OECD issues final report on the tax challenges of the digital economy under Action 1

Executive summary

On 5 October 2015, the Organisation for Economic Co-operation and Development (OECD) released its final report on the tax challenges of the digital economy (Action 1) under its Action Plan on Base Erosion and Profit Shifting (BEPS). This report was released in a package that included final reports on all 15 BEPS Actions. The document, Addressing the Tax Challenges of the Digital Economy (the Digital Economy Report or Final Report), largely follows the initial Action 1 deliverable on the digital economy released by the OECD on 16 September 2014 (the 2014 Deliverable). At 290 pages, the Final Report exceeds the 2014 Deliverable by 88 pages.

The Final Report provides the OECD’s conclusions regarding the digital economy and recommended next steps to address the tax challenges presented by its evolution. The Final Report continues to acknowledge that special rules designed exclusively for the digital economy would prove unworkable, broadly stating that the digital economy cannot be ring-fenced because it “is increasingly becoming the economy itself.” The Final Report summarizes key features of evolving digital business models that the OECD considers relevant for the overall BEPS analysis; in addition, the Final Report considers the broader direct and indirect tax challenges raised by the digital economy and evaluates the options to address those challenges.

To address the direct tax challenges, the Digital Economy Report does not recommend creating special rules; rather, it states that those challenges will be effectively addressed by the work carried out under other BEPS Actions.

In that regard, the Digital Economy Report recommends:

(i) Modifying the list of exceptions to the definition of Permanent Establishment (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.
(ii) Modifying the definition of a PE to address artificial arrangements through certain “conclusion of contracts” arrangements²

(iii) A correlative update to the Transfer Pricing Guidelines³

(iv) Changes to the controlled foreign company (CFC) rules addressing identified challenges of the digital economy⁴

The Final Report also addresses the indirect tax treatment of certain digital transactions, recommending that countries apply the principles of the OECD’s International Value Added Tax and Goods and Services Tax (VAT/GST) Guidelines as well as consider the introduction of the collection mechanisms included therein. Each of the above recommendations is discussed in more detail in this Alert.

Future work in the area of Action 1 will be conducted in consultation with a broad range of stakeholders, and on the basis of a detailed mandate to be developed by the OECD during 2016 in the context of designing a globally inclusive post-BEPS monitoring process. A supplementary report reflecting the outcome of continued work on the overall taxation of the digital economy should be released by 2020. The OECD intends to develop implementation packages to enable countries to implement the OECD’s International VAT/GST Guidelines in a coordinated manner.

EY is hosting a series of webcasts that will provide a comprehensive review of the final BEPS reports and outlook for country action. The final report on Action 1 will be addressed in a webcast on Digital Economy Developments and BEPS Action 1 on 27 October, 12 noon EDT.

Detailed discussion

Similar to the 2014 Deliverable, the Final Report is organized into a number of different chapters: Fundamental principles of taxation (Chapter 2); Information and communication technology and its impact on the economy (Chapter 3); The digital economy, new business models and key features (Chapter 4); Identifying opportunities for BEPS in the digital economy (Chapter 5); Tackling BEPS in the digital economy (Chapter 6); Broader direct tax challenges raised by the digital economy and the options to address them (Chapter 7); Broader indirect tax challenges raised by the digital economy and the options to address them (Chapter 8); Evaluation of the broader direct and indirect tax challenges raised by the digital economy and the options to address them (Chapter 9); and Summary of the conclusions and next steps (Chapter 10).

The report also includes: Annex A, which discusses prior work on taxation and the digital economy; Annex B, which illustrates typical tax planning structures in integrated business models; Annex C, which contains the text of a report on possible approaches for implementing a more efficient collection of VAT/GST on imports of low-value goods; Annex D, which presents Chapter 3 of the International VAT/GST Guidelines; and Annex E, which provides an overview of the expected economic incidence of the three proposed options to address the broader tax challenges of the digital economy. Annexes C, D and E were not contained in the 2014 Deliverable.

Fundamental principles of taxation

The Final Report starts by examining overarching tax policy considerations that have traditionally guided the development of taxation systems. The Final Report makes reference to the Ottawa Taxation Framework Conditions of Neutrality, Efficiency, Certainty and Simplicity, Effectiveness and Fairness, and Flexibility.

Following the discussion of tax policy considerations, the Final Report goes on to describe the typical forms of taxation on income and consumption. This includes an overview of the principles underlying corporate income taxes in the context of both domestic law and tax treaties, as well as an overview of VAT systems. The Final Report addresses the taxation of cross-border income through a discussion of CFC rules, the potential for double taxation in the allocation of cross border income, and the rules related to the taxation of PE’s under tax treaties.

Information and communication technology and the emergence of new business models

The Digital Economy Report includes a discussion of the evolution and expansion of information and communication technology (ICT) across the economy, the
key features of the new business models that have emerged as a result of this evolution, and their impact on the economy. Building on this discussion, the Final Report identifies some key trends in the evolution of ICT and new business models that are viewed as contributing to the tax challenges of the digital economy. The following features are noted as examples of new business models resulting from the evolution of ICT:

- Ecommerce (including business-to-business, business-to-consumer, and consumer-to-consumer models)
- App stores
- Online advertising
- Cloud computing (including infrastructure-as-a-service, platform-as-a-service, software-as-a-service, content-as-a-service, and data-as-a-service)
- Payment services
- High frequency trading
- Participative networked platforms

The Final Report identifies the key features of the digital economy and new business models that are potentially relevant from a tax perspective as:

- Mobility, including mobility of intangibles on which the digital economy relies, mobility of users of the digital economy, and mobility of business functions resulting from a decreased need for local personnel to perform functions as well as flexibility to choose the location of servers or other resources
- Reliance on data (collection, analysis and storage)
- Network effects (understood with reference to where user participation, integration and synergies are important)
- Use of multi-sided business models (a business model in which the two sides of the market may be in different jurisdictions and interact through an intermediary or platform increasing flexibility and reach)
- A tendency toward monopoly or oligopoly in certain business models
- Volatility (resulting from relatively low barriers to entry and rapidly evolving technology)

Emerging technologies (such as Internet of Things, virtual currencies, robotics, and 3D printing) are also identified and underscore that the landscape is still moving rapidly, therefore making it a challenge to anticipate all potential issues.

Identifying planning opportunities and tackling BEPS in the digital economy

The Final Report states that the Task Force on the Digital Economy6 (the Task Force) discussed how some of the tax and legal structures used to implement business models in the digital economy can create BEPS planning opportunities. The Final Report notes that while many strategies used by digital businesses may be similar to those used by more traditional businesses, some of the key features of the digital economy may exacerbate BEPS risks in the context of both direct and indirect taxation. The Final Report illustrates how planning strategies in a direct tax setting take advantage of those key features and how the digital economy places pressure on VAT systems.

In the context of direct taxation, the Digital Economy Report provides more detail on the four core elements of planning strategies identified in the OECD’s February 2013 report Addressing Base Erosion and Profit Shifting:

- Minimization of taxation in the market (source) country (through the minimization of functions, assets and risks or other avoidance of a taxable presence by contractually allocating risk and legal ownership of intangibles, or in the case of a taxable presence, by shifting profits or maximizing deductions)
- Reduction or elimination of withholding tax at source
- Reduction or elimination of taxation at the level of the recipient (achieved through low-tax jurisdictions, preferential regimes, or hybrid mismatch arrangements) with entitlement to substantial non-routine profits often built-up via intra-group arrangements
- Elimination of current taxation of low-tax profits at the level of the ultimate parent

The Final Report states that the work developed under other BEPS Actions took into account the digital economy’s key features to ensure that the proposed solutions effectively address BEPS in the
digital space. It notes that while all of the BEPS recommendations will tackle the challenges raised by the digital economy by restoring taxation on “stateless” income, the deliverables regarding CFC rules (Action 3); artificial avoidance of PE (Action 7); and transfer pricing (Actions 8 through 10) will be particularly relevant.

In the context of indirect taxation, the Final Report identifies the tax planning opportunities that may be created when countries do not fully implement the OECD’s international VAT/GST Guidelines for the collection of VAT on cross-border business-to-consumer supplies and services and intangibles. BEPS concerns could therefore arise in two types of VAT transactions:

- Remote supply of digital goods and services to VAT exempt businesses
- Remote supply of digital goods and services to a centralized location for resupply within a multinational group not subject to VAT

The Final Report concludes that implementing Guidelines 2 and 4 of the OECD’s international VAT/GST Guidelines will minimize those planning opportunities.

Addressing the broader tax challenges raised by the digital economy and potential options to address those challenges

The Final Report discusses the broader, more systemic direct tax and indirect tax challenges and evaluates potential options to address those challenges.

**Direct taxation**

In the area of direction taxation, the Final Report identifies the three main tax policy concerns raised by the digital economy:

- **Nexus** – Ability to have significant digital presence without being liable to tax
- **Data** – How to attribute value created from the generation of data through digital products and services and determining the share of profit attributable to these value drivers
- **Characterization** – Proper characterization of income in the context of new business models

In relation to the above challenges, the Digital Economy Report sets out key recommendations in a number of areas, centering on the following:

1. **Permanent establishment**
   
   Regarding the modification of the PE rules, the Final Report states that it was agreed under the work carried out in relation to Action 7 to modify the list of exceptions to the definition of PE in Article 5(4) of the OECD Model Tax Convention (OECD Model) 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 Final Report provides 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 seller of physical products (whose business model relies on the proximity to customers and the need for quick delivery to clients), would constitute a PE for that seller. Some countries, however, believe 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 changes to the definition of PE in the OECD Model are included in the document *Preventing the Artificial Avoidance of Permanent Establishment Status, Action 7: 2015 Final Report*. The OECD expects the new rules to be implemented across the existing tax treaty network in a synchronized and efficient manner via the conclusion of the multilateral instrument that modifies bilateral tax treaties under BEPS Action 15.

2. **Modifying the definition of a PE to address artificial arrangements through certain “conclusion of contracts” arrangements**

   In addition to the above changes within Action 7, the OECD also agreed to modify the definition of PE in Article 5(5) and 5(6) 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.

The Final Report sets out a second example to illustrate this concept, describing a scenario where the sales force of a local subsidiary of an online seller of tangible products or an online provider of advertising services habitually plays the principal role in the conclusion of contracts with prospective large clients for those products or services, and those contracts are routinely concluded without material modification by the parent company. That activity would result in a PE for the parent company.8

3) A correlative update to the OECD’s Transfer Pricing Guidelines

In the context of the OECD’s work on transfer pricing in Actions 8-10, it was noted that companies in the digital economy rely heavily on intangibles in creating value and producing income and that many BEPS structures adopted by participants in the digital economy involve the transfer of intangibles or rights in intangibles to tax-advantaged locations, coupled with the position that these contractual allocations (together with legal ownership of intangibles) justify large allocations of income to the entity allocated the risk even if it performs little or no business activity.

The Final Report also noted that improvements in ICT have accelerated the spread of global value chains, thereby enabling multinational companies to become more integrated and better able to maximize opportunities in a global economy. The Final Report states that attention should be devoted to the implications of this increased integration and the need for greater reliance on value chain analyses and transactional profit split methods.

It was concluded that the BEPS work in the area of transfer pricing took those issues into account under the revisions to the guidance on intangibles and the agreement to further examine the practical application of transactional profit split methods. The Final Report notes that the latter work will take the Action 1 conclusions into account and will address the application of transactional profit split methods to highly integrated business operations, as well as addressing situations where the availability of comparables is limited.9

4) CFC rules

The Final Report notes that the work on designing effective CFC rules under BEPS Action 3 may also contribute to restoring taxation in the jurisdiction of the ultimate parent company.

The report states that although CFC rules vary significantly from jurisdiction to jurisdiction, income from digital goods and services provided remotely is frequently not subject to current taxation under CFC rules. 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.

The OECD work on BEPS Action 3 resulted in recommendations in the form of six building blocks, including a definition of CFC income which sets out a non-exhaustive list of approaches or a combination of approaches that CFC rules could use for such a definition.

In the context of Action 1, the Report states that countries may implement those approaches to design CFC rules that would subject income that is typically earned in the digital economy to taxation in the jurisdiction of the ultimate parent company. For instance, countries could use the categorical analyses to define CFC income to include types of revenue typically generated in digital economy transactions, such as license fees and certain types of income from sales of digital goods and services. If countries adopted the excess profits approach, this could characterize any “excess profits” generated in low tax jurisdictions, which may include profits attributable to IP-related assets, as CFC income. This approach could potentially limit the use of offshore deferral structures popular with digital economy multinational companies that indefinitely defer foreign income from taxation in the residence jurisdiction. Both approaches may be combined with a substance analysis aimed at verifying whether the CFC is engaged in substantial activities.10
5) **Options that were considered but not recommended**

The Task Force also considered several options to address the broader tax challenges raised by the digital economy. None of the following additional options were recommended at this stage:

(i) A new nexus test in the form of a significant economic presence requirement

(ii) A withholding tax on certain types of digital transactions

(iii) An equalization levy

While these options were not recommended, the Final Report does state that countries could introduce any of them in their domestic laws as additional safeguards against BEPS, provided they respect existing treaty obligations, or include them in their bilateral tax treaties. Adoption as domestic law measures would require further calibration of the options in order to provide additional clarity about the details, as well as some adaptation to ensure consistency with existing international legal commitments.

A determination will be made by the OECD as to whether further work on the above options should be carried out. This determination will be based on a broad look at the ability of existing international tax standards to deal with the tax challenges raised by developments in the digital economy.

**Indirect taxation**

In the context of indirect taxation, the Final Report identifies as the main policy concerns the ability of private consumers to acquire goods, services and intangibles from remote suppliers, and the use of exemptions for imports of low-value goods.

The Final Report recommends that countries apply the principles of the International VAT/GST Guidelines and consider introducing the collection mechanisms included in those guidelines.

**Next Steps**

The Digital Economy Report notes that the conclusions may evolve as the digital economy continues to develop, which means it will be important for countries to monitor developments in the digital economy and to review and analyze data that will become available over time. The Final Report states that continual monitoring will enable the Task Force to assess the extent of the broader direct tax challenges and determine whether future work on the three additional options should be carried out.

The 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. The Task Force will produce a report reflecting the outcome of the continued work on the digital economy by 2020.

In addition, OECD Working Party 1 will clarify the characterization under current tax treaty rules of some payments made under new business models, particularly cloud computing payments. The OECD will develop implementation packages to ensure that countries can implement the International VAT/GST Guidelines in a coordinated manner.

**Implications**

While there still remain certain areas of disagreement among stakeholders (e.g., import of data in driving value for tax purposes), the Final Report shows there is consensus that more work should be done in a variety of areas, including addressing PE issues in the digital economy and consumption taxes on business-to-consumer transactions.

In light of the interaction among all the focus areas in the BEPS Action Plan, the OECD’s work on the taxation issues within the digital economy will continue into 2015 and beyond. However, countries are already taking national action with respect to the tax treatment of activity in the digital economy. Companies should therefore consider putting in place or increasing their efforts to monitor change at both multilateral and national levels.

The implications of the Digital Economy Report and the outlook for action focused on the digital economy in jurisdictions around the world will be the focus of an upcoming EY global tax webcast (the third in a series of webcasts on BEPS developments), with further information and registration details below:
OECD BEPS project outcomes Part 3: Digital Economy Developments and Action 1

Date: Monday, 27 October 2015

Time: 12:00 p.m. New York; 9:00 a.m. Los Angeles; 16:00 London


Join our panel of tax professionals as they discuss the OECD BEPS, Action 1 on the digital economy and the various country responses in detail.

Featured panelists:
Kim Paykel, International Tax Senior Manager, EY UK
Sean A Monahan, International Tax Partner, EY Australia
Joe Bollard, Tax Partner, EY Ireland
Jamie T Wolfe, International Tax Partner and EY Americas Tax Technology Sector Leader, EY USA

Moderator
Channing Flynn, Ernst & Young LLP, International Tax Partner and EY Global Tax Technology Sector Leader

Webcasts

EY is hosting a series of eight tax webcasts that will provide a comprehensive review of the final BEPS reports and the outlook for country action (with replays available after the live webcast):

- OECD BEPS Project Outcomes: Highlights and Next Steps - 15 October, 10 am EDT
- New Reporting under BEPS Action 13 - 20 October, 10 am EDT
- Digital Economy Developments and BEPS Action 1 - 27 October, 12 noon EDT
- Permanent Establishment Developments and BEPS Action 7 - 5 November, 10 am EST
- Transfer Pricing and BEPS Actions 8-10 - 12 November, 10 am EST
- Anti-abuse Measures under BEPS Actions 3, 5, 6 and 12 - 19 November, 10 am EST
- Financial Payments and BEPS Actions 2 and 4 - 3 December, 10 am EST
- Dispute Resolution and BEPS Action 14 - 10 December, 10 am EST

Endnotes


2. See EY Global Tax Alert, OECD releases final report on preventing the artificial avoidance of permanent establishment status under Action 7, dated 19 October 2015.

3. See EY Global Tax Alerts, OECD releases new guidance on cross-border commodity transactions under BEPS Actions 8-10, dated 13 October 2015, OECD issues final guidance on transfer pricing for intangibles under BEPS Action 8, dated 13 October 2015, OECD releases final transfer pricing guidance on risk and recognition under Actions 8-10, dated 13 October 2015, and OECD releases new guidance on transfer pricing for low value-adding intra-group services under BEPS Actions 8-10, dated 13 October 2015.


5. Chapter 1, Introduction to tax challenges of the digital economy, briefly discusses the background leading to the adoption of the BEPS Action Plan, including the work to address the tax challenges of the digital economy.
6. A group within the OECD responsible for work with respect to Action 1.

7. For more information, see EY Global Tax Alert, OECD releases final report on developing a multilateral instrument to modify bilateral tax treaties under BEPS Action 15, dated 10 October 2015.

8. See EY Global Tax Alert, OECD releases final report on preventing the artificial avoidance of permanent establishment status under Action 7, dated 19 October 2015.

9. See EY Global Tax Alerts, OECD releases new guidance on cross-border commodity transactions under BEPS Actions 8-10, dated 13 October 2015, OECD issues final guidance on transfer pricing for intangibles under BEPS Action 8, dated 13 October 2015, OECD releases final transfer pricing guidance on risk and recognition under Actions 8-10, dated 13 October 2015, and OECD releases new guidance on transfer pricing for low value-adding intra-group services under BEPS Actions 8-10, dated 13 October 2015.


For additional information with respect to this Alert, please contact the following:

**International Tax Services, Global Technology Sector, San Jose, CA**
- Channing Flynn +1 408 947 5435 Channing.Flynn@ey.com

**International Tax Services, Global Technology Sector, San Francisco, CA**
- Stephen Bates +1 415 894 8190 Stephen.Bates@ey.com
- Jess Martin +1 415 894 4450 Jess.Martin@ey.com

**International Tax Services, Washington DC**
- Barbara Angus +1 202 327 5824 Barbara.Angus@ey.com
- Rob Thomas +1 202 327 6053 Rob.Thomas@ey.com
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