Virtual compliance

International Tax

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Bill Dodwell looks at the dilemma faced by the new EU digital taskforce in discerning digital services compliance in a global marketplace

One of the current hot topics is the taxation of digital services. This has been the subject of detailed consideration by the European Commission and by the digital task force established as part of the G20/OECD BEPS project.

In the end, neither the EU group nor the task force was minded to recommend a separate tax system for digital activities. They also noted that for most businesses digital is embedded in the business model as a whole.

It is easy to see that ordering goods online is simply the modern equivalent of catalogue shopping. For some businesses the online ordering system serves multiple

countries, but in all cases the business requires access to warehouses full of goods and a logistics system to deliver to customers. A similar approach applies to, say, flight bookings, which can be made online or through a smartphone app rather a phone call or a visit to a travel agent as would have been the case 20 or 30 years ago. Yet the service – the flight – remains the same.

Ever since corporate tax (or income tax on companies) was invented, it has been based on the activity that takes place in a particular country. ‘Activity’ means looking at what the company does based on its people, property and equipment. Today, despite the advancement and reach of machines, the ultimate designer and controlling mind remains human.

The activity-based system has always made sense because the tax authority can visit the business to see what takes place there. As the BEPS project has noted, it was also based on the assumption that none of the activities escaped taxation.

What BEPS does – and the UK’s diverted profits tax encourages before it is fully in place – is driven by the recognition that profits need to be aligned with the value-added activities in each country. Legal points, such as legal ownership of assets or the place where the contract is made, will no longer be relevant to where the profits or losses should be recorded. BEPS is already starting to be implemented through adoption of new approaches to transfer pricing. Some of the changes will require modifications to double tax treaties and will not be implemented before 2017 (or later, depending on individual countries).

Interestingly, the first post-BEPS treaty has just been signed between Australia and Germany and awaits ratification. The UK is in the vanguard of domestic law implementation and, no doubt, will ratify the multilateral instrument once drafted.

The question of digital services remains open, though. Of course, any digital service provider has physical presence. Many need to develop technology and some will own substantial datacentres. Yet even the biggest providers can deliver their services around the world from a limited number of physical locations. The picture becomes even more complex when the providers use the infrastructure of others – and deliver their service from machines remotely managed from another country.

The revenue models of some of these new businesses may also be different. Many services – from email to music to search – are distributed free. In some cases, advertising finances them; in other cases, gathering data may provide something of

value to the provider.

The approach from the G20, OECD and the EU has been to apply the existing rules to these new businesses. The changes to the permanent establishment rules and transfer pricing for intellectual property will have an impact on some types of digital services. It is clear, for example, that it will no longer be possible to receive substantial income in a country simply because of legal ownership.

The new approaches to transfer pricing will seek to attribute that income to the people-based activities. The changes to the taxable presence rules (permanent establishment) will render irrelevant the place of contract – which might be a simple mouse click – if there is substantial marketing activity involving physical presence in another country.

However, these changes will not affect all providers of digital services – and it will continue to be possible to locate physical activities in a small number of countries with low tax rates. It is part of the global philosophy that sovereign countries should be able to compete (fairly) for activities.

Perhaps the reasons why some countries have not been able to agree on a separate regime are:

- Purely digital activities are a small part of global trade and all have a physical component that is taxed somewhere.
- The digital market is developing fast and there is no desire to choke off development, which is of broader economic benefit than corporate taxation. Many digital companies are small or are making low profits or even losses.
- There are no agreed methods of assessing and allocating value (France has explored a variety of ideas but has yet to find anything suitable).
- Countries with substantial activities in technology, such as, but not limited to, the US, are most unlikely to give up existing income streams for others to tax.
- There is currently no realistic possibility of conducting compliance activities.

The G20/OECD digital taskforce will continue to work on the area until 2020 and it is possible that new proposals could emerge. It is, however, unrealistic for individual countries to ‘go it alone’ due to the significant interactions (and binding legal treaties) with other countries.