KPMG
cutting through complexity

Tax in the digital domain

getting it right

Are traditional international tax principles and treaty rules fit for the challenges of the world's burgeoning digital economy?

In 1999, when e-commerce was taking off, the Organisation for Economic Co-operation and Development (OECD) led a worldwide inquiry into this question. Six years later, the OECD's Technical Advisory Group (TAG) concluded that existing concepts seem sufficient to ensure tax-neutral treatment for e-commerce and physical transactions[1].

Fast forward to 2013, and the OECD is again studying these issues – but in a climate that is much more politically charged. The current project's focus is on tax avoidance through base erosion and profit shifting (BEPS). According to the OECD's July 2013 Action Plan[2], *"BEPS is a concern in the context of the digital economy."* Action number one of the Plan is to:

Identify the main difficulties that the digital economy poses for the application of existing international tax rules and develop detailed options to address these difficulties, taking a holistic approach and considering both, direct and indirect taxation.

Given the TAG's findings in its 2005 Final Report, this latest project may come as a surprise. But as the digital economy has expanded since the speculative internet bubble of 2000–01, the stakes have climbed higher and corporate tax planning has come under fire. From hearings before UK parliamentary committees to the G20's 2013 World Economic Forum, much of the criticism targets new businesses that rely on new technologies and intangible property to derive profits and on tax treaties and arbitrage to reduce tax.

As scrutiny of tax and the digital economy heats up once again, the OECD clearly no longer upholds the TAG's 2005 finding that *"[…] there does not seem to be actual evidence that the communications efficiencies of the Internet have caused any significant decrease to the tax revenues of capital importing countries."*

[1] *Are the current rules for taxing business profits appropriate for e-commerce? Final Report*, OECD Centre for Tax Policy and Administration (OECD Publishing), November 2002.
[2] *Action Plan on Base Erosion and Profit Shifting*, OECD Centre for Tax Policy and Administration (OECD Publishing), 19 July 2013.

The way forward

In evaluating the best way forward, KPMG's network of member firm tax professionals believe that it is best to set aside the emotions that have coloured debates in recent times and bring the discussion back to a systematic and objective review of current business practices, existing taxation principles and possible alternatives.

As the OECD begins to implement its Action Plan, it is important to focus on and discuss these three key questions:

1. **Re-assessing the systematic approach –** Are there compelling reasons to change the systematic approach taken by the TAG in performing its similar evaluation from 1999 to 2005?
2. **Distinguishing how fact patterns have changed –** What significant changes have occurred since 2005 to business models, transactions in the digital domain and other considerations on which the TAG based its conclusions?
3. **Identifying and evaluating the alternatives –** What alternative solutions have been discussed within the tax community since 2005, and how do they stack up against a set of evaluation criteria to be defined?

Join the debate

KPMG member firms welcome this important debate and look forward to engaging with the international tax community. We strongly believe that effective, widely-accepted approaches can only be formed through collaboration and participation of a broad group of tax professionals working in business, government and public practice.

To this end, KPMG is pleased to launch a forum, that seeks to aggregate the global discussions and serve as a catalyst for developing consistent, fair and effective approaches to international taxation in the digital age.

Find out more and get involved: kpmg.com/digitaltaxdebate

1. Re-assessing the systematic approach

In developing any alternative solutions, the evaluation criteria will govern the project's ultimate outcomes. In its 2005 Final Report, the TAG selected the following criteria to evaluate existing treaty rules for digital businesses:

- **Consistency –** Residence and source countries should follow the same conceptual basis for sharing the tax base between them.
- **Neutrality –** Digital economy and traditional transactions should be taxed equivalently.
- **Efficiency –** Tax rules should not impose an undue burden on taxpayers to comply with them or impose excessive administrative costs on tax administrations to enforce them.
- **Certainty and simplicity –** Tax rules should be clear and simple to understand.
- **Effectiveness and fairness –** Taxation should produce the 'right' amount of tax at the right time while minimising the potential for evasion and avoidance.
- **Flexibility –** Tax rules should be dynamic enough to keep pace with technological and business developments.
- **Compatibility –** New tax rules should not infringe on existing rules of international trade.
- **Consensus –** Universally agreed rules are crucial for avoiding harmful tax competition.

At the outset of the debate, it is important for the tax community to determine whether these criteria are still the right ones for evaluating current and new rules for the taxation of digital businesses. These criteria also need to be prioritised because potential new solutions could infringe on one or more of the criteria.

Further, the OECD's Action Plan aims to analyse indirect tax solutions, which the TAG Final Report did not address. A systematic approach must be developed to integrate indirect taxation aspects into the evaluation.

2. **Distinguishing** how fact patterns have changed

When re-evaluating the TAG's 2005 conclusions, a first step is to determine what significant changes have occurred regarding the underlying fact pattern or what other considerations of the TAG can be recognised. For example:

- Digital business models have grown exponentially since 2005, and recent empiric studies prove that base erosion is a real phenomenon[3].
- The TAG's assumption in 2005 that consumer retail business (B2C) represents only a fraction of the e-commerce between businesses (B2B) is out of date.
- The TAG's premise that e-commerce business models need a physical local presence "to maintain a competitive advantage and to provide the desired product or service to the recipient in the quickest and most cost-effective manner" is not valid today. In fact, many new e-commerce models are tailored to avoid a physical nexus wherever possible.
- The OECD's BEPS Action Plan is top of mind around the world. A growing number of countries such as Australia, France, Germany and the UK are examining unilateral ways to enforce the taxation of digital businesses conducted within their borders. As the OECD's Action Plan concedes, such unilateral measures could pose a significant threat of double taxation unless treaty rules are amended.

Given these developments, there is ample evidence that we need to revisit many of the assumptions on which the TAG based its 2005 conclusions.

3. **Identifying** and evaluating the alternatives

Potential policy options to address the challenges of taxing the digital economy can be grouped under four broad alternative approaches[4]:

1. **Extending residence based taxation**, for example, by tightening controlled foreign company rules.
2. **Extending source-based taxation**, for example, by restricting deductions for intra-group payments, extending withholding taxes, introducing nexus-free 'virtual' permanent establishments, and/or redefining transfer pricing rules for intangibles.
3. **Fundamentally reforming corporate income taxation**, for example, by introducing formulary apportionment or destination-based cash-flow tax approaches.
4. **Reforming reporting and transparency rules**, for example, by introducing country-by-country tax reporting requirements.

[3] An overview of the empirical studies can be found in: Centre for European Economic Research: Discussion Paper No. 13-044: *Profit Shifting and 'Aggressive Tax Planning' by Multinational Firms: Issues and Options for Reform*, p. 8ff.

[4] *Centre for European Economic Research: Discussion Paper No. 13-044*, p. 2.

While the global tax community is debating aspects of the options, there seems to be no comprehensive study to weigh them against a standard set of evaluation criteria or to map feasible transition paths for introducing potential new rules. We strongly believe that such a study is necessary to steer the global debate to a systematic and objective course and serve as a transparent basis for policy makers to draw conclusions.

The recent report of the French government's Task Force on Taxation of the Digital Economy (widely known as the 'Colin/Collin report')[5] offers an in-depth analysis of the value creation chains in digital business models. The report recommends a two-pronged approach that would:

1. Introduce new rules for creating 'virtual' permanent establishments (PE) and for the allocation of virtual assets to that PE.
2. Introduce a short-term, transitional 'Special Data Tax'.

In terms of the four alternatives noted previously, this potential solution would be classed as an extension of source-based taxation over the long term, combined with a new tax during the transition period. While many of the report's views are provocative and not shared by everyone in the tax community, the level of in-depth analysis it provides sets a valuable benchmark.

Join us in the dialogue and collaboration at kpmg.com/digitaltaxdebate

We look forward to engaging with the tax community and contributing our experience and knowledge to this important issue. Our goal is to ensure that the perspectives of market participants are considered, and that the outcomes are fair, practical and supportive of a competitive tax and business environment.

[5] French Ministry for Industrial Recovery, *Mission d'expertise sur la fiscalité de l'économie numérique*, 18 January 2013.

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