2 Tax challenges of the Digital Economy

The fiscal answer to the increasingly blurry frontiers for digital companies

In which country should value-added tax on online transactions be paid? Can we rely on the old definition of Permanent Establishment? There is an uneven playing field between foreign digital companies and local retailers. Meanwhile, millions of euros in tax revenues are lost every year. National regulatory initiatives arise and the OECD aims to reach a consensus.

The irruption of the digital economy is changing the economic paradigm and requires rethinking previous concepts and rules as they might not fit this new reality. This new environment brings both positive effects, like an increased customer choice and greater competition, and unintended consequences like reduced tax collection or an uneven playing field for local companies. Indeed, customers might acquire products and services from digital providers located in foreign countries where taxes are lower. This phenomenon is growing and regulators are adopting measures that should allow the maximum benefit to be obtained for all stakeholders, while still maintaining a fair competition. The Organisation for Economic Cooperation and Development (OECD) is aware of this situation: “Because the digital economy is increasingly becoming the economy itself, it would be difficult, if not impossible, to ring-fence the digital economy from the rest of the economy for tax purposes”.[3]

What is at stake? The OECD’s answer

The digital economy opens up the door for businesses to operate on a global scale. New business models and delivery channels arise and the traditional definition of direct or indirect taxes does not apply in most cases, as it is hard to determine which is the competent authority to comply with. These gaps in international rules reduce tax income and might allow shifting profits to low-tax locations with little or no presence of the company. The OECD refers to these activities as base erosion and profit shifting (BEPS) and has created an action plan to review current tax rules in order to reach consensus on how to approach this issue.

The Action Plan on BEPS[4] identified 15 actions, based on three fundamental pillars: introducing coherence in the domestic rules that affect cross-border activities, reinforcing substance requirements in the existing international standards and improving transparency. On Action 1, BEPS addresses the tax challenges of the digital age and identifies the main difficulties that the digital economy faces for the application of existing international tax rules. Their conclusions show the need to redefine how direct and indirect taxes are being established, while keeping the main principles of consistency, neutrality, efficiency, certainty and simplicity, effectiveness and fairness, flexibility, compatibility and consensus.

Direct tax applies to companies that are based within one country. To determine this, the Permanent Establishment (PE) concept is used to decide whether a company has to pay tax in one country or another. The challenge relies on how to decide where a digital business is located. A good example to understand this situation is the typical arrangement of global e-commerce sellers, where an internet provider can have its core businesses in one country, effectively invoicing from that location, despite using local warehouses to deliver the goods for their customers. Can we consider that the warehouse is a taxable nexus? Regulators are concerned by these organisational arrangements, and are aware of the potential use of those gaps in the interaction of different tax systems to artificially reduce taxable income. In this situation, a new definition of the PE concept is required to take into account three policy concerns that have emerged with the digital economy: nexus, data and characterisation of the income.

3: OECD. (2014), *Addressing the Tax Challenges of the Digital Economy, OECD/G20 Base Erosion and Profit Shifting Project*, OECD Publishing, Paris. DOI: http://dx.doi.org/10.1787/9789264218789-en
4: OECD. (2013), *Action Plan on Base Erosion and Profit Shifting*, OECD Publishing, Paris. DOI: http://dx.doi.org/10.1787/9789264202719-en

Indirect taxes or value added taxes (VAT) are also being affected by this new paradigm. One of the main consensuses achieved is that, for digital services, the place of taxation should be based on the place where the consumption occurs. However, this statement leads to further questions, like for example who is liable to account for the tax due and what mechanisms can be used for compliance and the payment of the tax due. Related to this, there is another issue to consider: the tax exemptions that most countries apply to small value goods at customs collection points, because administrative costs associated exceed the value of the VAT potentially collected. In the past this was a marginal concern, but with the growth of e-commerce VAT revenues have suffered a significant decrease and regulators are thinking of new systems to improve tax collection at national borders. A possible solution pointed out by the OECD in its Low Value Import Report implies reducing the cost of collecting VAT. Now, the issue at stake is how to avoid an unfair competition with national providers while keeping basic principles of international taxation, like avoiding a double taxation.

However, the biggest concern is related to the cross-border delivery of intangibles, like streaming content or applications. Those services do not enter the country through customs and might be contracted directly by the end user without the intervention of national intermediaries. Regarding this, OECD's E-commerce guidelines[5] recommend that the supplier registers, collects and remits VAT according to the rules of the jurisdiction where the customer is. This increases in complexity in terms of the process of selling abroad, but promotes local fair competition. However, this VAT registry is independent of the PE for direct taxes purposes.

EU and USA latest developments

Non-EU companies that want to operate in the EU can only declare PE in one member country for direct taxes purposes. In the case of indirect taxes of business-to-consumer (B2C) services, it is worth mentioning the creation of an optional scheme, the Mini One Stop Shop (MOSS) system. This scheme allows businesses that supply telecommunications, broadcasting or e-services to consumers in Member States in which they do not have an establishment to account for the VAT due on those supplies via a web-portal in one Member State. This foreign company will have to identify the EU countries where it has supplied that service and the VAT applied. The relevant tax authority will then split the amount among all countries involved. This regulation was established to create a level playing field among national and foreign merchants, as VAT applied is the local rate. If the provider decides not to use MOSS, it will have to register in each country where it provides services.

In the case of the US, this issue is also in regulators' agendas and many US states and cities are currently reviewing what measures should be taken, since there is no federal framework to cover all tax-related issues. As an example, the definition of taxable nexus, usually a physical presence, or the internet tax sales differs among states. To provide a common field, the Marketplace Fairness Act requires that states simplify their sales tax laws and grants states the authority to compel online and catalogue retailers ("remote sellers"), no matter where they are located, to collect sales tax at the time of a transaction.

New challenges: the example of 3D printing

Although there have been several advances made regarding international taxation of digital sales, there are still grey areas that must be assessed. A good example for this is 3D printing, where the final product is produced at the buyer's premises, even though the design can be made in any other place. In this case, deciding in which country the value creation took place that is to be taxed is complex. For 3D printing products, its value-added tax derives from its intellectual property (IP) rather than from its production costs. An obvious question arises: who owns this IP? However, once the 3D IP is owned and authorised for local

5: OECD. (2003), *OECD Guidelines for Protecting Consumers from Fraudulent and Deceptive Commercial Practices across Borders*, OECD Publishing, Paris.
DOI: http://dx.doi.org/10.1787/9789264103573-en-fr

use, an income might arise from that use that must also be taxed. The current VAT system is based on the notion that full value is delivered to the consumer, which is how it is taxed today. Capturing the full value of a 3D sale could be more challenging, as the product purchased becomes more intangible than tangible.

In conclusion, the digital economy is currently developing and further challenges related to it will surely arise. In this environment, regulators will have to find solutions to ensure a proper tax collection system, while promoting new business models and increased competition.

DISCLAIMER

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