At the intersection of international tax and digital transformation

OECD BEPS Project coming into the home stretch

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:

1. They need to understand the level of uncertainty they face as they monitor and prepare for ongoing change in technology taxation worldwide.
2. They should always keep in mind the current context of potentially varying tax treatment from country to country.
3. They should map the tax treatment of intellectual property (IP), transfer pricing, research and development (R&D) and other technology-related issues to their business models from the very outset, as they first develop their strategies and build in flexibility for the long-term.

Overview

Now is when the proverbial rubber hits the road, with digital economy tax models expected to be finalized this year by the Organisation for Economic Co-operation and Development (OECD) and its base erosion and profit shifting project (BEPS Project). Countries are already beginning to adapt, adopt — and in some cases co-opt — the pending tax models to suit their own national needs. Multinationals are reviewing their borderless digital business models amid this accelerating tax change.

Did we say "accelerating"? Here is what Pascal Saint-Amans, Director of the OECD's Centre for Tax Policy and Administration, told the BBC in May: "The impact of what we are doing will not take years, it will be immediate. We are already having an impact. A number of companies are changing their tax structures to anticipate BEPS."[1]

Examples of recent national developments are as game-changing as the UK's recently implemented diverted profits tax (DPT), which preempted work within the OECD's BEPS Project and was soon followed by similar moves against perceived multinational tax avoidance in Australia, the US and elsewhere. Private sector responses have been as headline-grabbing as recent reports of multinationals realigning profit allocations among European countries.

Digital economy tax change is expected to affect not only large but also mid-sized multinationals. Currently favored digital business models could face higher taxes, pressured by such changes as new country-by-country (CbC) tax reporting rules and an expected alignment of some intellectual property (IP) allocations.

We invite you to explore EY's *Worldwide Cloud Computing Tax Guide* (more than 120 countries and growing), which shows where governments stand today with regard to many of the issues addressed in this column, at ey.com/cloudtaxguide. Nearly every organization is using cloud computing to access new markets, products and services, as well as achieve efficiencies and cost savings through technology that is scalable and flexible.

Critical tax issues for both cloud service providers and cloud users are covered in the guide. Whether your arrangement involves a foreign principal providing digital content/services to a customer through a commissioned agent, through a commissionaire or through a buy-sell entity, the guide answers questions about withholding tax, nexus/PE risk, value-added tax/goods and services tax (VAT/GST) and more. You can also read our newly updated *Cloud taxation issues and impacts*, available at http://www.ey.com/GL/en/Industries/Technology/Cloud-taxation-issues-and-impacts.

[1] "OECD attacks 'aggressive' tech tax plans," BBC, 14 May 2015.

Highlights and takeaways

Tax update	Technology impact	Ask yourself
OECD's new country-by-country reports could usher in a new era of tax transparency.	Global digital business models may face greater scrutiny in the coming months.	Are you prepared to confidently present your global tax position to tax authorities, the investment community and the press?
The Australian government crafts digital economy tax measures.	As one of the first multifaceted digital tax blueprints unveiled at the national level, Australia's approach will be watched closely by government and industry worldwide for its implementation and impact.	What are the potential risks in your current and proposed tax positions, and is any restructuring required this year?
Media reports say Italy is considering a 25% withholding tax on the virtual presence of foreign multinationals.	Tax policymakers and multinationals worldwide continue to debate what constitutes a locally taxable permanent establishment (PE) in a global digital economy.	By any reasonable measure, could your business activity in any given country be construed as a "virtual PE?"
The OECD's BEPS Project will soon complete its work.	The OECD's lead tax policymaker promises immediate impact, while countries like the US are already implementing BEPS-related tax measures, but digital business models continue to raise difficult questions about remaining BEPS action items on PE and other matters.	Are you weighing in with global and national authorities on the issues that matter most to your tax planning? Moreover, are you getting ready for implementation?

Item 1: Communicating in an era of tax transparency

In recognition of an all-too-common tendency in business to leave communications considerations to last, this column begins with a pointed reminder about communicating your tax profile in a changing environment.

There is good cause. CbC tax reporting is expected to usher in a new era of tax transparency, with the first reports to be filed as early as 2017 (covering fiscal year 2016), as other regional and even industry-specific tax transparency initiatives have also emerged. Countries adopting the OECD's CbC guidelines would require more comprehensive global operational reporting by companies resident within their jurisdictions. The information could then be shared with other nations' tax authorities, where relevant, via government information exchange mechanisms.

There may be some comfort in knowing that as CbC rules come into force, reports will not automatically be made public. Many participating countries have indicated their support for limiting access to tax authorities and protecting taxpayer confidentiality (as required by law in many places). That said, companies will only have one chance to make a good first impression, as the saying goes, when they file their initial CbC report. They should be prepared to confidently present their global tax position to tax authorities and the press.

Already, intensifying press coverage of tax matters has been presenting some multinationals with difficult choices between tax optimization and reputational risk.

Incorporating tax into communications strategies
Rigorously crafted communications strategies could help companies to blunt criticism, including the following tactics:

- Proactively identify your company's full economic contribution around the globe – not only in terms of income tax, but also property, payroll, sales and employee income taxes on stock-based compensation
- Make sure that the overall substance, including the operational responsibilities and functionality of a foreign intellectual property (IP) subsidiary, can be presented to the appropriate constituencies
- Preview all press releases for potential tax significance
- Establish a policy and procedure for responding to tax inquiries from the press
- Maintain a dialogue between the tax and corporate communications functions

The care and feeding of the investor community
Investors and securities watchdogs are critical audiences for your overarching communications strategy, not just required financial statements. Institutional investors, in particular, will want to understand the possible implications of global tax reform. And certain companies have begun disclosing potential state aid, BEPS exposure and related transfer pricing issues in their financial statements and securities filings.

Internal communications lay the foundation
All of the advice above assumes that internal communications are proceeding apace, with the tax department already communicating to upper management and the board that increased tax scrutiny and cost could be on the way. If not, Communications Priority No. 1 should certainly be internal. And going forward, a key takeaway, often repeated, is that the tax function should be part of any internal discussion regarding significant business change.

Considerations
Communications strategy – internal and external – is fundamental. All of top management needs to recognize that a low tax rate is no longer guaranteed to produce positive reactions from stakeholders. Standard communications policy and practice should be updated with this new understanding and with close consideration of the messages your company conveys – intentionally or unintentionally – about the taxes it pays as a global corporate citizen. For further insight, go to ey.com/tax and read EY's new report titled *Managing tax transparency and reputation risk*.

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Item 2: Australia crafts digital taxation blueprint

The Australian Government has crafted digital economy tax measures as part of its recent 2015/2016 federal budget proposal. Of particular interest to multinationals operating in Australia are:

- A draft law to counter perceived cross-border tax avoidance by multinationals, akin to the UK's diverted profits tax (DPT)
- A draft law designed to level the playing field for goods and services taxes (GST) between offshore and local digital content providers
- Enhanced transfer pricing documentation requirements consistent with the OECD's new CbC reporting framework

Measure targets perceived profit diversion

The government has announced a change to the General Anti-avoidance Rule (Part IVA) to tackle perceived tax avoidance by multinationals. The draft law would affect companies with annual global revenue exceeding A$1 billion (US$760 million).

While Australia's proposed measure would operate within the existing tax law framework, it has raised several questions that are expected to be clarified by a consultation period and published guidance from the Australian Taxation Office. Among the questions is whether treaty protection will be available to protect against an assessment of tax, since Part IVA can override various double tax treaty obligations, as drafted.

Australia and the UK differ in the way they address cross-border profit diversion – for example, only the UK has issued a specific new tax. But they have at least one thing in common, as both countries have acted ahead of the conclusion of the OECD BEPS Project's recommendations for a globally coordinated response to the issue.

International streaming media faces GST

Streaming media to Australian consumers, whether by offshore or local providers, would be subject to the same GST treatment under another proposed measure. Included would be the streaming or downloading of movies, music, apps, games and e-books, as well as professional services and other services offered to individuals.

Australia adopts CbC reporting

Australia is becoming an early adopter of documentation standards in line with the OECD's CbC reporting guidelines. Multinationals that operate in Australia and have global revenue of A$1 billion or more will be required to provide the following information for any year commencing on or after 1 January 2016:

- CbC report including information on global activities, location of income and taxes paid
- Master file containing an overview of the global business, organizational structure and transfer pricing policies
- Local file that provides detailed information about the local taxpayer's intragroup/intercompany transactions

Administrative guidance including how this information will be shared with other jurisdictions will follow, but this key issue could have a ripple effect well beyond Australia's borders.

Considerations

As one of the first multifaceted digital tax blueprints unveiled at the national level, Australia's new measure, along with its implementation, will be watched closely by government and industry around the world for its impact. Implications for multinational technology companies doing business in Australia range from: the administrative (such as GST registration and remittance) to the strategic (such as pricing strategies for affected services) – up to and including, potentially, upward pressure on their effective tax rates. Companies should review their current and proposed tax structures to determine if any restructuring is required before January 2016.

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Item 3: Italy may consider taxing virtual presence

According to Italian press reports, Italy's government is considering the introduction of a 25% withholding tax on the virtual presence of foreign multinationals.

The measure would cover foreign companies selling into the Italian market without the presence of a physical structure that falls within the traditional definition of permanent establishment (PE). The new tax was expected as this column went to press, amid the second phase of a major Italian tax reform set in motion by parliament in February 2014.

Such a plan would align with an option identified in the OECD BEPS Project to address the challenges that global digital business models can pose for tax authorities, given their reduced need for a local physical presence (PE) in any given country.

"Presence" = revenue threshold

The withholding tax would be based on the presence of a virtual PE, defined as a significant digital presence as measured by revenue (with an initial threshold of €1 million, or US$1.1 million, over six months).

Mechanisms to avoid double taxation in connection with taxes already paid in Italy would be expected. The new withholding tax would not apply if a foreign entity discloses a PE in Italy.

Considerations

PE thresholds – virtual or otherwise – continue to resist a consensus definition among global tax policymakers. In the meantime, in Italy, assess your likelihood of additional tax obligations and compliance burdens as tax reform advances. In fact, this exercise should also be repeated in any country in which you do significant business.

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Item 4: OECD BEPS Project due to wrap up

The pressure is on, with less than six months to go, with the OECD promising that its BEPS Project will culminate in a final set of digital economy tax models this year.

While the OECD last year declined to "ring fence" the digital economy for special tax treatment within the BEPS Project, the organization nevertheless declared the overall global economy to be digital and proceeded writing tax models with profound implications for technology companies.

BEPS impact described in blunt terms
Now, as noted above, the OECD's Saint-Amans is forecasting an immediate impact from the BEPS Project and related CbC reporting, requiring companies to pay more tax in the countries in which they sell goods and services.

As he explained in his BBC interview: "Countries will have to change their domestic legislation, they will have to cooperate, they will have to exchange information like country-by-country reporting — asking multinationals: Where is your turnover? Where are your profits? Where are your employees? Where do you pay your taxes? This type of information will be collected by all the countries and will be sent to the countries where the companies operate. That's a game changer."

US joins countries advancing on BEPS
Some countries are indeed beginning to implement new BEPS-related measures even before the BEPS Project is finalized, including Australia, Italy and the UK. Joining this group recently is the United States.

In May, the US Treasury Department released proposed revisions to its Model Income Tax Convention. US officials specified that their goal is to address current abuses of US treaties that facilitate non-taxation and create stateless income. One set of provisions, for example, addresses issues arising from so-called "special tax regimes," which provide low rates of taxation in certain countries to royalties, interest and other mobile income. Read our full analysis in a 21 May 2015 *EY Global Tax Alert* titled "US Treasury Department proposes revisions to US model tax treaty," at ey.com/tax.

Deliberations continue amid complexity
Despite this year's looming final deadline, BEPS deliberations continue on several difficult issues, including transfer pricing and PE thresholds.

Recently, in a discussion draft of BEPS Action 8, significant changes were proposed from existing guidance on cost contribution arrangements (CCAs).

The changes include new guidance requiring each participant's contribution to be measured at value rather than at cost and a new requirement that CCA participants must have the capability and authority to control risks associated with their activities. Read our full analysis in a 4 May 2015 *EY Global Tax Alert* titled "OECD releases discussion draft on cost contribution arrangements under BEPS Action 8," at ey.com/tax.

Our last column devoted considerable attention to whether BEPS recommendations would force technology companies to establish many more PEs around the world. Notably, new PEs mean additional tax filing obligations and an increased potential for controversy.

A revised discussion draft on preventing artificial PE avoidance (BEPS Action 7) substantially refines and narrows the OECD's focus, although it still would lower the PE threshold and tighten the exceptions to PE status. Questions remain about the degree to which it would do so, and guidance has not yet been developed on appropriate rules for determining the profits attributable to such new PEs.

Comments were being submitted on the new Action 7 discussion draft as this column went to press. But the question regarding profit attribution is one that may remain unanswered until completion of negotiations over the multilateral instrument needed to implement BEPS recommendations in bilateral tax treaties. Work began in May 2015 on this instrument, which is intended to prevent the need to rewrite all the 3,000 bilateral treaties in effect worldwide. Completion is scheduled by the end of 2016. Read our full analysis in a 21 May 21 2015 *EY Global Tax Alert* titled "OECD releases revised discussion draft on preventing artificial avoidance of PE status under BEPS Action 7," at ey.com/tax.

Considerations

Companies operating in the digital realm or undergoing digital transformation should stay informed about developments, evaluate how the proposals may affect them and begin to reflect how to appropriately address these changes. In such specific areas as transfer pricing, for example, companies should be evaluating and scenario planning around proposed CCA changes and their possible impact on tax profile and documentation. At the same time – even at this date – companies should still consider global or national participation in the dialogue regarding the BEPS Project and its underlying international tax policy issues. The US is among the countries encouraging such comment on its recently proposed changes to the US model treaty.

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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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