Digitalization of the Economy

- Setting the Scene from a Tax Perspective

- London, 26 September

Defining the Digital Economy

From “the digital economy” to the “digitalization of the economy”

Characteristics of digital business models and digital enterprises

- Significant investments and the need for scalability
- Cross-jurisdictional scale-without-mass (heavily involved in economic life without significant presence)
- Reliance on intangibles (software and algorithms)
- Reliance on data, user participation and network effects (i.e. decisions by users may have a direct impact on the benefit received by other users)
- No consensus on the contribution to value creation

Defining the Digital Economy

Examples of ”higly digitalized businesses”

- Online retailer model (Amazon, Zalando, Alibaba)
- Social media model (Facebook, Xing)
- Subscription model (Netflix, Spotify)
- Collaborate platform model (AirBnb, Uber)

Digitalization goes far beyond……

- Cloud computing
- 3D-printing
- Blockchain technology, crypto currencies, ICOs
- Web-sales
- Virtual organizations
- Etc.

Tax Challenges

Digitalization may impact all parts of the economy

The rise of the internet tests many traditional tax principles

- Tax legislation continues to focus primarily on the physical world and has yet to address many of the challenges posed by this new world

Relevant topics

- Sufficiency and application of current tax rules with respect to nexus?
- Data (valuation, nexus, profit allocation and qualification)
- Qualification of income related to digital business models
- Does the digitalization increase the risk of BEPS?

Tax Challenges

Well known example: Google

- Business model: Internet advertisement and service provider
- Local Google entities provide support services to the local market, e.g. technical support, administration, promotion, marketing
- Customers conclude contracts with Google Ireland (subsidiary of Google US)
- Local Google entities do not constitute agent PEs and are remunerated based on a cost-plus service fee
- Challenged – without success – by several countries inter alia France (Paris Administrative Tribunal 12 July 2017)
- BEPS 7 (MLI Art. 12): Expanding the definition of an agent PE to also include activities leading to the conclusion of contracts
- Questionable whether the changes affects the Google model

Tax Challenges

The OECD, the EU MSs and a number of other countries agree that there is a problem!

- Well, is there?
- And if so: is there a burning platform......?

What is the impact of OECD's BEPS project and the US tax reforms and when can these effects be measured?

Tax implications of the Digitalization of the Economy

London, 27 September

CORIT ADVISORY©
INDEPENDENT TAX CONSULTING

Agenda

1. Overview of tax issues raised by the digitalization of the economy
2. International reform proposals – OECD, EU and unilateral measures
3. Impact for the tax advisor and MNEs?

Tax Challenges

Overall challenge

- Digitalization may impact all parts of the economy
- The rise of the internet tests many traditional tax principles
- Tax legislation continue to focus primarily on the physical world and have yet to address many of the challenges posed by this new world

Concrete topics to consider

- Sufficiency and application of current tax rules with respect to nexus?
- Data (valuation, nexus, profit allocation and qualification)
- Qualification of income related to digital business models
- Does the digitalization increase the risk of BEPS?
- Impact on automation and AI on the workforce
- Impact of 3D printing and augmented reality on value chains
- Real time tax compliance through big data and analytics
- Impact of online platforms on the changing taxable status of economics actors – standard labor contracts to self employed (OECD report 2019)

International Reform Proposals

OECD activities

- BEPS # 1 highlights possible solutions - without recommendations:
  - Significant Economic Presence: SEP PE, Virtual PE, Digital PE etc.
  - Withholding tax on digital transactions
  - Equalization levy

- Comprehensive draft OECD report March 2018
  - Main conclusion:
    - *"These issues raise very complex technical questions, and there are also different views among the more than 110 members of the Inclusive Framework on the question of whether and to what extent these features of highly digitalized business models and digitalization more generally should result in changes to the international tax rules."*

  - Next step?

International Reform Proposals

OECD activities (continued)

- Implementation and impact of the BEPS package
  - Preventing the artificial avoidance of PE (Action 7)
  - Transfer pricing in line with value creation (Actions 8-10)
  - Strengthen CFC rules – include sales income generated from the use of underlying IP (embedded royalties)
  - Early indications
    - Digitalized MNEs have started changing their trade structures based on remote sales models to local resellers
    - Shift from remuneration based on cost to remuneration based on sales
    - Conclusion of contracts through local distribution activity
    - …… will not solve the broader challenges…..

International Reform Proposals

EU activities

- Talinn Summit sept. 2017: COM(2017)547 final
  - *”The underlying principle for corporate tax is that profits should be taxed where value is created. However, in a digitalized world, it is not always very clear what the value is, how to measure it, or where it is created?”, p. 7.*
- Two key tax policy challenges are identified:
  - Where to tax? (nexus)
  - What to tax? (value creation)
- The Digital Tax Package presented 21 March 2018
  - The comprehensive solution
    - Recommendation
    - Directive proposal on Significant Digital Presence
  - The interim solution
    - Directive proposal on Digital Services Tax

CORIT ADVISORY© INDEPENDENT TAX CONSULTING

Significant Digital Presence PE

- Applies to entities within the EU or elsewhere
  - Exemption: Entities resident in third country treaty states
    - Unless the tax treaty contains similar concepts
- A PE shall be taken to exist if a significant digital presence exists through which a business is wholly or partly carried on
- Definition of “significant digital presence”
  - If the business carried on through it consists wholly of partly of the supply of digital services through a digital interface
  - One or more of the following conditions are met:
    - Revenues in MS exceeds EUR 7M
    - Number of users in MS exceeds 100,000
    - Number of business contracts for the supply of any such digital service in that tax period exceeds 3,000

Significant Digital Presence PE

- Allocation of profits to a SDPPE
  - Based on functional analysis (functions, risks and assets)
  - Take into account economically significant activities performed by such presence through a digital interface
  - Due account shall be taken of the economically significant activities performed which are relevant to development, enhancement, maintenance, protection and exploitation (DEMPE) of the enterprise's IP
  - Profit split shall be used (splitting factors mentioned)

What to tax?

The attribution of profit will take into account the market values of:

- **Profits from user data**
  (e.g. placement of advertising)
- **Services connecting users**
  (e.g. online marketplace, platforms for "sharing economy")
- **Other digital services**
  (e.g. subscription to streaming services)

The Digital Services Tax

Targeted solution

- Directive on levy on digital revenue (Digital Services Tax)
- ”Interim measure”?
- ”Revenues”:
  - Services supplied for consideration consisting in:
    - Advertisement space targeted users of interface
    - Services supplied for consideration consisting in making available of digital platforms/marketplaces to users (intermediation services) – (Airbnb, Uber)
    - The valorization of user data or sale of user data (aiming at Facebook, Google AdWords, Twitter, Instagram, ”free” Spotify)
  - Outside the scope: supply of digital content/solutions for customers
    - Media, streaming, online gaming, IT solutions, cloud services and fintech

The Digital Services Tax

Targeted solution (continued)

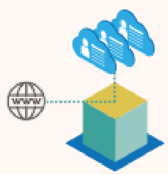
- Conditions:
  - Supply of digital services
  - Exceeding the following threshold:
    - Global revenue exceeding 750 mEUR
    - Annual revenue from the supply of digital services exceeding 50 mEUR within the EU by entity
- Cross border and domestically
- Taxation where user value is created
  - Advertisement = where the advertisement is shown, i.e. ”where the eyeballs are”
  - Digital platforms = where device is used and contract concluded and as backup account opened with device in MS
  - Data: where data is generated (use of device)
- Rate: 3% - deductible in CIT

Political status?

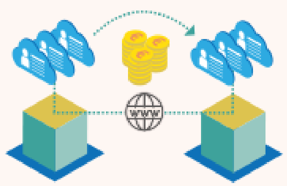
CORIT ADVISORY©
INDEPENDENT TAX CONSULTING

The Digital Services Tax

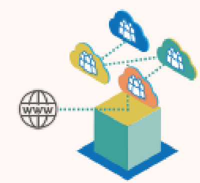
An interim tax of 3% on revenues made from three main types of services, where the main value is created through user participation.



Online placement of advertising



Sale of collected user data



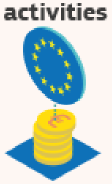
Digital platforms that facilitate interactions between users

... and provided by businesses with:

Total annual worldwide revenue above

750 M€

Total annual revenue from digital activities in the EU above



50 M€

CORIT ADVISORY©
INDEPENDENT TAX CONSULTING

Unilateral Measures

Alternative application of PE threshold	• India (SEP), Israel (SEP), Slovak Republic (expanded definition of fixed place of business for certain digital platforms), Austria, Indonesia, Thailand, Turkey • Service PE (disputed) – Saudi Arabia and India
Withholding taxes	• Proposals in UK, Thailand
Turnover taxes	• India: Equalization levy (6% on payments to foreign entities for advertisement services) • Italian web tax (3% on intangible digital products) • Hungary: Advertisement tax • France: tax on online and physical distribution of audio-visual content
Specific regimes targeting large MNEs	• UK Diverted Profits Tax (DPT) • Australian: Multijurisdictional Anti Avoidance Law (MAAL) • US: Base Erosion and anti-abuse tax (BEAT) • Proposed in New Zealand

- 11 EU MSs have planned unilateral measures
- Impact of such uncoordinated initiatives?

Takeaways for Tax Advisors

Impact on MNEs – moving target – but the tendency is clear!

- Tax legislation continue to focus primarily on the physical world and have yet to address many of the challenges posed by this new world

Advisors should follow the development and acknowledge that this will not only affect tech giants

Understand potential risks

- The risk of double taxation is obvious – most predominantly in light of uncoordinated unilateral measures
- Nightmare of complexity - compliance
- Data is becoming increasingly important: Preparing for taxation based on value creation with focus on the collection and processing of data
- Preparing for several PEs and allocation challenges
- Impact from more integrated value chains - more complex TP issues
- Qualification of payments from digital business models

ORIT ADVISORY©
INDEPENDENT TAX CONSULTING

Outro on Value Creation

Taxation and value creation

- Is there a difference between value creation in digital business models and other business models?
- Market value:
  - Is value created by consumption compared to R&D, innovation and production?
    - Tax policy – at least *not* in line with the previous perception of value creation
    - Isn't consumption taxed through the VAT-system?

- Data:
  - Does the collection of data create value?
  - Does value come from human innovation (significant people functions) or "data mining"?
  - Value is created when data is collected systematically, analyzed and used to incentivize user activity:
    - Which data is collected?
    - Systems for the collection and storage of data
    - Development of analytic tools
    - Use of analytic results to take business decisions, which creates value

JAKOB BUNDGAARD

MANAGING DIRECTOR
HONORARY PROFESSOR, M.SC., PH.D.

CORIT ADVISORY P/S
LYNGBY HOVEDGADE 17, 2. SAL
2800 KONGENS LYNGBY
DENMARK

WWW.CORIT-ADVISORY.COM

P: +45 40 42 22 84
E: JB@CORIT.DK