E/C.18/2017/CRP.21

Distr.: General
5 October 2017

Original: English

Committee of Experts on International Cooperation in Tax Matters
Fifteenth session
Geneva, 17-20 October 2017
Agenda item 5(c)(ix)
Tax consequences of the digitalized economy — issues of relevance for developing countries

CHALLENGES OF THE DIGITAL ECONOMY: AN OVERVIEW[1]

Introduction

Sometimes referred to as the "internet economy", the Digital Economy is a term connoting an economic system based on digital computing technologies. The transition from an economy of brick and mortar business to the Digital Economy is the result of a transformative process brought by information and communication technology. Over the past decade, this process has produced standardized technologies that are both cheaper and more powerful, resulting in improved business processes and innovation across all sectors of the economy. Most recently, we have seen the impact of Digital Economy on the retail sector in the United States: many shopping malls and department and retail stores have been closed because of the impact of operations like Amazon and Best Buy where consumers shop online. The survival of these operations is now dependent on their online sales development. Presumably, this U.S. phenomena is experienced globally especially in emerging markets like South America and Africa.

[1] Contributed, at the request of the secretariat, by Marc M. Levey, Baker & McKenzie, New York, NY. This paper should not necessarily be taken as representing the views of the UN or the secretariat.

2. The proliferation of technology and commensurate rise of the Digital Economy presents a plethora of administrative concerns, not the least of which are embodied in international taxation. The traditional tools available to tax authorities were developed at a time when physical presence was the norm, and cross-border transactions lacked this type of fluidity. Like the retail stores of the brick and mortar economy, these tools have become outdated, and may soon be rendered obsolete by the Digital Economy. Thus, it is necessary for international organizations and tax authorities to take note of the challenges posed by the Digital Economy, and adapt their approaches accordingly.

I. Tax Challenges in the Digital Economy

i. Nexus

3. Predominantly a state tax concept in the United States, nexus refers to the connection between an out-of-state taxpayer and a particular state; a connection that gives rise to that state's right to impose tax. Traditionally, the existence of a nexus has turned on the physical presence of the taxpayer within a state, and whether that presence was "substantial." However, in the Digital Economy, companies are able to provide goods and services to customers in various states without ever physically setting foot in that state. To remedy this deficiency, some have advocated for the introduction of a "digital" or "economic" presence test such as the location of the customers for nexus to supplant the physical presence test, which would find a nexus only where the activity meets or exceeds a particular threshold that reflects substantial digital interaction with the economy of the particular state. While it is important not to overstate this concern,[2] the concept of "nexus" must shift to address realities of business in the Digital Economy. As discussed below, the U.S. "nexus" issue draws comparisons to the global "permanent establishment" concept as contained in most bilateral tax treaties.

ii. Permanent Establishment

4. For the definition of permanent establishment (or "PE") for bilateral treaty purposes, most tax treaties provide that a state will not have a right to tax income earned by a foreign business unless that income is attributable to a PE in that state. Like nexus, the existence of PE depends on the physical presence of the foreign business, although the OECD has added a "material participation test", as

[2] Many companies will decide to establish a physical presence where their customers are located, even in the Digital Economy. For example, proximity may be essential in certain enterprises to reduce latency, comply with regulations, increase efficiencies, or to address other business needs.

presently adopted by the BRICS countries. A PE is generally a fixed place of business, such as a sales office, or the presence of employees, who have and regularly exercise, an authority to conclude contracts that are binding on the foreign corporation. Under most treaties, certain activities are specifically excluded from the definition of a PE, such as using facilities solely for storage, display or delivery of inventory, the mere purchasing of goods or collecting of information or any other activity of an auxiliary or preparatory nature, although many countries are questioning whether the storage facilities are truly auxiliary to the taxpayer's production and sales businesses.[3]

5. The relevance of a physical presence is significantly diminished in the Digital Economy. Similarly, the significance of an employee's ability to conclude contracts is mostly, if not entirely, eliminated where contracts can be concluded remotely through technological means with no employee interaction. Thus, an adjustment is needed to account for the digitalization of business. Some common suggestions include modifying the definition of PE and exceptions thereto as provided by the OECD and as are prevalent in India, China and some African countries. For example, adjusting the exceptions to ensure that they are restricted to activities that truly qualify as preparatory or auxiliary. These modifications could, among other things, deny benefits to foreign companies that maintain facilities (and employees therein) for purposes of storing and delivering goods that were sold to customers remotely from abroad (*e.g.*, Amazon and Alibaba).

6. Similarly, a modification to include a "significant digital presence" test, taking into account the location of the ultimate customer, could help to alleviate the inadequacies of outdated treaty provisions. For example, a number of proposals by France and BRICS countries have introduced a PE definition whereby a PE may be established by end-user activity (*e.g.*, where the user "clicks"). One justification for this expansive definition is cross-border data transfer: digital interactions with customers facilitate, and often necessitate, the transfer and collection of data to/from the user, which arguably requires a *de facto* domestic presence. Although these click-focused proposals could significantly decrease the ability of companies to avoid establishing a PE through artificial means, some argue that they are not economically neutral, as the risk of establishing a PE solely through user-interfacing could drastically alter international commerce in the Digital Economy.

[3] Secretariat note - The 2017 OECD Model (reflecting BEPS Project outcomes) seeks to address this issue in part by providing that, for any of the subparagraphs of paragraph 4: the activities will be treated as not constituting a PE where: "that such activity or, in the case of subparagraph f), the overall activity of the fixed place of business, is of a preparatory or auxiliary character." The UN Model does *not* list "delivery" as an activity that is excluded from constituting a PE under paragraph 4.

7. The European Commission of Finance Ministers, ("ECOFIN,") have discussed, on behalf of the member states, updating the tax rules for taxing the use of digital technology. They note that the problems connected with the digital economy and the need for solutions have been the subject of discussion for some time, observing that countries have been deprived of significant tax revenues. Business models of the digital economy differ significantly from traditional business models as companies operate virtually in several countries. The international tax rules, which generally tax based on physical presence, do not accommodate these models, making solutions difficult at best. Accordingly, the ECOFIN is considering modifications of the permanent establishment rules under a concept of a virtual permanent establishment to address this issue. Also, and of equal importance, is conformity with the rules of attribution of profits to a permanent establishment. These are very complex concepts which produce numerous ancillary issues such as an extension of the VAT rules to online suppliers of goods. Likely, the ECOFIN will look to the OECD for multilateral solutions and support for these issues. Unanimity, however, is not a given.

iii. Anti-deferral Regimes

8. In recognition of the possibility that foreign-based competitors may operate under income tax systems that exempt extraterritorial income, a number of states without that exemption have enacted international tax rules to defer the recognition of certain foreign-source income until those earnings are brought back (or "repatriated"). As with any rules providing deferral of tax imposition, these rules have been the means of perceived pervasive abuse that lead to tax base erosion. As a result, anti-deferral rules, sometimes referred to as controlled foreign corporation ("CFC") rules, provide a means of taxing domestic parents on certain income that can be easily shifted to foreign subsidiaries in low or no tax jurisdictions.

9. CFC rules aim to prevent tax avoidance where foreign-source income would not be taxed until repatriated (*e.g.*, in the form of a dividend to the domestic parent) or constitute "nowhere" income. The United Kingdom has CFC rules[4] under which shareholders of a CFC are generally taxed on income that does not result from active business activities. France has similar rules under Section 209B of its Tax Code, which recaptures certain income transferred to a CFC or PE that enjoys a privileged tax regime. French CFC rules however do not apply to foreign-controlled entities that carry on an active trade or

[4] A company is generally a CFC if it is resident outside the home country, controlled by persons within the home country, and subject to a lower level of taxation than it would be in the home country.

business even though they benefit from a privileged tax regime. But what is an "active" business in the Digital Economy? And, the U.S. CFC rules have been criticized as somewhat mechanical and thus easily avoided.

10. Consider, for example, a transaction for the sale of goods or services through a company like Airbnb or Ebay, where users act as both buyer and seller, with the company facilitating the transaction. These sales are often, if not always, the result of the consumer locating a publicly accessible website, selecting an item posted for sale by another user, and providing their payment card information to finalize the purchase. Should income derived by the company for facilitating these sales be characterized as passive or active? In other words, to what extent should anti-deferral rules seek to recapture income earned in the Digital Economy? This simple example demonstrates the need for clarity in the realm of anti-deferral rules. One possible, yet potentially over-broad option, may be to implement full-inclusion CFC regimes that CFC are easily applicable, without the need to identify whether the income is active or passive, or implementing some less expansive threshold for recapture.

iv. Transfer Pricing

11. Transfer pricing refers to the rules and methods for pricing transactions between entities under common ownership or control. The core concept of transfer pricing is the belief that there is an "arm's length" price to every transaction, which should act as the lodestar – the guiding star - for intercompany transactions. There are numerous methods for determining the arm's-length price. Which method is appropriate depends on the particular transaction at issue, and the reliability of comparable data. These methods, however, were devised at a time when integrated global supply chains were the exception, not the rule. Indeed, they did not anticipate a Digital Economy nor cloud computing. Prior to the rise of the Digital Economy, the structure of multinational enterprises (MNEs) generally consisted of separately functioning subsidiaries in each jurisdiction largely based on sales and manufacturing functions. These structures were more economical given the high cost of transportation, slow speed of communication, and other expenses such as customs duties and currency exchange.

12. Today MNEs are operating more and more as interconnected, cohesive global units with supply chains digitalized. Thus, there is a need for transfer pricing methodologies that can account for this fundamental change to the value chains of MNEs. This widespread global integration is often the product of valuable intangibles and other non-routine value chain contributions. These intangibles are

recognized as the key value contributors of digital business models. Accordingly, many insist that transfer pricing in the Digital Economy must focus on profit split methods, which are capable of aligning profits, under innumerable sets of circumstances, with the value-creating contribution of intangibles throughout value chain. Absent specific transactional methodologies to accommodate the digital world, this is the default method.

II. Ancillary Issues

13. In addition to the various tax challenges posed by the Digital Economy, there exist technological developments that pose challenges to other administrative tasks. Several of these developments are discussed below.

i. **Data & Data Privacy**: Data protection has always been a major concern for individuals and businesses. As the Digital Economy grows, data accumulates at a near exponential rate. Companies are finding that the sheer volume of data produced, while valuable, can also be overwhelming, adding a counterproductive complexity to their business operations. Perhaps not surprisingly, the number and frequency of data breaches has risen along with the amount of data. The vast majority of data breaches target businesses in the private sector. Furthermore, the interconnected nature of the Digital Economy means that many of these breaches occur on a global scale. Consider, for example, the "WannaCry" ransomware attack earlier this year, which infected more than 230,000 computers in over 150 countries.[5] Current administrative systems are not capable of addressing the multitude of challenges presented by the data collection in the Digital Economy, and the need to protect it from these kinds of attacks. Their policies and regulatory schemes must be updated to reflect best practices in the Digital Economy and protect the valuable data checked.

ii. **Cloud Computing**: Cloud-computing refers to the provision of services via a network of remote servers hosted on the Internet. Cloud-computing enables a user to store, manage, or process data, without reliance on a local server or personal computer. The provider of

[5] Secretariat note - The attack is reported to have cost one entity alone, A.P. Moller-Maersk, US$ 300 million: Danny Palmer, "Petya ransomware: Cyberattack costs could hit $300m for shipping giant Maersk", Zdnet 16 August 2017: http://www.zdnet.com/article/petya-ransomware-cyber-attack-costs-could-hit-300m-for-shipping-giant-maersk/

these services is in physical possession of the equipment (*e.g.*, servers). In fact, one key value driver of cloud-computing is its ability to relieve the user of obligations related to acquisition, maintenance and disposition of equipment. However, because the very essence of the business model is that the user never has physical possession, the user cannot be regarded as in control of the properties being used in its business. In addition to the various tax issues that this presents (such as nexus and PEs, as discussed above), there are countless regulatory concerns, arguably the most significant of which is data privacy. For example, consider an enterprise that carries on its business through a website hosted on the server of a remote service provider. Though the software and data being run on the server may be dictated by the enterprise, the server, its location and security are at the disposal of the service provider.

iii. **Escheat**: Escheat is a common law doctrine that provides for the reversion of abandoned and unclaimed property to a nation or state. For example, if an individual dies with no will or legal heirs, the decedent's property may become the property of the state through escheat. Certain states also have escheat laws related to unclaimed property held by a company for a certain number of years (*e.g.*, an untraceable gift card that was purchased but never used or an E-wallet). In these cases, escheat law may require the company to give the value of the unused gift card or unclaimed property in an E-wallet to the state. The Digital Economy has the potential to both frustrate and alleviate issues surrounding escheat laws for certain companies. Continuing with the gift card example, the Digital Economy has expanded the use of digital gift cards so companies may carry greater potential escheat liability. On the other hand, the digital nature of the cards may assist in identifying the rightful owners, rather than having to hand them over to the state through escheat.

iv. **E-Wallets**: An e-wallet, sometimes referred to as a "digital wallet," is a digital device that stores a variety of payment data and allows for electronic transactions (*e.g.*, purchasing an item by scanning a cell phone). E-wallets were birthed by the Digital Economy, and the issues raised by e-wallets closely mirror those of the Digital Economy more generally. For example, e-wallets presents another avenue for theft (of funds or identities), and creates potential privacy issues where the e-wallet is, as they often are, tracking and

transmitting transaction history to a third party. In this space, the security of the technology and the privacy laws related thereto has generally lagged behind the proliferation of e-wallets. E-wallets also pose additional escheat concerns. Consider a company that operates in various countries through independent contractors that it pays via e-wallets issued by third-party service providers. These arrangements, which are increasingly common in the Digital Economy, also present new difficulties, not the least of which is the threshold matter of identifying the person bearing the ultimate escheatment obligations under the applicable law.