

China Tax Alert

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OECD Task Force on the Digital Economy release Interim Report

Regulations discussed in this issue:

- Interim Report on the Tax Challenges Arising from Digitalisation, prepared by the Task Force on the Digital Economy (TFDE), released on the OECD website on 16 March 2018.
- BEPS Action 1 Report "Addressing the Tax Challenges of the Digital Economy", prepared by the Task Force on the Digital Economy (TFDE), released by the OECD on 5 October 2015.

On 16 March 2018, the [Interim Report on the Tax Challenges Arising from Digitalisation](#) (Interim Report), prepared by the Task Force on the Digital Economy (TFDE), was released on to the OECD website. The Interim Report reviews the progress made in tackling the issues of double non-taxation, and aggressive tax planning, which motivated the 2013-2015 Base Erosion and Profit Shifting (BEPS) project to reform global tax rules. It surveys the increasing adoption, across countries, of unilateral measures to tax digitalised businesses. It sets out a new theoretical framework for analysing the value creation processes in digitalised business models, to underpin the revision of international tax rules. Most importantly, the report makes clear that while there is no current consensus among countries on how to revamp the international tax framework for the digital era, and no consensus on the use of interim measure turnover taxes, the Inclusive Framework on BEPS will seek to arrive at a new global consensus by 2020.

Interim Report main content

The 218 pages of the Interim Report are divided into eight chapters, the most important of which are Chapter 5, 'Adapting the International Tax System to the Digitalisation of the Economy', which sets out the alternative views of countries on the need for long-term restructuring of international tax rules, and Chapter 6, 'Interim Measures to address the tax challenges arising from Digitalisation', which sets out the conflicting positions of countries on the need for interim measure turnover taxes. Highlights of the report include the following:

- **BEPS outcomes:** The report concludes (Chapter 3) that the BEPS measures, adopted by countries since 2015, have had some success in tackling the multinational enterprise (MNE) tax planning behaviours that motivated the launch of the BEPS project. There is some evidence that MNEs are changing their corporate structures (e.g. moving to local distributor models, 'on-shoring' of IP), though more evidence is needed. While the adoption of the BEPS PE rule changes by countries is below expectations, progress has been made with the rollout of the BEPS recommendations and standards for VAT, CFC rules, treaty abuse measures, transfer pricing, and IP regimes.

This being said, the report considers the BEPS measures to be inadequate to tackle the more fundamental long-term problems, caused by digitalisation and business model change, for traditional international tax rules.

- **Unilateral measures:** The report segments (in Chapter 4) unilaterally adopted digital economy tax rules into four categories.

These include (i) alternative applications of the PE threshold (e.g. India, Israel); (ii) withholding taxes; (iii) turnover taxes (e.g. India, Italy, France); and (iv) specific regimes to deal with large MNEs (e.g. UK, Australia, US). The report observes that the adoption of such measures reflects a growing discontent among countries with the tax outcomes of the current international tax rules, and has increased the sense of urgency to revamp the existing framework.

- **Value creation in digitalised businesses:** Chapter 2 sets out a new theoretical framework for analysing the value creation processes in digitalised business models. Moving beyond the classic 'value chain', the report describes two further 'value creation categories', the 'value shop' and the 'value network'. The latter encompasses, *inter alia*, internet advertising and intermediation services models, which rely on active user contributions/participation, and on direct and indirect network effects in their target markets. The report indicates that, out of the three value creation categories, the strongest case for value creation 'in the market' (in the absence of physical presence) can be made for value networks.
- **Interim measures:** The report is clear that many countries strongly oppose interim turnover taxes on digitalised businesses, and sets out the risks and adverse consequences for economic welfare, productivity and competition. As some countries are, however, determined to proceed, considerations for minimizing their negative impact are outlined (e.g. high revenue thresholds, targeting at internet advertising and intermediation services).
- **Long-term solutions:** Looking to the long-term revamp of international tax rules, the report identifies three groups of countries with disparate views. One group consider that targeted measures are called for, which are directed solely at certain highly digitalised businesses, in light of the manner in which their business models rely on user participation/contributions. A second group consider that a broader reconsideration of the international tax framework, as it applies to both digitalised and traditional businesses is called for, in light of the progressive digitalisation of the entire economy. However, this second group is highly diverse in its views, some considering that no special emphasis should be put on user participation/contributions in the redesign of tax rules, and others considering this calls for major changes to nexus and profit allocation rules. A third group consider that the existing framework does not need alteration.

KPMG observations

The fact that the TFDE work thus far has been unable to arrive at a consensus, on either the need or justification for interim measures or the direction of the long-term solution, may mean that the international tax system is headed into a 'period of turbulence'. The EU Commission is set to unveil their proposed interim measure turnover tax for EU countries in the coming week, joining India and Italy which have already implemented turnover taxes. India, Israel and Taiwan have adopted Virtual PE rules, with more countries also looking in this direction. Businesses operating cross-border may anticipate greatly heightened double tax risk and uncertainty.

The challenge for the Inclusive Framework on BEPS, supported by the TFDE and assisting OECD working parties, will be to reconcile the positions of the three groups of countries outlined above in the course of 2019 and 2020, and put forward expansion of and / or alteration to international tax principles and detailed rules which are robust into the future. It is noted that China is playing a pivotal role in the global quest for consensus on the tax issues facing the digital economy, tenaciously adhering to the principle of neutrality in the taxation of the traditional and digital economies, which is in line with the 1998 Ottawa principles.

The issues dealt with in TFDE Interim Report are highly complex and KPMG China will issue further, more detailed publications in the near future.

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