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UN Tax Expert Committee
Subcommittee on Tax Challenges related to the Digitalisation of the Economy

Summary

Mr. Aart Roelofsen, co-coordinator of the Subcommittee on Taxation Issues Related to the Digitalization of the Economy, prepared this paper to be discussed at the 17th session of the Committee.

The paper describes recent developments relating to the digitalization of the economy, particularly its effects on domestic taxation and potential tax base erosion and profit shifting. It considers some new business models that render obsolete the concept of permanent establishment (PE), which has been used as a basis for taxation of profits earned by multinational enterprises (MNEs) in different jurisdictions. In addition, the paper raises the following aspects: 1) identification of the main concerns and interest of developing countries, taking into account the varying features of their economies; 2) analysis of short-term versus long-term measures; and 3) consideration of the consequences that policy decisions might have on other business sectors.

The paper is addressed to the Committee, with a view to discussing it at its forthcoming session to seek Committee's guidance for the Subcommittee on its work going forward, including for the purpose of updating relevant provisions in the UN Model Double Taxation Convention.

I. INTRODUCTION

At its fifteenth session, held in Geneva in October 2017, the Committee of Experts on International Cooperation in Tax Matters formed a Subcommittee on Tax Challenges Related to the Digitalization of the Economy (hereinafter SubCo TCRDE), to be coordinated by Mr. Babatunde Fowler and Mr. Aart Roelofsen with the following mandate:

> The Subcommittee is mandated to draw upon its own experience as a body widely representative of affected stakeholders and engage with other relevant bodies and interested parties with a view to:
>
> - Analysing technical, economic and other relevant issues;
> - Describing difficulties and opportunities especially of interest to the various affected agencies of developing countries;
> - Monitoring international developments;
> - Describing possible ways forward; and
> - Suggesting measures and drafting provisions related to the digitalization of the economy, with regard to:
> - Income taxes;
> - Double tax treaties;
> - Value added tax as well as other indirect taxes.
>
> The Subcommittee will report on its activities, recommendations and conclusions at each Committee session with an initial response on issues, possible options and working methods for consideration by the seventeenth session in October 2018.

II. COMPOSITION

One or two subcommittees?

As reflected in para 28 of the Report on the fifteenth session (E/2018/45-E/C.18/2018/1), the Committee had to decide on the question of whether this subcommittee would also analyse tax administration issues related to digitalization and whether two subcommittees could be formed, each dealing with one of the two issues (tax challenges of the digitalization of the economy and the tax administration issues related to the digitalized economy). During the Committee's sixteenth session in New York from 14-17 May 2018 a solution was found based on a suggestion by the new director for the Financing for Sustainable Development department, Mr Navid Hanif. It was agreed that consequences of digitalization for tax administration would remain an important area of work for the Committee but that it would not be included in the mandate of the SubCo TCRDE.

Membership

Committee practice is that the (co-)coordinators of subcommittees decide on the composition and membership of "their" subcommittee based on expression of interest among Committee Members and observers.

Numerous representatives of observer countries, international organizations, NGO's, academia and business have expressed their interest in membership of the Subcommittee.

Below you will find a proposal for a 'basic approach' to be discussed during the meeting of the Subcommittee in Geneva on Monday.

Based on that 'basic approach' the added value of the participation in the SubCo of observer from business sectors, academia and civil society has to be discussed as well. Given the balanced composition of the Committee the same holds true for members state observers.

Observers from international organizations like OECD, ATAF, CIAT could however be valuable to guarantee coordination with initiatives taken by those organizations.

The secretariat has noted the following interest from Committee members to participate in the work of the SubCO TCRDE (DE)

Co-coordinators

1. Aart Roelofsen
2. William Babatunde Fowler

Committee Members

3. Aleksandr Smirnov
4. Carlos E. Protto
5. Carmel Peters
6. Chinyama Margaret Moonga Chikuba
7. Christoph Schelling
8. Elfrieda Stewart Tamba
9. George Omondi Obell
10. Ingela Willfors
11. Marlene Patricia Nembhard-Parker
12. Mitsuhiro Honda
13. Moussa Arreh Abdoulfatah
14. Patricia Mongkhonvanit
15. Rajat Bansal
16. Sing Yuan Yong

17. Stephanie Lynn Smith
18. Yan Xiong
19. Dang Minh

Based on expression of interest by Committee Members received by the Secretariat, the co-coordinators propose to invite all Committee members to the meeting of the Subcommittee on Monday 15 October.

In a later phase international organization and, when proposals are developed, observer countries, academia, NGO's and business observers could be included.

III. BASIC APPROACH

The Committee of Experts on International Cooperation in Tax Matters is mandated to

i. keep under review and update as necessary the United Nations Model Double Taxation Convention between Developed and Developing Countries and the Manual for the Negotiation of Bilateral Tax Treaties between Developed and Developing Countries;
ii. provide a framework for dialogue with a view to enhancing and promoting international tax cooperation among national tax authorities;
iii. consider how new and emerging issues could affect international cooperation in tax matters and develop assessments, commentaries and appropriate recommendations;
iv. make recommendations on capacity-building and the provision of technical assistance to developing countries and countries with economies in transition; and
v. give special attention to developing countries and countries with economies in transition in dealing with all the above issues.

The United Nations Model Double Taxation Convention between Developed and Developing Countries has a separate and independent position from the OECD Model and a separate and independent relevance for international tax practice. However, for practical reasons, the UN Model and Commentary in many parts refers to the OECD Model.

A similar approach appears to be practical for the SubCo TCRDE.

Considerable efforts have been made in OECD and other bodies to describe the development of business models related to the digitalization of the economy. Also, OECD has worked on a useful summary of different domestic measures targeted at digital business models. In the opinion of the co-coordinators, this work is a good basis for the SubCo TCRDE and needs not to be repeated.

Given the existence of sufficient factual information, the SubCo TCRDE could focus on, and restrict itself to, a discussion on policy consequences. In doing so it could

- describe the concerns and the interest of developing countries,
- take into account the varying features of their economies,
- distinguish between short term and long-term measures
- and consider which consequences policy decisions would have for other business sectors.

CIVs to claim the benefits of the treaty and if the “equivalent beneficiary” test is not fulfilled; treaty benefits will be denied to non-CIV funds under this provision.

IV. WAY FORWARD

The background and objective for the proposed and introduced measures described under ‘recent developments’ below may differ from the objective of the UN Committee.

The EC aims at guaranteeing the level playing field in a single European Market, including by countering tax avoidance and evasion.

The purpose of the work of the OECD/G20/IF is to remove obstacles for international trade with measures to avoid double taxation and creating an effective tax system by avoiding tax avoidance through base erosion and artificial profit shifting. Taxation in a digitalizing economy in an effective and coherent way is part of that system.

The responsibility of the US government is limited to its own economy.

Yet, all three packages include elements that are worth studying by the SubCo TCRDE. The SubCo TCRDE could evaluate the proposed and introduced measures on their merits for governments and tax administrations in developing countries.

That work of the SubCo should start with a clear description of the problems developing countries encounter with the taxation of digital services and with the digitalization of the economy in general. Since resources are limited and meetings in person are demanding, we could start this part of the work with a questionnaire to the members. A proposal for such questionnaire is included in Annex 1.

It is the view of the coordinators that the OECD Report contains a sufficiently elaborated description of business models. That work should not be taken on by the SubCo TCRDE.

The overview of the relevant tax policy developments (domestic measures introduced) could be updated with a focus on developing countries. Each committee members, possibly with the assistance of regional organizations, could contribute to that update.

The conclusions of the SubCo TCRDE should then reflect:

- -the concern that developing economies have regarding the digitalization of the economy
- -the merits of coordination and coherence,
- -the preferred characteristics of long term solutions and
- -the risks and advantages of interim measures.

V. RECENT INTERNATIONAL DEVELOPMENTS

OECD

On 16 March 2018 the OECD released the Interim Report on the Tax Challenges Arising from Digitalisation, responding to a mandate from the G20 Finance Ministers to work on the implications of digitalisation for taxation and agreed upon by the members of the OECD/G20 Inclusive Framework. More than 110 countries and jurisdictions have agreed to review two key concepts of the international tax system, nexus and profit allocation, and will work towards a consensus-based solution by 2020. The Interim Report was presented to the G20 Finance Ministers at their meeting on 19-20 March in Buenos Aires, Argentina.

The summary conclusions of the Interim Report are reflected below.

1. The 2015 BEPS Action 1 Report identified a number of tax challenges relating to digitalisation that go beyond BEPS - namely nexus, data and characterisation - and considered options that could address some of these broader challenges. However, no agreement was reached in 2015 on whether any of these options should be adopted. In the absence of consensus, a number of countries have subsequently begun to explore and implement a range of uncoordinated and unilateral actions (see Chapter 4).

2. Following the delivery of the BEPS package, it was agreed that the Task Force on the Digital Economy would continue its work within the Inclusive Framework delivering an interim report in 2018 and a final report in 2020. Since then, important advances have been made in our understanding of how business models and value creation are being affected by the process of digitalisation. With a focus on highly digitalised business models, Chapter 2 describes new processes of value creation and a number of salient characteristics that are frequently observed in these businesses; namely scale without mass, heavy reliance on intangible assets and the importance of data and user participation. The transformative changes associated with digitalisation are quickly reaching across a growing number of businesses and as the BEPS Action 1 Report concluded, it would be difficult, if not impossible, to ring-fence the digital economy from the rest of the economy.

3. The more than 110 members of the Inclusive Framework, representing a diverse range of economies at varying levels of development, recognise their common interest

in maintaining a relevant and coherent set of international tax rules. The proliferation of unilateral approaches is likely to have adverse impacts on investment and growth, and risks increasing double taxation and complexity for taxpayers and tax authorities alike.

4. However, the tax issues raised by digitalisation are technically complex, and this interim report identifies the different views among countries on whether and to what extent the features of highly digitalised business models and digitalisation more generally should result in changes to the international tax rules. Overall, there is support for undertaking a coherent and concurrent review of two key aspects of the existing tax framework, nexus and profit allocation rules that would consider the impacts of digitalisation.

5. The work required to further progress discussions on these complex issues is identified in Chapter 5. In addition to refining the understanding of the value contribution of certain aspects of digitalisation, technical solutions will also be explored to test the feasibility of different options. In addition to ongoing dialogue between Inclusive Framework members, this process will also involve ongoing engagement with different stakeholder groups, including business, civil society and academia. Following an update on progress in 2019, the Inclusive Framework will work towards a consensus-based solution by 2020.

6. There is no consensus on the merits of, or need for, interim measures, and therefore this report does not make a recommendation for their introduction. Chapter 6 recognises that a number of countries do not agree that features such as “scale without mass”, a heavy reliance on intangible assets or “user contribution” provide a basis for imposing an interim measure and consider that an interim measure will give rise to risks and adverse consequences irrespective of any limits on the design of such a measure, including as a result of uncertainty and double taxation. Countries that are in favour of the introduction of interim measures acknowledge that such challenges may arise but consider that at least some of the possible adverse consequences can be mitigated through the design of the measure and that, pending a consensus-based global solution, there is a strong imperative to act to ensure that the tax paid by certain businesses in their jurisdiction is commensurate with the value that they consider is being generated in their jurisdictions. Where jurisdictions wish to proceed with consideration of interim measures, they have identified a number of considerations that they believe need to be taken into account as guidance to limit the potential for divergence and possible adverse side-effects.

7. Separately from the broader tax challenges and considering more specifically the BEPS issues that may be exacerbated by digitalisation, there is preliminary evidence

already available suggesting that implementation of the OECD/G20 BEPS package is having an impact. Adopted in October 2015, the BEPS package, and in particular, those measures most relevant to digitalisation (Actions 3, 5, 6, 7, and 8-10), has already begun to take effect as described in Chapter 3. The early response of some highly digitalised MNEs also suggests that they have begun making changes to their business structures to improve alignment with their real economic activity. Continuing to monitor the impact of the BEPS package, in particular after the 2017 US tax reform, will be an important part of the work of the TFDE going forward.

8. In addition to its impact on the international tax rules, the digital transformation is also having an important influence on other aspects of the tax system. As described in Chapter 7, these range from the implications of changes to the taxable status of economic actors arising as a result of a shift from standard to non-standard work, to new tools available to tax administrations that deliver improved taxpayer services, more effective data matching, and greater capabilities to detect and investigate tax evasion and fraud.

9. While some work on these topics related to the impact of digitalisation on other aspects of the tax system is already underway, a number of additional areas have been identified in Chapter 7 to ensure that the tax system, from policy through to administration, remains able to respond to and make use of the latest developments in digital technology.

10. Ensuring that our tax systems are ready to meet the changes brought by digitalisation, as well as to leverage from its opportunities and provide protection from its potential risks, is a critical challenge. Political support will be required to undertake the detailed, often complex work, needed to deliver on these objectives, noting that the tax system remains a foundation stone in the relationship between States and their citizens.

The full Interim Report can be read here:
Interim Report on the Tax Challenges Arising from Digitalisation

EUROPEAN COMMISSION

On the 21st March 2018 the European Commission (EC) released 6 documents relevant for this Subcommittee:

- A Communication from the Commission to the European Parliament and the Council:
- "Time to establish a modern, fair and efficient standard for the digital economy";
- An Annex to that Communication including a timeline of relevant measures;

- A Proposal for a Council Directive laying down rules relating to the taxation of a significant digital presence (the so called long term solution);
- An Annex to that Proposal including a list of European domestic taxes on which the Proposal would apply and a list of services that would be targeted by the Proposal;
- A Commission Recommendation relating to the corporate taxation of a significant presence;
- A Proposal for a Council Directive on the common system of a digital services tax on revenues resulting from the provision of certain digital services (the so called interim solution).

Earlier, on the 21st September 2017, the EC had issued a Communication to the European Parliament and the Council “A Fair and Efficient Tax System in the European Union for the Digital Single Market”.

The EC documents can be found here:
https://ec.europa.eu/taxation_customs/business/company-tax/fair-taxation-digital-economy_en

Annex 1

Possible Questionnaire for Committee members on Challenges from the digitalization of the economy

1. Can you describe which concerns governments of developing countries could have regarding the taxation of multinational enterprises (MNE's)?

    a) Regarding direct taxes

    b) Regarding indirect taxes

2. Which of these concerns are exacerbated due to the digitalization of the economy?

3. Does this relate to all sectors of MNE's or to a specific sector?

    a) If to a specific sector, how would you describe the services this specific sector provides?

4. Do you agree with the principle that profits of MNE's should be taxed where value is created?

    If not, what should be the correct base for attributing taxing rights on MNE's?

5. Do the concerns you described under Q1 and Q2 relate to the fact that the current rules do not allow taxation where value is created?

    If so, could you indicate which rules you refer to?

    If so, why do you think that value is created in the State that does not have the taxing right over services described under Q3a? How is that value created?

6. Has your country introduced tax measures aimed at taxing certain digital services over the last 2 years?

7. Could you give the reason why they were introduced and describe those measures?

Annex 2

United States

One of the aspects of the digital economy that both the OECD Report and the EC proposals mention is its heavy reliance on intangible assets. In that light the SubCo TCRDE should take note of recent developments in the US. On the 1st January 2018 a set of measures known as the Tax Cut and Jobs Act entered into force. For corporate tax and international business, the following elements are relevant:

- The tax rate was decreased from 35% to 21%
- Past profits held off shore will be taxed at a rate of
- BEAT
- GILTI
- FDII

- The following summary of the International Tax Provisions of The United States Tax Reform Bill as Enacted can be found.

  The United States Senate passed today, and the House of Representatives passed yesterday, a final tax reform bill that reconciled competing House and Senate bills and amends current Code provisions to create a new U.S. approach for taxing international commerce. The bill will be enacted into law upon the President's signature and generally will be effective for tax years beginning after December 31, 2017.

  Territorial System with Enhanced CFC Regime.

  The final bill would reduce the corporate income tax rate to 21% and shift the United States towards a territorial system of taxation. Any amounts earned by foreign subsidiaries of U.S. corporations that are not taxed currently under a controlled foreign corporation ("CFC") regime could be distributed back to corporate U.S. shareholders free of U.S. tax. The CFC regime would include the existing rules that tax U.S. shareholders currently on the passive income of CFCs and would also include new rules that tax U.S. shareholders currently on certain excess returns earned through CFCs that are not subject to a minimum level of foreign tax. Under these new rules, a U.S. parent corporation would currently include in income the excess returns of its CFCs (termed "global intangible low-taxed income"), which generally would be calculated as CFC income in excess of a 10% return on the tangible assets of the CFCs. The U.S. parent corporation would be entitled to deduct an amount equal to 50% of the excess returns amount included and would be able to credit against its U.S. income tax 80% of the foreign taxes paid by the CFCs on the excess returns amount. Because the U.S.

parent would be including 50% of the excess returns amount to be taxed at a 21% corporate tax rate, all excess returns would be taxed at a combined US and foreign effective tax rate of at least 10.5%. Taking into account the allowance of a foreign tax credit for 80% of foreign taxes paid, no additional US tax would be owed if the excess returns of all CFCs in the aggregate have been subjected to foreign tax at an average rate of at least 13.125%. In general, no U.S. tax would be imposed on the distribution of earnings back to a corporate U.S. shareholder paid after December 31, 2017. However, foreign branch operations of a domestic corporation would continue to be subject to current U.S. taxation. Furthermore, taxable dispositions of CFC stock would continue to be subject to U.S. taxation, excluding the portion of gain attributable to undistributed earnings.

Transition Tax.

In connection with the transition to a territorial system, a tax would be imposed on the accumulated untaxed post-1986 earnings of foreign subsidiaries. The rate would be 15.5% for earnings held in the form of cash and cash equivalents and 8% for other earnings. Foreign tax credits would be permitted to reduce the tax due, but foreign tax credits would be scaled back proportionately with the rate reduction, with the effect that some U.S. tax would be due unless the average effective foreign tax rate on the accumulated earnings was at least 35%. This transition tax would arise on a deemed repatriation of the earnings as of the last day of the last taxable year of each foreign subsidiary beginning before January 1, 2018. The tax would be payable in instalments over 8 years (with no interest charge).

Foreign-Derived Intangible Income Deduction

The final bill contains a separate regime intended to benefit foreign-derived intangible income of domestic corporations. The intangible income of a domestic corporation would be defined as the excess of its taxable income over a 10% rate of return on its tangible depreciable assets. Foreign derived intangible income would be that portion of the total intangible income that corresponds to the portion of a domestic corporation's total income that consists of income from the sale/license of property or services for use outside of the United States. A deduction would be provided equal to 37.5% of the amount of such foreign derived intangible income, lowering the effective tax rate on such income to 13.125%.

Interest Deduction Limitation

The final bill also contains a significant limitation on the deductibility of interest expense. In particular, no business could deduct interest expense in an amount in excess of the sum of its gross interest income plus an amount equal to 30% of its taxable income computed without interest *income or expense, net operating loss deductions or deductions for depreciation and amortization (similar to EBITDA). Beginning in 2022, deductions for depreciation and amortization would be taken into account in calculating the limitation, meaning that the limitation would equal 30% of the business' taxable income computed without interest income or expense or net operating loss deductions (similar to EBIT).*

Inbound Base Erosion Rule

The final bill includes an inbound base erosion rule in the form of an alternative minimum tax that would apply to domestic corporations that make deductible payments to related foreign corporations. This alternative minimum tax is referred to as the base erosion anti-abuse tax (or "BEAT"). Domestic corporations generally would calculate an alternative minimum tax at a 10% rate (5% in 2018) on a tax base that disallows deductions for payments (e.g., interest, royalties, service fees, reinsurance payments) paid to foreign related parties and depreciation deductions for property purchased from foreign related parties. Deductions for certain qualified derivative payments and payments for certain low-value services charged at cost would be allowed, however, in calculating the alternative minimum tax. A deduction for cost of goods sold would be allowed for purchases of inventory from foreign related persons in measuring the alternative minimum tax base, unless the inventory is acquired from a foreign member of an inverted group of companies. The alternative minimum tax rate is one percentage point higher for banks and securities dealers (i.e., 6% in 2018 and 11% in later years). To the extent that the tax on the alternative tax base, calculated at the lower rate, exceeds the domestic corporation's regular tax liability, the excess amount would be payable in addition to regular income tax. This regime would apply only to domestic corporations that are members of domestic affiliated groups with gross receipts in excess of $500,000,000 on average per year over three years.

Anti-Hybrid Rules

The final bill also includes certain anti-hybrid rules. It provides that the 100% participation exemption will not apply if the U.S. shareholder receives a hybrid dividend, which in general is a dividend that is deductible in the foreign jurisdiction of the payor. Moreover, a hybrid dividend paid between two CFCs results in an immediate CFC inclusion to the U.S. shareholder. In addition, the final bill disallows a deduction for interest or royalties paid to a foreign related party if made pursuant to a hybrid transaction or made by or to a hybrid entity. Regulatory authority is provided to address conduit arrangements or structured transactions.