

Comments on the OECD Discussion Draft on the Tax Challenges of the Digital Economy

To Committee on Fiscal Affairs' Task Force on the Digital Economy **From** KPMG's Global International Tax Services Group

Date 14 April 2014

KPMG's Global International Tax Services Group professionals (KPMG) very much appreciate the opportunity to present our collective feedback to the OECD on the Public Discussion Draft BEPS Action 1: Address the Tax Challenges of the Digital Economy.

1. Background

The Public Discussion Draft on 'BEPS Action 1: Address the Tax Challenges of the Digital Economy' (Discussion Draft), published on 24 March 2014, responds to the OECD charge set out in Action 1 of the OECD's Action Plan on Base Erosion and Profit Shifting ('BEPS'). Specifically, to:

1. Identify the tax challenges presented by the digital economy; and
2. Develop detailed options to address these challenges.

Both direct and indirect taxes are to be considered. The Action Plan identifies specific issues to be addressed in the Action 1 Report, including:

1. The ability of companies to have a significant digital presence in the economy of another country without being liable to taxation because of a lack of nexus;
2. The attribution of value created from the generation of marketable location relevant data through the use of digital products and services;
3. The characterization of income derived from new business models;
4. The application of related source rules; and
5. How to ensure the effective collection of VAT/GST with respect to the cross-border supply of digital goods and services.

The Task Force's work should include a thorough analysis of digital economy business models.

2. Summary observations

2.1 Ring-fencing the Digital Economy

We commend the Task Force for concluding that it is "neither appropriate nor feasible" to ring fence the digital economy to create a separate set of rules for digital economy businesses. The task force appropriately observed that there is no separate digital economy, but that the overall global economy is increasingly digitized. Consistent with the Task Force's conclusion that it is not feasible to ring-fence the digital economy, the only options addressing the tax challenges of the digital economy that should be pursued are those that apply to all taxpayers.

2.2 Other aspects of the BEPS Action Plan addressing the tax challenges of the Digital Economy

The principal BEPS concern is "... practices that artificially segregate taxable income from the activities that generate it,"¹ creating no, or low, taxation. The OECD's work under the other aspects of the BEPS Action Plan is expected to address this concern generally and therefore can be expected to address BEPS across all sectors of the economy. As a result, no separate rules need be created for digital businesses.

1. BEPS Action Plan, page 10

2.3 The Discussion draft's options to address the tax challenges of the Digital Economy

Modifications to the Exemptions from Permanent Establishment Status

KPMG recommends further exploration of the option of modifying the exemptions under paragraph 4 of Article 5 of the OECD Model Treaty as a solution to the tax challenges of the digital economy as well as BEPS across all sectors. Specifically, the exceptions of paragraph 4 should be retained, but modifications could be considered that would provide that if an otherwise exempt activity is a 'core activity' for the taxpayer, the exception may not apply. Detailed guidance on what constitutes core activities will be necessary. KPMG believes that this action, coupled with the other aspects of the BEPS Action Plan, should fully address the tax challenges of the digital economy.

A new Nexus based on significant Digital Presence

This option should not be pursued as it is impractical and opens the door for significant risk of double taxation – impractical because of the difficulty in ring-fencing digital aspects of any enterprise; and gives rise to substantial risk of double taxation due to the difficulty of defining the fact patterns that would trigger a 'digital presence' and the attribution of profit or loss to the digital presence (particularly where the OECD transfer pricing guidelines emphasize important functions in terms of Significant People Functions).

Virtual Permanent Establishment

This option should not be pursued for the same reasons as mentioned above with regard to the proposal to create a new nexus for a significant digital presence. Further, these options would generally create a taxable nexus without regard to consideration of whether such presence is a significant element of the enterprise's value creation activities.

Creation of a Withholding Tax on Digital Transactions

KPMG does not recommend that this option be further pursued because of the complexities in administration identified in the Discussion Draft as well as the fact that, from KPMG's experience, many of the enterprises offering digital goods and services are either loss making or generating relatively low margins that would not support a final gross basis withholding tax (even a withholding rate as low as five percent). Digital goods and service are not equivalent to high-profit payments that typically draw withholding tax (e.g., dividends, interest and royalties) and should not be taxed similarly. Introduction of a specific withholding tax would have an immediate effect of restricting growth and development of the digital (global) economy itself. A gross basis tax imposed on 'business profits' payments from the source country should be a value added tax, not a final withholding tax.

Consumption Tax options

KPMG is supportive of the Task Force's further pursuit of options to improve the efficiency of collecting and reporting VAT and agree that doing so is essential to reducing exemption thresholds. We are also supportive of efforts to develop workable solutions to VAT collection and remittance on cross-border B2C digital transactions. We expect that this issue will be dealt with by Working Party 9 as part of the VAT TAG.

Discussion draft summary and background

The Discussion Draft spends the initial 47 pages outlining the evolution of Information and Communication Technology ('ICT') and its impact on the economy; discusses the emergence of new business models and the key features of the digital economy; identifies opportunities for BEPS in the digital economy and reviews how the other action areas within the overall Action Plan could address concerns raised in the digital economy. The final 14 pages cover the broader challenges raised by the digital economy and actions so far presented for discussion to the Task Force.

Not surprisingly given the substantial work already performed within the EU on the VAT issues associated with the digital economy, in contrast to the other work-streams VAT/GST is given equal footing with direct tax matters. Indeed, there appears to be clear acceptance that in the context of VAT/GST as it relates to digital services, the place of taxation should be linked to the location where the service is consumed. Notwithstanding the clarity gained from such a decision, there is still plenty to determine, what factors are used to ascertain location of consumption, who is liable to account for the tax due, what simplified processes should be considered to reduce compliance burdens on business and make collection feasible.

Finally, due to the complexity of the issue, the Discussion Draft is seeking input on the best way to address the issues raised by the digital economy and a number of detailed questions on both direct and indirect tax are raised.

The OECD context of what defines BEPS

To address the overall question posed by the Discussion Draft (i.e., what should be done to address the tax challenges of the digital economy), we first step back to review the BEPS problem generally and then the specific tax challenges of the digital economy. With this background, we conclude that the other aspects of the BEPS Action Plan should address the tax challenges of the digital economy.

In the February 2013 OECD Report on Base Erosion and Profit Shifting, a number of strategies were identified as being responsible for BEPS in the context of direct taxation which can be summarized into four areas:

- Minimization of taxation in the market country by avoiding a taxable presence, or in the case of a taxable presence, either by shifting gross profits via trading structures or by reducing net profit by maximizing deductions at the level of the payer;
- Low or no withholding tax at source;
- Low or no taxation at the level of the recipient (which can be achieved via low-tax jurisdictions, preferential regimes, or hybrid mismatch arrangements) with entitlement to substantial non-routine profits often built-up via intra-group arrangements; and
- No current taxation of the low-tax profits at the level of the ultimate parent.

From the perspective of VAT, to the extent that Guidelines 2 and 4 of the OECD's 'Guidelines on place of taxation for B2B Supplies' are not implemented, BEPS concerns may be summarized as:

- Remote digital supplies to exempt businesses; and
- Remote digital supplies acquired by multi-location enterprises that are engaged in exempt activities.

As well as the above two specific examples of how BEPS may occur in the context of VAT, the draft also notes that connectivity afforded by the global adoption of ICT, puts two additional pressures on the correct accounting for and collection of VAT, namely undeclared VAT on B2C supplies and the ability of businesses to deliberately structure their operations to take advantage of a country's low value thresholds² and sell goods to consumers without the payment of VAT.

Tax challenges of the Digital Economy

The Discussion Draft notes that many of the key features of the digital economy exacerbate the opportunities for BEPS.

Specific examples are drawn out such as:

- The importance of intangibles in the context of the digital economy, combined with the mobility of intangibles for tax purposes under existing tax rules;
- The mobility of users creates substantial challenges and risks in the context of the imposition of VAT; and
- The ability to centralize infrastructure at a distance from a market jurisdiction and conduct substantial sales into that market from a remote location.

However, many of these features are found throughout all industries and amongst most modern enterprises as a result of the digitization of business in the modern world. Indeed, para 2.2.8 of the UN 'Practical Manual on Transfer Pricing for Developing Countries' notes that:

"The key features of MNEs (multi-national enterprises) are that they are integrated (global) businesses. Globalisation has made it possible for an MNE to achieve high levels of integration and the ability to have control centralised in one location. Modern Information and communication systems also provide increased horizontal communications across geographic and functional business lines..."

2. Many VAT jurisdictions apply an exemption from VAT for imports of low value goods as the administrative costs associated with collecting the VAT on the goods is likely to outweigh the VAT that would be on those goods.

Business will generally outsource activities in which they do not have a competitive advantage³. Outsourcing has been driven by advances in computing power and the growth and development of the internet. These same factors allow for the realization of efficiencies from centralizing key functions within an enterprise. Indeed, not only is technology pervasive throughout business but throughout major consumer markets. In para 30 of the Discussion Draft, it is noted that within the OECD area, households alone have approximately 1.8 billion connected devices, with estimates that this could reach 14 billion by 2022. Rightfully, the Discussion Draft concludes that,

“As digital technology is adopted across the economy, segmenting the digital economy is increasingly difficult. In other words, because the digital economy is increasingly becoming the economy itself, it would be difficult, if not impossible, to ring-fence the digital economy from the rest of the economy. Attempting to isolate the digital economy as a separate sector would inevitably require arbitrary lines to be drawn between what is digital and what is not. As a result, the tax challenges and BEPS concerns raised by the digital economy are better identified and addressed by analysing existing structures adopted by MNEs together with new business models and by focusing on the key features of the digital economy and determining which of those features raise or exacerbate tax challenges or BEPS concerns, and developing approaches to address those challenges or concerns.”

We strongly endorse the Task Force’s conclusion stated above and encourage the OECD to develop solutions through other aspects of the BEPS Action Plan to address the tax challenges of the digital economy—challenges manifest more clearly through innovative and modern business models adopted across all sectors.

2.4 Specific question answered:

The paper states that, “comments are welcome on any of the issues addressed in the Discussion Draft and in particular on specific issues highlighted in the draft.” We provide comment on several of these issues:

Whether it is possible to ring-fence the digital economy from the rest of the economy, and if not, whether specific types of digital transactions could be identified and addressed through specific rules

We commend the Task Force for concluding “that ring-fencing the digital economy as a separate sector and applying tax rules on that basis would be neither appropriate nor feasible⁴.” We are in complete agreement. Indeed, para 208 of the draft, notes that if the issues noted above are fully addressed through the measures envisaged in the BEPS Action Plan, addressing the challenges posed by the digital economy may become less pressing. The danger will be pressing on with specific digital solutions before the full impact of other work streams can be assessed. We strongly endorse the Task Force’s recommendation to address the challenges of the digital economy through the other measures of the BEPS Action Plan. As the modern economy is a digitized economy, the other aspects of the BEPS Action Plan should address the concerns identified by Action 1 of the BEPS Action Plan.

The key features of the digital economy identified by the Task Force and whether there are other key features that should be taken into account

We believe that one aspect of the digital economy that is over emphasized by the Discussion Draft is the reliance on intangible property. Along with many other industries that rely on intellectual property, it is the combination of people, functions, finance, assets and risk that should determine the correct allocation of reward. A sale may be made by a remote server but there are a lot of people who have supported the creation and maintenance of a business that enables a remote server to make such sales. We suggest that the ongoing work concerning Transfer Pricing Guidelines and Attribution of Profits to a Permanent Establishment could address this concern.

Whether other measures should be developed during the course of the work on other aspects of the BEPS Action Plan to address BEPS concerns in the digital economy and if so which ones

We endorse the view of the Discussion Draft that other key work streams can address the BEPS concerns of the digital economy, given the breadth of the action plan addressing so many aspects of the BEPS concerns, and given the digital economy is inseparable from the general economy we are confident that the other actions should address the concerns within the digital economy. That said we would recommend that the digital economy Task Force addressing BEPS Action 1 is maintained and coordinates closely, going forward, with the groups responsible for other aspects of the BEPS Action Plan to ensure that the digital economy concerns are adequately considered.

3. Dunning, JH & Lundan, SM, Multinational Enterprises and the Global Economy, 2nd edition (Cheltenham: Edward Elgar, 2008)

4. Discussion Draft, Para 205

3. Potential options to address the broader tax challenges raised by the Digital Economy

The Discussion Draft presents five options to address the broader tax challenges raised by the digital economy—covering (i) modifications of the permanent establishment threshold, (ii) the imposition of a withholding tax on certain types of digital transactions, and (iii) improvement of the indirect tax system relative to digital transactions.

3.1 Modifications to the Exemptions from Permanent Establishment Status

KPMG recommends further exploration of the option of modifying the exemptions under paragraph 4 of Article 5 of the OECD Model Treaty as a solution to the tax challenges of the digital economy as well as BEPS across all sectors. Specifically, the exceptions of paragraph 4 should be retained, but modifications could be considered that would provide that if an otherwise exempt activity is a ‘core activity’ for the taxpayer, the exception may not apply.

The Discussion Draft states that the ability of companies to maintain some level of business connection ‘within a country’ without being subject to tax on business profits from sources within that country is the result of particular policy choices reflected in domestic law and tax treaties, and is not in and of itself a BEPS issue. (Para. 124). The purpose of the concept of permanent establishment is to provide guidance to taxpayers and tax authorities on the allocation of taxing rights. These guidelines must also facilitate the resolution of disputes under the Mutual Agreement Procedure of treaties that embody these concepts and therefore require clear guidance rather than broad concepts. Article 5: Permanent Establishment has been one of the areas of international taxation where countries have often struggled to arrive at a common interpretation and KPMG has seen many challenges on permanent establishment issues due to differing interpretations of Article 5. As far as possible the OECD should seek to eliminate the use of subjective tests to determine permanent establishments.

Post-World War I, there was a rapid expansion in world trade driven through manufacturing and transport. The consideration of double taxation in earnest commenced in 1921, when the League of Nations appointed a committee of economists (Committee of Experts) to undertake a theoretical study of double taxation. From the first report issued by the Committee of Experts in 1923, through to the development of The London Model in 1945, the term permanent establishment was an enduring feature and concept. The London Model defined in Article V that a permanent establishment exists when there is a fixed place of business in the host country where the place of business contributed to the enterprises income. If a permanent establishment does not exist, then the activity is ‘trading with a country’ and no taxing rights arise on the sale.

The considerable body of work by the League of Nations over a period of 24 years laid the foundation for managing the competing taxing rights of source and residence countries and are reflected in the current UN and OECD Model Tax Conventions. The current exemptions listed in Article 5 paragraph 4 of the OECD Model Tax Convention are the reiteration of the second condition for a permanent establishment detailed in the London Model—that the business located in the host country must contribute to the enterprise’s income; core activities where value is created for the enterprise.

The imposition of a net income tax on a foreign enterprise is an intrusive exercise that requires disclosure of significant and sensitive financial and other detailed information of the foreign enterprise. The possible imposition of a net income tax is a consideration for many enterprises in evaluating cross-border trade decisions. A source country net income tax imposed upon a foreign enterprise is not only intrusive, but also places the enterprise in a position of net basis taxation from both the residence and source countries and the associated issues related to avoiding double taxation (not to be taken lightly as residence countries often dispute the existence of a foreign permanent establishment and the amount of profit attributable to such establishment). These concerns have long driven the policy considerations behind the permanent establishment concept as well as the specified exceptions to permanent establishment status.

Although innovative business models making particular use of ICT may raise less familiar fact patterns relevant to where value is created and whether a foreign enterprise’s source-country presence is of a preparatory and auxiliary nature, these concerns should not warrant an abandonment of over 70 years of sound tax policy. We therefore recommend that the exemptions to permanent establishment contained in paragraph 4(a) through (d) be retained. We support the development of a qualitative standard that clarifies when these exceptions would be inapplicable based on the identified activity as ‘core’ to the foreign enterprise’s business. Potential modifications to the definition of permanent establishment are part of Action Item 7 which is due by September 2015. KPMG will provide detailed comments at the appropriate time on Action Item 7. However, we note that any modifications should include bright line guidance that provides certainty for business and tax administrators.

3.2 A New Nexus Based on Significant Digital Presence

This option should not be pursued as it is impractical and opens the door for significant risk of double taxation—impractical because of the difficulty in ring-fencing digital aspects of any enterprise; and gives rise to substantial risk of double taxation due to the difficulty of defining the fact patterns that would trigger a ‘digital presence’ and the attribution of profit or loss to the digital presence (particularly where there OECD Transfer Pricing Guidelines emphasize important functions in terms of Significant People Functions).

This option considers the need to establish an alternate concept of nexus in which businesses are conducted wholly digitally. A two part assessment is discussed, first ascertain whether an enterprise is engaged in “fully dematerialised digital activities” and then assess whether it maintained a significant digital presence in the economy of another country.

With regard to the first test the Discussion Draft identifies eight potential indicators that could be included in a test for when a fully dematerialized digital activity was conducted. Two variants are then proposed and examples given to ascertain whether a significant digital presence has been breached. In the first “significant digital presence test,” a permanent established would be deemed to exist if the foreign enterprise has a significant market presence for its digital goods or services. In the second “significant digital presence test” a permanent establishment would be deemed to exist if the foreign enterprise, engaged in a fully dematerialized digital activity, conducts a significant business in a country using personal data obtained by regular and systematic monitoring of internet users in that country through the use of multisided business models.

To begin with, this proposed nexus standard appears to contradict the Discussion Draft’s conclusion (see paragraph 205 referenced above) that ring-fencing the digital economy is neither appropriate nor feasible. This approach is impracticable not only because of the difficulty of identifying digital goods and services offered across multiple sectors, but because of the difficulty of defining terms such as “significant” and “substantial,” as well as the thorny issue of attributing profits to a Digital permanent establishment. This problem was acknowledged by the Task Force. (Para. 216).

Additionally, this approach would be a major shift from three fundamental long-standing tax policy concepts – (i) the ability to ‘trade with a country’ without creating a taxable presence, (ii) the acceptance of a force of attraction principle, and (iii) a presumption that value is created at the location of consumption. As a relevant example, the 2010 Report on the Attribution of Profit to Permanent Establishments states, “. . . since a server-PE will not be carrying out any significant people functions relevant to the attribution of economic ownership of assets and/or the assumption of risks in the absence of personnel acting on behalf of the enterprise, no asset or risk could be attributed to it under the authorized OECD approach, supporting the conclusion that little or no profit would be attributed to such a PE”⁵. We reiterate that the OECD should carefully consider the consequences of abandoning long-standing principles that establish jurisdiction to tax rights predicated on the existence of a core physical presence.

The proposals relating to the creation of a Digital permanent establishment as a result of gathering consumer data is particularly troubling. This proposal pre-supposes market data alone is sufficient to trigger a taxable nexus and that such raw data is a key value driver to the enterprise. We see no support for such a conclusion. It is difficult to get an estimate of how much data is created every day but an often quoted estimate puts it at 2.5 quintillion bytes per day, with 90% of the data generated in mankind’s existence having been created in the last two years⁶. There is no doubt that modern computers can process massive amounts of data and through statistical analysis identify potential correlations between data, however the value lies in the identification of causation and that involves the development of highly complex algorithms, software tools, and expensive research and development. Raw data is being produced at a rate that is driving its unstructured value to a minimum; the value can only be attributed to the activities that turn that data into something meaningful, and profits should be attributed to the location where that occurs, not the raw production.

This leads us back to one of the more troubling aspects of this proposal as mentioned briefly above—attribution of profit to a Digital permanent establishment. It appears inconsistent to posture that income from intangibles should be allocable to Significant People Functions (e.g., where the research and development activities occur) and ignore the people functions that drive value for businesses offering digital goods and services (e.g., the people functions that create the digital content, perform the supporting research and architect the necessary IT infrastructure). The digital content and functionality of these offerings is ultimately created by people. If this analysis were to follow the current emphasis on people functions in the draft Chapter VI Transfer Pricing Guidelines, there is no basis to find significant value based on consumption activity.

5. Part 1: General Considerations, para 66, (July 22, 2010)

6. http://www.ibm.com/smarterplanet/us/en/business_analytics/article/it_business_intelligence.html

3.3 Virtual Permanent Establishment

This option should not be pursued for the same reasons as mentioned above with regard to the proposal to create a new nexus for a significant digital presence.

The discussion draft notes that over recent years a number of alternative options for PE thresholds have been discussed. The most recent work being performed by the Business Profits TAG which considered three broad alternatives:

- A virtual fixed place of business PE – created through the maintenance of a website on a server of another enterprise located in a jurisdiction ad carries on business through that website.
- A virtual agency PE – extend the habitual conclusion concept when this is performed through technology and not a person
- On-site business presence PE – created through on-site services or other business interface at the customer's location

The Discussion Draft states the above are only mentioned for completeness – which implies they are not proposing to pursue any of the options at this time. This is presumably on the basis that existing principles, such as selling into a market without presence or a dependent agent, are accepted as not creating a PE, and for the reasons outlined above are not changed by the adoption or expansion of technology into the economy.

3.4 Creation of a Withholding Tax on Digital Transactions

KPMG does not recommend that this option be further pursued because of the complexities in administration identified in the Discussion Draft as well as the fact that, from KPMG's experience, many of the enterprises offering digital goods and services are either loss making or generating relatively low margins that would not support a final gross basis withholding tax (even a withholding rate as low as 5 percent). Digital goods and service are not equivalent to high-profit payments that typically draw withholding tax (e.g., dividends, interest and royalties) and should not be taxed similarly. Gross basis source country tax imposed on "business profits payments" (clearly a point made in the Discussion Draft's lengthy discussion of business models), if imposed at all, should be value added taxes, not withholding taxes. This position is consistent with long standing tax policy.

It is interesting to note that the income payments currently subject to withholding tax relate to primarily passive forms of income associated with capital investment in the form of equity or debt (dividend and interest withholding) and income from rights that have been transferred be they protected under patent or copyright or process knowledge such as know-how. A common feature of such items is that they represent a return from an asset that subsists within the economic framework of the country making the payment and therefore can be considered to have a source within that country. Another common feature of such passive investments is that as a general rule nothing further is required of the investor, they have given up the right to enjoy the money or asset and have to do nothing more to enjoy the interest, dividend or royalty. As such, absent possible sundry expenditure the gross payment is an adequate estimate of the income generated from the underlying asset. This is in direct contrast to the sale of (digital) goods or services that give rise to business profits. There is all manner of expenditure incurred by the selling party to get the good or service to the point of consumption and it is impossible to ascertain what level of profit is associated with the good or service in question and the application of a withholding tax could push even an otherwise profitable transaction into economic loss. Assessing the rate of withholding to be applied would be a monumental task as well as an effective collection mechanism as the bulk of purchases will be B2C.

This proposal also raises serious complexities around income characterization. What would constitute a digital good or service? Further, would DVDs, CDs, and other digitally embedded media/hardware constitute a digital good? What about future goods and services we cannot envision today? This issue further illustrates the administration complexities of this proposal.

Further, B2C transactions present significant administrative concerns. It is unlikely that individual consumers will collect and pay over a withholding tax. Imposing a withholding tax on these transactions will create significant burdens for the financial system—a concern of the Ottawa principle of neutrality. Such administrative issues appear to be essentially the same as those applicable to the indirect tax system for cross-border digital transactions.

In our opinion, not only are there similarities in administration for this proposed gross basis withholding tax and VAT, both taxes appear to have the same end result—i.e., a tax levied on consumption, not value creation. This has historically been the role of indirect taxation. In other words, long standing tax policy holds that net income tax is imposed on the location of value creation whereas VAT is imposed on the location of consumption—notwithstanding that value may have been created elsewhere. Given the similarities of this proposal to a VAT and the difficulties of imposing a new digital withholding tax as discussed above, we discourage the OECD from pursuing this option.

3.5 Consumption Tax Options

A constant theme in the Discussion Draft is the impact of ICT in the economy and the observation that for goods and services that may be digitized business has embraced these technologies and in certain circumstances adopted a business model that enables them to market and sell goods and services from remote locations to consumers in foreign jurisdictions. Automatic credit checking and billing platforms have facilitated the growth in online shopping by consumers. These developments have presented challenges to VAT collection as these supplies often result in no or an inappropriately low amount of VAT collected and create potential competitive pressures on domestic suppliers.

Exemptions for Imports of Low Valued Goods

In an attempt to optimize the costs of collection and administration requirements, many countries have implemented a VAT exemption on the import of low value goods. The thresholds for these exemptions vary widely across jurisdictions. Many of the exemption systems were introduced before the on-line sales and the year on year growth in digital sales may require a review of the exemption systems to ensure that they are still appropriate.

It is proposed that if improvements to the efficiency of processing low value imports were made by tax authorities, it would be more feasible to lower VAT exemption thresholds and increase the relative VAT revenue collected. The discussion draft concedes that a key element of the solution is for non-resident vendors of low value parcels to be able to efficiently charge, collect and remit the tax on the imports of these goods in the importing jurisdiction. This will likely only be achieved through simplified registration and compliance mechanisms, using the possibilities offered by new technologies (e.g. on-line registration and filing, electronic payment).

KPMG agrees that governments should take all necessary measures to protect their tax base and to ensure competitive distortions are avoided. However, this must be in the context of ensuring that the cost of collection and compliance is commensurate with the VAT collected.

Remote digital supplies to consumers

As noted above a key element to the solution is to require the non-resident supplier to register and account for the VAT on these supplies in the jurisdiction of the consumer. Many jurisdictions, most notably the EU have announced proposals that will set out to achieve this aim.

Whilst this remains the most viable option, it is recognize that requiring non-resident suppliers to register in countries to which they remotely deliver services may impose significant compliance burdens. It is recommended therefore that countries should consider the use of simplified registration regimes and registration thresholds to minimize the potential compliance burden on businesses. KPMG recommends that in order to minimize the administrative burden in this area that OECD develops recommendations on these points so that countries can adopt uniform rules that apply on a global basis.

To assist in managing the challenges in enforcing compliance from non-resident suppliers, improved international co-operation between jurisdictions is likely to be required and should consider enhanced exchange of information, assistance in recovery and simultaneous audits.

3.6 Whether the Ottawa taxation framework principles identified above are an appropriate framework for analyzing options to address the tax challenges, and whether and how they should be supplemented.

We have some concerns about the explanation for “neutrality” in the Ottawa principles. The principles were put together in 1998, which predate by nine years the launch of the smart phone (around 2007) and the explosion in on-line businesses in the last ten to fifteen years. Digital businesses often do not have an analogous non on-line equivalent – for example social networking sites do not have an analogous non on-line equivalent. We are concerned about statements that taxation should be neutral between “conventional and electronic forms of commerce” may cause inappropriate comparisons of unique digital businesses and non-similar conventional businesses. Furthermore, is it really appropriate to say that a business selling computer game discs in a particular country through physical shops should be tax neutral with a business selling computer games on line, or providing the game for free and allowing users to pay for advantages within the game or particular features? We think not. We feel the concept of neutrality as outlined in the Ottawa principles is now outdated, and should be replaced by a concept of neutrality that provides for tax guidance that treat all business fairly through uniform broad based rules that do not single out a particular sector or business model for “special treatment”.

4. Conclusion

Para 59 of the Discussion Draft summarizes the challenge faced by trying to address this particular issue in isolation:

“As digital technology is adopted across the economy, segmenting the digital economy is increasingly difficult. In other words, because the digital economy is increasingly becoming the economy itself, it would be difficult, if not impossible, to ring-fence the digital economy from the rest of the economy. Attempting to isolate the digital economy as a separate sector would inevitably require arbitrary lines to be drawn between what is digital and what is not. As a result, the tax challenges and BEPS concerns raised by the digital economy are better identified and addressed by analysing existing structures adopted by MNEs together with new business models and by focusing on the key features of the digital economy and determining which of those features raise or exacerbate tax challenges or BEPS concerns, and developing approaches to address those challenges or concerns.”

We endorse the conclusion that there is no separable digital economy without reservation and encourage the Task Force to address the tax challenges of the digital economy through the other aspects of the BEPS Action Plan. The principles of international trade that started in the late 19th century, were tackled by the League of Nations over a 24 year period from 1921, and embodied in the OECD Model Tax Convention are as relevant today as they were when first considered by the League of Nations’ Panel of Experts.

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Publication name: Comments on the OECD Discussion Draft on the Tax Challenges of the Digital Economy

Publication number: 131465

Publication date: June 2014