



To OECD Task Force on the Digital Economy

Date October 2017

From KPMG International

Ref OECD Digital Economy – KPMG  
Comments.docx

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**Comments with respect to the Request for Input with respect to the series of questions related to the BEPS Action 1 report on *Addressing the Tax Challenges of the Digital Economy* (the 2015 report) and the Draft Outline of the Interim Report for the G20 Finance Ministers**

Professionals in the member firms of KPMG International (“KPMG”) welcome the opportunity to comment on the OECD’s Request for Input with respect to the series of questions posed related to the BEPS Action 1 report on *Addressing the Tax Challenges of the Digital Economy* (the 2015 report) and the Draft Outline of the Interim Report for the G20 Finance Ministers.

KPMG appreciates the openness of the OECD to comments and recognizes the complexities of the issues.

KPMG’s comments in response to the Request for Input are presented below.

**General Comments**

We recognize the significant political pressures driving the debate regarding the tax challenges of the digital economy. The political dialogue is often framed in a manner that identifies highly digitalized companies as not paying their ‘fair share of tax.’ This assertion is supported by claims that such companies derive significant revenues in market countries without paying any, or at least proportionate, tax in those jurisdictions. We believe that framing the challenges of taxing the digital economy in this manner is counterproductive. It mischaracterizes the real concern of some countries over the current division of jurisdiction to tax and impugns the motives of digitalized companies that are playing by the rules (including the new rules of the BEPS package).

At the heart of the debate on the taxation of the digital economy is dissatisfaction by some countries with the status quo regarding the scope of jurisdiction to tax. In many cases these countries seek to expand source-based taxation rights, by moving beyond traditional conceptions of ‘source’. Other countries, however, prefer the current balance between residence and source-based taxation – particularly within the framework of the BEPS package designed to limit double non-taxation. Such countries seek to address BEPS concerns related to digitalized business models through the existing agreed international tax framework. Rebalancing residence and source-based taxation rights is a significant endeavor that requires global consensus which is likely to be reached only through a thorough and inclusive global process. This will require time and further research into expected implications for cross border trade and investment. Special tax measures targeting highly digitalized business models obscure these fundamental challenges, create additional complexity, foster uncertainty and lead to economic distortion (i.e., taxing various sectors differently). Consistent with the original consensus reached in the 2015 BEPS Action 1

report (*Addressing the Tax Challenges in the Digital Economy*) and the G-20's mandate on the importance of certainty to promote economic growth, these concerns warrant a well-developed global effort that focuses on how tax policy should develop to promote overall economic growth in light of the inevitable digitalizing of the world economy.

Additionally, the BEPS package is only now being implemented. Time is needed to determine the extent to which the BEPS package has adequately addressed the unique tax challenges of the digital economy. As explained further below, at this early stage, there are positive signs that the BEPS package is effectively addressing many of these concerns. We encourage the members of the OECD's inclusive framework to adhere to the original consensus reached under the 2015 BEPS Action 1 report and defer further action that would ring-fence or target highly digitalized companies until the effectiveness of the BEPS package can be objectively determined and the broader underlying international tax policy considerations can be adequately addressed. If governments believe that immediate action is required to respond to the digitalization of the economy and protect their tax bases, we suggest that the best way to do that is to create a regulatory and economic environment that encourages the use of digital technologies to increase economic activity in their jurisdictions, including through appropriate investment in infrastructure.

Finally, we note that there are significant legal and practical considerations that must be addressed with any targeted special tax measures. These considerations should be fully addressed before any recommendations are made for taxing the digital economy through 'special measures.' To do otherwise would only create more tax uncertainty, risk of double taxation and impediments to global trade and investment.

## Specific Comments

### **A. Digitalization, Business Models and Value Creation**

*Question A.1 - The process of digitalization has become one of the main drivers of innovation and growth across the economy. Please describe the impact of this process on business models, and the nature of these changes (e.g. means and location of value creation, organization, supply chains and cost structure).*

The process of 'digitalization' encompasses a range of transformative changes occurring across the economy as a whole. Digitalization refers to the conversion of analogue or physical goods and services into digital goods and services as well as the creation of innovative digital products and services – e.g., digital music or remote engine maintenance checks over the internet. Digitalization also includes the concept of 'Digital Transformation', that is, the adoption, by multi-national enterprises ('MNEs'), of digital business strategies and deployment of sophisticated software and algorithms in order to gain deep business insights to transform the way an organization operates or engages the market. Digital Transformation allows MNEs to be more effective at core business processes (e.g., marketing to key customer demographics through social media) and to drive efficiency gains by reducing operational expenses, freeing up capital and labor for investment in activities yielding higher ROIs, and improving the success rate of strategic investment choices. Significantly, these digital capabilities have allowed for innovation in business models previously unimaginable – e.g., digital platforms that connect buyers and sellers anywhere in the world, social media, and digital content driving on-line advertising sales.

Digitization of the broader economy is only in its early days. It is clear that we have entered a new era of rapid change and disruption. By removing, or reducing, many of the physical limitations which once shaped operating models, businesses are now able

to more efficiently and effectively deliver goods and services to customers on a global scale. Digital Transformation has enabled new market entrants to remake entire industries, unseat traditional dominant players, and capture market share while in many cases doing so at a fraction of the cost and footprint of established industry participants.

Digitalization is not a process limited to a particular industry or segment of the economy. Digitalization is enabling innovative business models and allowing businesses to drive more efficient global value chains across all industries and segments. Indeed, as the 2015 BEPS Action 1 report (*Addressing the Tax Challenges in the Digital Economy*) concluded, “the digital economy is increasingly becoming the economy itself . . .”

Policymakers should avoid picking winners and losers among businesses through tax policy which unequally targets or exempts certain business models.

***Question A.2 - Highly digitalised business models are generally heavily reliant on intangible property (IP) to conduct their activities. What role does IP play in highly digitalised businesses, and what are the types of IP that are important for different types of business models (e.g. patents, brands, algorithms, etc.)?***

Digital business models generally do rely heavily on intangible property. However, such reliance is not unique to digitalized businesses models. Traditional business models across multiple sectors also place significant reliance on intangible property – e.g., consumer goods, pharmaceuticals, etc. If there is a unique aspect of how digitalized business models rely on intangible property as compared to traditional business models, it is that digitalized business models place greater reliance on algorithms. The significance of this difference is likely to diminish in the near future as traditional business models also increase their reliance on algorithms. The development, enhancement, maintenance, protection and exploitation (DEMPE) framework established through the OECD’s recent revisions to Chapter VI of its Transfer Pricing Guidelines, if appropriately applied, should serve to appropriately identify how and where digitalized businesses, as well as traditional businesses, create value with regard to intangible property.

***Question A.3 - Digitalization has created new opportunities in the way sales activities can be carried out at a distance from a market and its customers. How are sales operations organized across different highly digitalized business models? What are the relevant business considerations driving remote selling models, and in which circumstances are remote selling models (as opposed to local sales models) most prevalent?***

Sales operations across the entire economy continue to evolve as new technology enables smaller-footprint distribution models. Remote selling is not unique to highly digitalized businesses. Traditional businesses are quickly adopting ‘digital strategies’ that include remote selling channels in order to capture market share, drive efficiencies, connect with customers and respond to customer preference. Some of the relevant business considerations driving remote selling models are:

- 1) Consumer preferences – changing customer preferences have driven more retail business online to enable sales by responding to increased customer affinity for on-demand delivery and wider variety of inventory items.

- 2) The low barrier to enter a market – the diminishing need to hire local personnel or establish a local office in order to sell products into a particular market reduces the cost of entry. This is a particularly powerful consideration for start-ups and early stage businesses without the resources to expand via traditional distribution channels. At the same time, remote sellers still have real people creating value within their organization. Remote seller models have enabled non-traditional market participants to flourish globally where historically they may have encountered significantly more challenge.
- 3) Operational efficiency – a remote seller model allows an organization to centralize global or regional sales activity creating efficiencies by eliminating redundancies, reducing costs, and enhancing their competitiveness in the marketplace.
- 4) A growing services economy – digital and technology-enabled services make up an increasing share of economic activity and they are uniquely suited to a remote seller model where digital delivery or performance is both efficient and responsive to customer demands.

*Question A.4 - Digitalization has permitted businesses to gather and use data across borders to an unprecedented degree. What is the role of data collection and analysis in different highly digitalized business models, and what types of data are being collected and analyzed?*

Companies have always collected data (customer, market, demographics, etc.) to inform business decisions. New technologies are enabling a massive increase in the collection of customer and market data. The collection of raw data is becoming increasingly ubiquitous with the growth of the internet of things (“IoT”) technologies, wearables, and similar technologies. However, as a leading technology company noted in 2016, approximately 80% of data comes from untapped or unstructured data (sometimes called ‘dark data’).<sup>1</sup> Broadly speaking, the value of data lies along a spectrum with raw and unstructured data being of relatively low value, processed data being of more value, and ‘smart data’ (actionable data that is available in real time) that informs business decisions being of greater value.

Although customer and user data are often front and center in the discussion regarding the tax challenges of the digital economy, the digitization of the global economy highlights that broad spectrums of data hold the promise of being used as ‘smart data.’ For example, one company has utilized fiber optic sensors along oil and gas pipelines to monitor and analyze the temperature, vibrations and audio patterns of oil and gas flow to detect potential pipeline disruption earlier – thereby preventing oil spills, reducing operating expense and ensuring more stable supply.

*Question A.5 - In a number of instances, businesses have developed an architecture around their online platforms that encourages the active participation of users and/or customers from different jurisdictions. Is the establishment and operation of such global (or at least cross-country) user networks new and specific to certain highly digitalised business models, and what are the potential implications for value creation?*

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<sup>1</sup>Data is Everywhere and That’s a Good Thing; <https://www.ibm.com/blogs/business-analytics/data-is-everywhere>

Global online platforms, social networks, online communities, and similar “digital commons” are merely virtual manifestations of historic networks. However, digitalization has increased the speed, scale, and reach of such interactions and given rise to innovative digital business models that offer these features to networks’ stakeholders. Businesses innovating through digital networks create value through the development and exploitation of intangibles, effective risk management, and operational excellence. However, digital networks have also introduced significant business risk as companies must manage, maintain, and protect customer and user data. Security, reputational, and financial risks presented by digital networks are unique and present considerable challenge to digitalized companies.

*Question A.6 - The digitalisation of the economy is a process of constant evolution. Please describe how you see business models evolving in the future due to advances in information and communications technology (e.g. Artificial Intelligence, 3D printing).*

As the digitalization of the economy increases in velocity and across sectors, it is impossible to predict *what* will emerge as the next successful innovation that will drive disruption and innovative business models. However, we can observe some clear trends that have emerged over the past decade that can be extrapolated into the future:

- 1) An increasing pace of change – Digitalization is enabling businesses to move faster, gain efficiencies and decrease the time to develop a product or service and get it to market.
- 2) More ‘smart data’ – New technologies such as artificial intelligence, machine learning and quantum computing, coupled with greater data volumes (e.g., through IoT and increasingly miniaturized data collection tools becoming ubiquitous), will give rise to new business models currently unforeseeable.
- 3) Lower barriers to entry / “democratization” of technology tools – Competition and traditional market forces will reduce the cost of new digital technologies that will empower new market entrants. New market entrants will bring innovation and increase competition across sectors.
- 4) Digital v. human labor – Machine learning and automation will continue to increase efficiency of traditionally manual tasks performed by humans. While we expect some tasks to be fully automated in the future (merely continuing a trend which has occurred since the dawn of the industrial revolution – e.g., steam locomotion, combustion engines, power tools, automatic coffee machines), we expect human activity to shift to tasks which are more difficult to automate (e.g., creative, empathetic, strategic, and evaluative tasks). In those areas not easily susceptible to full automation, we expect human machine interfaces and augmented reality tools to further enhance the scope and scale of human impact.
- 5) Political/regulatory responses to disruption – Business models exist within, and are enabled by, a social and political framework maintained by government and civil society. We recognize the unique challenges that highly digitalized business models place on government and civil society (in addition to traditional tax systems) as they seek to address matters of data privacy and security, transparency, labor market stability, and economic growth. It must be recognized that digitalized business models are driving new sources of economic growth and new labor markets which help offset the disruption caused by digitalization. They are also enabling efficiencies in the administration and enforcement of laws and policies. Governments that foster a stable social and political framework

promoting growth of the digital economy should reap significantly greater economic benefit than governments that do not.

The trends reducing barriers to market entry offer the potential to usher in a 'golden era' for small and medium size businesses ("SMBs"). New digital technologies will increasingly see SMBs 'born global' rather than requiring the traditional path from local to global reach. For example, with developments in AI, a pattern-matching, machine-learning algorithm operated by a centralized expert staff in a new SMB could allow the company to offer a specialized life sciences research service to customers around the world without the need to duplicate extensive capital or human resources in each market. Fostering a regulatory and social framework to support such innovation can bring great economic benefits to countries. Alternatively, a global tax landscape defined by uncertain and ambiguous tax rules, divergent approaches to taxing cross-border transactions, and increased controversy, would be infinitely harder for an SMB to manage than for a large MNE, given their limited resources. To avoid such barriers to innovation and healthy competition, tax policy makers should place a premium on achieving tax certainty and the principle of tax neutrality.

## B. Challenges and Opportunities for Tax Systems

*Question B.1 - What issues are you experiencing with the current international taxation framework? (e.g. legal, administrative burden, certainty)*

We observe the following trends within the current international taxation framework:

- 1) Increasing compliance burden: Businesses continue to face steadily increasing compliance burdens globally. Companies operating in the cross-border context face significant challenges in meeting the demands of multiple tax and regulatory bodies. This is a real cost to taxpayers, and we suggest that it is important for governments to thoroughly evaluate the costs and benefits of both existing and incremental reporting requirements.
- 2) Inconsistent indirect tax rules: Inconsistent global VAT / GST rules and non-existent double tax agreements in VAT matters (except EU Directive) contribute to uncertainty, add administrative burdens and increase potential issues of double taxation.
- 3) Move towards less objective standards: Countries have implemented less objective rules in order to cast a wider net against tax avoidance and tax evasion (e.g., UK DPT rules and Australia MAAL rules). While we understand the government concerns that motivate these less objective measures, they drive significant tax uncertainty and can lead to double taxation.
- 4) Unilateral action: Perhaps in response to the underlying lack of consensus, and in association with the move towards less objective standards, we see a rising trend of unilateral actions that are undermining consensus and leading to increased uncertainty regarding the global tax environment. This uncertainty hinders decision making, limits innovation and investment, and broadly undermines the growth of international trade.

*Question B.2 - Digitalisation raises a number of challenges and opportunities for the current international tax system. In particular:*

*a) What are the implications of highly digitalised business models and their value chain on taxation policy? In particular:*

*(i) What impact are these business models having on existing tax bases, structures of tax systems and the distribution of taxing rights between countries?*

*(ii) Are there any specific implications for the taxation of business profits?*

The implications of highly digitalized business models go far beyond tax policy. They reach the entirety of the political, regulatory and social framework of sovereign nations. Tax revenues of countries will be affected significantly more by the country's ability to foster economic growth in the digitalizing economy than they will by tax policies designed to raise revenue by targeting select sectors or taxpayers using targeted business models. Such targeted tax policies in fact cost a country far more in its overall tax base than it collects through measures that violate principles of tax neutrality.

### ***Unilateral action undermines economic development***

We recognize the substantial progress as a result of the broad consensus reached as a result of the BEPS project, yet we see significant risks globally from countries enacting or pursuing unilateral measures that depart from international norms whether long-standing or recently achieved. These unilateral measures, often borne from political pressures, apply new punitive tax regimes that unequally target the “digital economy” (however nebulous that term might be). These efforts create tax uncertainty and lack the international coordination and consensus needed to promote global trade and investment. Further, the desire to find a quick solution to issues raised by the digital economy has meant that there has been no comprehensive analysis of the reach and economic impact of the measures being considered. Without adequate consideration, there is risk that such proposals will in fact harm economic development, stifle start-up innovation and expansion, contribute to GDP contraction and increase the economic impact of technology-driven worker dislocation. Unilateral efforts, in particular, are not conducive to a stable, more certain tax environment which contributes to the OECD’s mission, and indeed the mission of its constituents - to promote policies that will improve the economic and social well-being of people around the world.

### ***The OECD BEPS project needs more time to determine its effectiveness***

The principal focus of the OECD’s BEPS initiative was to address the double-non-taxation of business profits. Early signs indicate that the BEPS initiative is effective in reducing double-non-taxation. More time is needed to determine whether the BEPS initiative will also be effective in addressing the tax challenges of the digital economy.

We observe MNEs changing behavior, exiting historic low-substance operating structures and increasing alignment of profit recognition with Significant People Functions and the control of business risk. Country-by-country reporting has provided a stark illustration of business alignment (or misalignment) with profit recognition and has elevated tax as a c-suite and corporate board level issue in unprecedented ways. The BEPS initiative is shoring up country and regional tax bases by encouraging increased focus on the alignment of value creation and profit alignment. Nevertheless, a number of challenges remain. Specifically, significant disagreement exists globally as to where value creation occurs. Further, there remains a lack of global consensus on the appropriate standards for profit attribution and insufficient willingness to adopt measures to relieve administrative burdens associated with divergent perspectives. The question of profit attribution is further exacerbated in the context of digital nexus. These two technical points highlight the more fundamental policy question underlying these matters – source versus residency based taxation.

### ***Source versus residency based taxation***

The fundamental issue behind the so-called ‘fair taxation of the digital economy’ appears to be driven by a desire to revisit the long-established balance between residency-based versus source-based taxation.

To a certain extent, the digital economy tax debate reflects the dissatisfaction by some countries with large shares of the digital economy tax base concentrated in jurisdictions where business risk is managed and significant people functions are performed. One side of the debate is of the view that the BEPS outcomes have already identified where profits should be taxed. The other side is dissatisfied with this result and wishes to shift more of the tax base to the markets where companies sell their goods and services. As noted above, consensus has been achieved and is driving changes in corporate behavior to align around historic understandings of value creation and arm’s length principles; however, these changes are not resolving the

concerns of countries that wish to rebalance the standards based on new concepts of source-based taxation.

An issue as important and far-reaching as striking the right balance between source and residency based taxation requires global consensus. As the OECD's Task Force on the Digital Economy ("TFDE") has already noted in its 2015 Action 1 report, the digital economy 'is' the economy. This tax policy debate should be pursued deliberately, multilaterally, and constructively to arrive at an agreed global consensus. Such collaboration and consensus is increasingly necessary when the international tax policy debate is viewed not in light of current disruption but rather the trends of digitalization across the entire global economy over the coming decades.

*b) What opportunities to improve tax administration services and compliance strategies are created by digital technologies?*

There are significant opportunities to use digital technologies to improve tax administration and compliance burdens. Additionally, we see these technologies reducing reporting burdens in areas outside tax. However, we believe a detailed discussions on this topic is more appropriately addressed in different fora.

## C. Implementation of the BEPS package

*Question C.1 - Although still early in the implementation of the BEPS package, how have the various BEPS measures (especially those identified as particularly relevant for the digital economy – i.e. BEPS Actions 3, 6, 7 and 8-10) addressed the BEPS risks and the broader tax challenges raised by digitalization? Please feel free to support your answers with real life examples illustrating these impacts.*

As mentioned above, a number of recommendations emerging from the BEPS package have already been adopted by a number of jurisdictions and therefore can be expected to affect all sectors and business models, including digitalized business models. Below we provide comments on key elements of the BEPS package relative to digitalized business models:

### BEPS Action 6

In practice, the implementation of BEPS Action 6, via MLI articles 6 and 7, has resulted in virtually all MLI signatories adopting the Principal Purpose Test (“PPT”). The impact of this change in addressing the challenges of digitalization is unclear. While the PPT is intended to provide tax administrations with a tool to address cases of abuse, it also introduces significant uncertainty into the double tax treaty context.

Highly digitalized businesses, with minimal local country footprints and highly efficient centralized global or regional sales operations may be disproportionately vulnerable to challenges under the PPT. Specifically, a significant concern exists that more aggressive taxing authorities may seek to utilize the PPT to deny treaty benefits to organizations with limited footprints without regard as to the extent to which such structures contribute to value creation in an organization.

Establishing clear guidelines implementing the PPT would assist local country tax authorities in distinguishing abusive tax and finance structures from new, innovative operating models that reflect genuine economic activity.

### BEPS Action 7

BEPS Action 7 changes to the permanent establishment standard were designed, at least in part, to limit perceived abuses by certain taxpayers operating centralized sales models. By expanding the scope of dependent agent permanent establishments (“DAPEs”) market jurisdictions will have claim on a portion of the tax base of digitalized business model taxpayers making use of DAPEs in their distribution function.

BEPS Action 7, and the associated Articles 12 – 15 of the Multilateral Instrument (“MLI”) have prompted businesses to reassess both their tax reporting practices and their operating models.

BEPS Action 8-10      The deliberations as part of the BEPS project reaffirmed the understanding that ‘control’ is at the core of value creation. Enterprise value creation is the product of the control of assets and processes internal to an enterprise. In confirming this, OECD members essentially have rejected the argument that enterprise value creation can be the product of actors/processes external to an enterprise.

The focus of BEPS Actions 8-10 has been to align the profits earned by members of an MNE group with their contributions to value creation. In order to achieve this alignment, the BEPS Actions 8-10 guidance requires that an associated enterprise earning returns from an intangible or from the assumption of economically significant risks at arm’s length must have people making significant decisions regarding the risks or intangibles.

In response to BEPS Actions 8-10, MNEs are reviewing and, where needed, reinforcing the alignment of their intangible ownership, risk assumption and associated profits and losses with important functions related to the development, enhancement, maintenance, protection and exploitation (DEMPE) of intangibles and the control of economically significant risks.

This alignment of profitability with value creation is occurring across industries—wherever intangibles and risk assumption are significant value drivers. Given the importance of intangibles to the digital economy and the risk profiles of digital businesses, this alignment necessarily covers digital businesses of MNEs throughout all industries, not just those with a specific digital focus. BEPS Actions 8-10 has been sufficiently broad to lead to realignment in both digital and non-digital businesses.

*Question C.2 - A growing number of countries have implemented the new guidelines and implementation mechanisms relating to value-added tax (VAT)/ goods and services tax (GST) that were agreed in the BEPS package to level the playing field between domestic and foreign suppliers of intangibles and services. What has been your experience from the implementation of these collection models (e.g. compliance, impact on business operations)? What are some examples of best practice in this area?*

We note that VAT/GST legislation has resulted in a heavy administrative burden on businesses. The shift of the burden of collection from governments to businesses has contributed to this burden. We think a continued debate regarding the appropriate balance of burdens associated with the VAT/GST collection function is fair and reasonable.

We observe inconsistencies in application of principles set out in OECD Guidelines:

- scope (just few digital services v. all services; B2C v. B2C + B2B);

- liabilities of electronic data processors (“EDPs”) vary greatly between jurisdictions; registration threshold (nil v. same as domestic businesses);
- registration (simplified registration v. standard registration);
- returns (complex v simple returns; monthly v. quarterly returns);
- invoicing requirements (required or not);
- bookkeeping requirements; data collection requirement (is the customer a business or not; where is the consumer located, etc.)

Often rules are implemented in local countries without detailed guidance that allows businesses in various sectors to adequately determine their VAT responsibilities. In certain jurisdictions we have seen new VAT rules implemented without leaving enough time for businesses to (1) determine their new VAT obligations and (2) adapt their systems to the new rules.

Some examples of VAT/GST administration best practices include:

- Focusing on B2C supplies and clearly identifying what constitutes a B2C (as opposed to B2B) supply
- Adopting a VAT registration threshold similar to the one available to domestic businesses
- Provide a simplified registration mechanism (i.e., only for collection and payment of VAT) with simple returns with longer filing periods (e.g., quarterly at least for most businesses subject to the rules)
- Do not require issuance of VAT invoices or at a maximum issuance of simplified invoices
- Provide flexibility in data set chosen to identify customer location as not all businesses have same data available
- Clarify VAT obligations of remote sellers and EDP’s
- Publish guidance on VAT obligations relating to the digital economy
- Provide sufficient time to businesses and tax authorities to prepare for the implementation of new rules
- Ensure that dispute resolution between countries is not be overly burdensome or harmful to businesses.

## **D. Options to address the broader direct tax policy challenges**

*Question D.1 - The 2015 Report outlined a number of potential options to address the broader direct tax challenges driven by digitalisation. Please identify and describe the specific challenges associated with the application (e.g. implementation, compliance, neutrality) of these options. What are the advantages and disadvantages of these options, including from an administrative and economic perspective, and how might some of the disadvantages be addressed or mitigated through tax policy design? In particular, comments are welcome on the following specific issues:*

*a) Tax nexus concept of “significant economic presence”:*

- (i) What transactions should be included within its scope?*
- (ii) How should the digital presence be measured and determined?*
- (iii) How could meaningful income be attributed to the significant economic presence and how would such an approach interact with existing transfer pricing rules and profit attribution rules applicable to the traditional permanent establishment?*
- (iv) How could such a measure be efficiently and effectively implemented in practice?*

Any recommendation by the OECD to implement a digital PE standard would be counter-productive to the success of the OECD’s BEPS initiative. Such a recommendation would lead to disparate rules across jurisdictions, tax uncertainty, and barriers to innovation. The DAPE PE standard recommended by BEPS Action 7 has, to date, only been adopted by a minority of countries participating in the BEPS Action 15 Multilateral Instrument. There is currently more disagreement amongst countries on the concept of virtual PE than there was with the DAPE concept. Thus a recommendation to adopt a virtual PE standard would lead to either: (i) a limited number of countries agreeing to modify their treaty definition of PE to include a virtual PE – thus creating tax complexity across jurisdictions, or (ii) domestic legislation intended to override treaty obligations – thus creating tax uncertainty, double taxation and barriers to cross border investment.

The creation of an economic nexus standard for digital businesses based on location of customers / users, rather than activities of the MNE taxpayer, would represent a fundamental shift with potentially far-reaching ramifications (see our earlier comments regarding the appropriate debate to be had regarding the balance between source and residency based taxation rights). For example, the Authorized OECD Approach (“AOA”) to profit attribution to a PE and the Transfer Pricing Guidelines (“TPG”) as revised by Actions 8-10 place significant weight on the location of Significant People Functions (AOA) and risk control functions (TPG) in determining the appropriate attribution of profit, and in fact the TPG were specifically revised by Actions 8-10 to limit the attribution of profits to jurisdictions where the taxpayer MNE had little or no significant functions or assets.

Therefore, any introduction of a concept of economic nexus to which profit should be attributed, based on digital presence, would require extensive revisions to the TPG as well as the AOA to achieve consistency and prevent double taxation. Further, as the Final BEPS Action 1 report stated, it is not possible to ring-fence the digital economy, and an economic nexus concept attributing value based on location of customers / users rather than location of functions, assets and risks of the enterprise cannot be limited to narrowly-defined digital enterprises. The concept of source-based taxation has far-reaching implications for any enterprise with significant disparities in the

location of its customers versus the location of its value creation activities as currently defined under TPG.

*b) Withholding tax on certain types of digital transactions:*

- (i) What transactions should be included within its scope?*
- (ii) How could the negative impacts of gross basis taxation be mitigated?*
- (iii) How could the threat of double taxation be mitigated?*
- (iv) How could such a measure be efficiently and effectively implemented in practice?*

Alterations to the economic nexus standard, the imposition of a digital economy specific withholding tax, or an equalization levy all present substantial challenges to the OECD's goal of driving global tax rule consensus and create significant tax uncertainty and risk of double taxation. In particular, a gross basis tax such as an equalization levy or withholding tax are likely to result in double taxation and cascading tax liabilities. Although these concerns might be mitigated through an input credit or an option to pay on a net basis. Any netting mechanism would raise the same profit attribution challenges discussed above in connection with the virtual PE proposal and might even duplicate VAT regimes. Further, there is a question of whether any such measures are ultimately sustainable within the global trade framework. Below we provide some additional specific areas of concern we see with these types of unilateral measures.

### **WTO Rules**

Under the General Agreement on Tariffs and Trade (GATT) members of the WTO have limited power to impose protectionist measures with regard to the import of goods. The application of the Most Favored Nation (MFN) rules by WTO members means that WTO members cannot discriminate amongst each other. A special condition granted to one member automatically applies to all other WTO members. A clear definition for digital products or digital trade is not made under GATT. However digital products distributed on tangible media and shipped from one country to the other may be subject to customs duty, while digital products electronically transformed from one country to the other are not subject to customs duties.

Under the WTO umbrella also falls the General Agreement on Trade in Services (GATS). Under GATS, services are defined as: "any service in any sector except services supplied in the exercise of governmental authority." A digital tax that may have cross border implications should therefore align with the non-discrimination conditions of the WTO.

While further analysis is certainly necessary, the implementation of a digital PE standard, the imposition of an equalization levy, or withholding tax on digital transactions may face significant challenges under the anti-discrimination rules under either GATT or GATS. Practically speaking, such rules would likely have to apply equally to all inbound transactions and would require modifications to domestic law and tax treaties.

### **The EU as a Test Case**

In the following comments we have evaluated some of the recent proposals with respect to various digital economy related tax initiatives being discussed by the EU Commission. In this respect, the EU really serves as a test case for many of the policy issues raised in our comments above.

On 22 September 2017, the EU Commission released a Communication on digital taxation. Proposals were discussed at the ECOFIN meeting in Tallinn on 29 September but without resolution. There have been suggestions that the EU should progress with adopting some kind of digital tax on a coordinated basis and, if the chosen system proves to be efficient, it could be later adopted at a global level.

We set out below some considerations on the EU introducing an EU wide digital tax through a Directive.

An initial proposal for an EU Directive would be presented by the European Commission and would have to be discussed and approved at unanimity by the Member States. In such procedure, the European Parliament has a consultative role only.

Under this scenario, the following legal checks would have to be performed:

- Is the introduction of a new tax (e.g. equalization tax or withholding tax) or of a new taxation nexus (i.e. “digital” PE) allowed under the Treaty on the Functioning of the European Union (TFEU)?
- Do the proposed rules comply with the principles of subsidiarity and proportionality?
- Once adopted, would the new rules be compatible with the existing bilateral tax treaties (1) between two Member States and (2) between Member States and third countries? In this respect, could EU law be considered to modify the domestic rules of all Member States and therefore override intra-EU treaties?

Any legislation implemented at a national level will need to comply with existing EU rules, including the fundamental freedoms, state aid rules, and existing directives (e.g. VAT Directive).

The potential requalification of a “digital” tax as illegal state aid will primarily depend on the particular features of the final legislation implemented. However, any challenge under EU state aid rules is likely to be based on the considerations that the tax provides a selective advantage to a particular sector or a certain number of companies:

- e.g., if the legislation provides an exemption for SMBs or start-ups
- e.g., progressive tax on turnover has been consistently considered by the EU Commission as illegal state aid (see Hungary’s advertisement tax and Poland’s tax on the retail sector)

Depending on the final characteristics of the tax, it could also be argued that a “digital” tax constitutes an infringement of the freedom of establishment, if it discriminates between resident and non-resident EU based companies (e.g. a German resident company taxed in France on its French digital transactions, while a comparable French company performing digital activities would be exempt).

Such tax could for example take the form of a levy based on the revenues derived from transactions carried out remotely by non-resident businesses with local customers. In this case, it would be necessary to further examine the following issues:

- Does the tax or withholding explicitly discriminate between resident and non-resident businesses?
- In case of a covert discrimination, does a correlation exist between the place in which a company has its seat, and a distinguishing criterion to be subject to taxation?

- If a discrimination exist, can it be justified and is it proportionate? (e.g., effectiveness of fiscal supervision and the need to prevent tax avoidance)?

The implementation of an “equalization” tax or any (withholding) tax levied on the gross value of certain payments to non-resident providers of goods and services online could raise net taxation concerns, i.e. not allowing non-residents to deduct expenses directly related to the taxable activity would, in principle, be an infringement on the freedom to provide services and/or on the freedom of establishment, if residents in a comparable situation can claim such expenses and therefore pay tax on a net basis.

A system based on a virtual PE presents similar concerns with regard to profit attribution. A non-resident with a virtual PE may be taxed on greater measure of profit than it would have been had it been a resident company (e.g., because not all relevant costs would be deductible) and this could constitute unfavorable treatment and a breach of the freedom of establishment.

Finally, the EU VAT Directive also raises significant matters which, depending on final legislation, may invalidate an EU wide “digital” tax. Member States are prohibited to levy turnover taxes, other than the VAT foreseen in the directive.

### ***The EU as a Test Case - A Revised Economic Nexus Standard***

A revised economic nexus standard might be designed based on revenue factors, digital factors and/or user-based factors as noted in Paragraphs 278, 279 and 280 of the Final BEPS Action 1 report and as discussed above. However, even with a revised nexus standard, existing arm’s length profit attribution rules (as affirmed in the Final BEPS Actions 8 – 10 report) would require that profit be allocated to the Significant People Functions, control of risk and value driving activities performed by a remote seller outside of the PE. As noted in the broader policy discussion above, there remains significant disagreement regarding the appropriate profit attribution standards.

In this respect, the following questions should be addressed:

- Is the “digital” PE definition compatible with the provisions of existing bilateral tax treaties (e.g. would it result in a modification of the allocation of the rights to tax between Member States or with third countries under existing bilateral treaties)?
- If there is an incompatibility (i.e. there is a provision in the existing bilateral treaty that would prevent a Member State to tax a “digital” PE in accordance with its domestic legislation) should the provisions of the bilateral treaty prevail over the directive?
- If such incompatibility results in a double taxation (e.g. the “digital” PE income is taxed by both the PE and the headquarters’ jurisdiction), would the taxpayer have any recourse?
- If a credit mechanism is developed to address potential double taxation scenarios, would the tax be paid up front subject to an input credit? If so, hasn’t this created a second VAT potentially in violation of the TFEU and VAT Directive?

For example, if such a revised standard were adopted by the EU, there is no clear-cut answer as regards the hierarchy of norms between treaty law and EU law. While it may be argued that treaty law should prevail over the conflicting provisions of a directive, article 351 TFEU and the principle of cooperation in good faith between Member States embedded in the fundamental treaties of the EU also support the view that Member States have the obligation to eliminate the incompatibilities between tax treaties and EU law.

An alternative to renegotiating all existing bilateral tax treaties would be the implementation at EU level of a multilateral instrument similar to the OECD MLI, under which existing bilateral tax treaties between Member States would be modified in a synchronized and efficient manner to implement the definition of a “digital” PE. Nevertheless, it would still leave unresolved any incompatibilities as regards the bilateral tax treaties negotiated between Member States and third countries.

In particular, in case a double taxation event occurs e.g. the “digital” PE income is taxed both by the PE jurisdiction (arguing the existence of taxable presence in its territory based on the “digital” PE definition available under its domestic legislation) and the headquarters’ jurisdiction (not recognizing a separate PE in the other jurisdiction, based on the PE definition available in the relevant bilateral tax treaty) it is questionable whether the taxpayer could still rely on the dispute resolution mechanisms foreseen by the relevant bilateral treaty.

Adoption of a revised economic nexus standard without robust multilateral agreement and coordination on the above types of issues will generate additional uncertainty, administrative burden and tax litigation that will hinder economic growth.

### ***The EU as a Test Case - An Equalization Levy***

An equalization levy raises additional issues as regards its compatibility with bilateral tax treaties. In this respect, the following questions should be addressed:

- Would an “equalization” tax qualify as a tax “on income and on capital” and therefore potentially fall within the scope of taxes covered by existing bilateral treaties?
- If the relevant bilateral tax treaty does not apply and this results in a double taxation, would the taxpayer have any recourse?

In order for an equalization tax to be compatible with the fundamental freedoms it would have to be levied on both resident and non-resident enterprises. It is unlikely that it could be justified as substitute for corporate income tax and only levied on non-residents. Therefore there would be increase in the tax burden on all digital businesses, including domestic ones, which may well be contrary to the overall tax policy of the country in question. Furthermore, this would raise state aid issues as it could result in a company selling via a digital channel having a greater tax burden than one selling through tradition means.

### ***The EU as a Test Case - Withholding Tax on “Digital Transactions”***

A withholding tax on “digital transactions” raises issues as regards its compatibility with bilateral tax treaties, in particular the following questions should be addressed:

- Would the withholding tax qualify as a tax “on income and on capital” and therefore potentially fall within the scope of taxes covered by existing bilateral treaties?
- If the relevant bilateral tax treaty is applicable, is the withholding tax compatible with such provisions (e.g. would a provision in the treaty prevent the application of the withholding tax)?
- If there is an incompatibility, should the provisions of the bilateral treaty prevail over the Directive?

- If this results in a double taxation event (e.g. the “digital” transactions are taxed both in the source state and the residence state), would the taxpayer have any recourse?

In summary, any of the special tax measures discussed herein are likely to be counterproductive as they thwart global tax consensus and foster tax uncertainty. Tax uncertainty is further exacerbated by the significant legal and practical impediments to implementing these measures. Many of these impediments are likely to take a prolonged time to resolve.

### **About KPMG**

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