and the EC recognized them as providing an adequate level of protection. Safe Harbor-certified businesses could then legally import personal data from the EU just like businesses inside the EU or in other "adequate" jurisdictions.

However, with its recent ruling in a case related to social media, the ECJ declared the Safe Harbor decision invalid, saying the EC did not assess that the US effectively "ensures" such an adequate level of protection under its domestic law or its international commitments. The ECJ also ruled that national data-protection regulators in EU member states have full authority to examine whether a challenged data transfer complies with EU law.

Considerations

While not a tax issue per se, this ruling could have an enormous impact on US financial services companies, internet companies and others – particularly those with recurrent and massive transfers of personal data. At this stage, all current EU data transfers relying on the Safe Harbor certification since October 6, 2015 are called into question.

In order to secure these data transfers and provide a framework for future transfers, businesses will need to reconsider their transfer strategy and consider the full range of alternative mechanisms under which personal data may be legally transferred to a "non-adequate" jurisdiction, such as EC standard contractual clauses and so-called binding corporate rules (BCRs). BCRs are binding internal rules within the same group of companies that ensure compliance with EU data-protection laws for the transfer and processing of personal data in countries with inadequate levels of data protection. If investigated, companies need to demonstrate that they have implemented or have engaged in best efforts to implement such legal vehicles to deal with transfers.

Meanwhile, within Europe, the EU Data Protection Directive has also been under a lengthy review, and a new General Data Protection Regulation is expected to be completed this year.[7]

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Note: the views expressed in this column are those of the authors and do not necessarily reflect the views of the global EY organization or its member firms. Check with your local EY tax advisor for the latest information regarding these rapidly developing topics.

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