BEPS AND DIGITAL ECONOMY

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INTRODUCTION TO BEPS

WHAT IS BEPS?

- "Base Erosion and Profit Shifting ('BEPS') refers to tax planning strategies that exploit gaps and mismatches in tax rules to make profits "disappear" for tax purposes or shift profits to locations where there is little or no real activity but the tax rates are low, resulting in little or no overall corporate tax being paid" – OECD FAQs

- Base Erosion refers to the reduction of companies that can be taxed and the amount of profits that a country can tax
  - Achieved by means of shifting residence to different country or causing profits to arise in different country (by transfer of intellectual property, etc.)

- Profit Shifting refers to aggressive tax planning strategies focused on shifting profits out of high tax country to lower tax country

BEPS strategies may not necessarily be illegal
Increased globalisation enables companies to exploit gaps arising on interaction of domestic tax systems and treaty rules within the boundary of acceptable planning

KEY MILESTONES

2008	BEPS project launched. Goal was revising the international tax framework to align it with developments in the global economy and ensure profits are taxed where economic activities are carried out and value is created
2013	Report titled "Addressing Base Erosion and Profit Shifting". OECD/G20 members adopted a 15 point Action Plan to address problems of BEPS
2015	Final reports were released on each of the 15 Action Plans ('BEPS Action Report'), after receiving inputs / comments on the draft reports published for public comments
2016	Basis Action Plan 15, in November 2016 the Multilateral Instrument (MLI) was released, a multilateral treaty, as a coordinated approach with consensual framework to tackle base erosion
2017	68 countries signed the MLI providing their provisional positions and adhering to minimum standards

Application of BEPS and MLI?

MLI will not replace the existing treaties completely instead will apply alongside existing treaties – supplementing the application to bring it in line with the measures set out in BEPS Action Reports.

What's In The BEPS Package?

BEPS Action Plans

Coherence

- Hybrid Mismatch Arrangements (2)
- Interest Deductions (4)
- CFC Rules (3)
- Harmful Tax Practices (5)

Substance

- Preventing Tax Treaty Abuse (6)
- Avoidance of PE Status (7)
- TP Aspects of Intangibles (8)
- TP/Risk and Capital (9)
- TP/High Risk Transactions (10)

Transparency

- Methodologies and Data Analysis (11)
- Disclosure Rules (12)
- TP Documentation (13)
- Dispute Resolution (14)

- Digital Economy (1)
- Multilateral Instrument (15)

Work Under BEPS On Digital Economy

- Public Discussion Draft – BEPS Action 1: Address the tax challenges of the digital economy *(March 2014 – April 2014)*
- Action 1: 2014 Deliverable – Addressing the Tax Challenges of the Digital Economy *(September 2014)*
- Public Discussion Draft - BEPS Action 7: Preventing the Artificial Avoidance of PE status *(October 2014 – January 2015)*
- Discussion Draft for Public Consultation – International VAT/GST Guidelines *(December 2014 – February 2015)*
- Revised Discussion Draft – BEPS Action 7: Preventing the Artificial Avoidance of PE status *(May 15, 2015 to June 12, 2015)*
- Final report – BEPS Action 7: Preventing the Artificial Avoidance of PE status *(October 5, 2015)*
- Final Report – International VAT/GST Guidelines *(April 12, 2017)*
- Mechanisms for effective collection of VAT/GST to support final implementation of International VAT/GST Guidelines *(October 24, 2017)*
- Launch of Tax Challenges Arising from Digitalization – Interim Report 2018, *(March 16, 2018)*

Introduction To Digital Economy

FEATURES

MOBILITY OF USERS

Customers may use services remotely while travelling across borders. For example, an individual can reside in one country, purchase an application while staying in a second country, and use the application from a third country

MOBILITY OF INTANGIBLES

Easy to shift legal ownership between associated enterprises – not necessarily to entity which developed the intangible

MOBILITY OF BUSINESS FUNCTION

No need for location in place of operations or place of customers – global operations can be managed on an integrated basis at a central location

RELIANCE ON DATA

Collection of massive amount of data is now possible – leads to improvement in product and services. For example, by recording internet browsing preferences, location data etc.

NETWORK EFFECTS

Decisions of users may have a direct impact on the benefit received by other users. For example, when additional people join a social network, the welfare of the existing users is increased, even though there is no explicit agreement for compensation between users

MULTI SIDED BUSINESS MODELS

Where various persons interact through an intermediary and the decision of each person affects the outcome for the other. For example, a card payment system will be more valuable to customers if more merchants accept the card.

Reliance on Data & User Participation – Value Attribution

- Huge amount of data is collected from users – this collection may be volunteered, observed or inferred
- Data collection helps in improvising service offering and serves as an input to the business – thus contributing to the overall value of the enterprise
- While all businesses collect data, digital technology has greatly increased the ability to leverage and monetize this
- In fact in social networking focused business models, for instance, companies frequently report that the active collaboration with users is a key value-driver for their business

Whether collection of data from users located in a jurisdiction should give rise to nexus?

If so, how should income generated from use of such data be attributed to that nexus?

Prominent Examples Of Digital Economy Models

Online Retailers/ Marketplace	• (e.g. Flipkart/ OLX/ UrbanClap)
Online broking services	• (For sale and purchase of homes, cars, etc.)
Online digital products/ services	• (e.g. Spotify, Netflix, Amazon's Cloud Computing, online education)
Online Advertising	• (e.g. via Facebook, YouTube, Instagram)
Online Aggregators	• (e.g. Airbnb, Zomato, Uber, Trivago)

Sectors Significantly Impacted By Information, Communication & Technology

- Retail
- Transport & Logistics
- Financial Services
- Manufacturing & Agriculture
- Education
- Healthcare
- Broadcasting & Media

Now, every sphere of life has effect of digitalisation

Information, Communication & Technology has also given rise to number of new Business models

Typical Digital Economy Business Models

- Business to Business (B2B)
- Business to Customer (B2C)
- Consumer to Consumer (C2C)
- Online payment service providers
- App Stores
- Online Advertising
- Cloud Computing
  - Infrastructure as a Service (IaaS)
  - Platform as a Service (PaaS)
  - Software as a Service (SaaS)
  - Content as a Service (CaaS)
  - Data as a Service (DaaS)
- High Frequency Trading
- Participative Networked Platforms

Typical Revenue Models of Digital Economy

- Advertisement based revenue (e.g. YouTube)
- Purchase/ Sale of Digital content on rental basis
- Selling of goods (digital products or tangible goods)
- Subscription based revenue
- Selling of services
- Licensing content and Technology
- Selling of User data and Customised Market Research
- “Hidden” fees and Loss Leaders

Key Tax Concerns in Digital Economy

Characterization of e-goods (such as e-books /e-videos) – whether "goods" or "services"?

Application of related source rules and how to ensure effective collection of VAT / GST for cross-border supply of goods and services

Ability to have significant digital presence in another country without liable to tax due to lack of nexus under current international tax rules.

Eg, store is replaced by website, remote interactions with customers are now possible, people are replaced by software. Current nexus rules do not address this.

Why the tax concerns?

Attribution of value created from the generation of marketable location - relevant data through the use of digital products and services

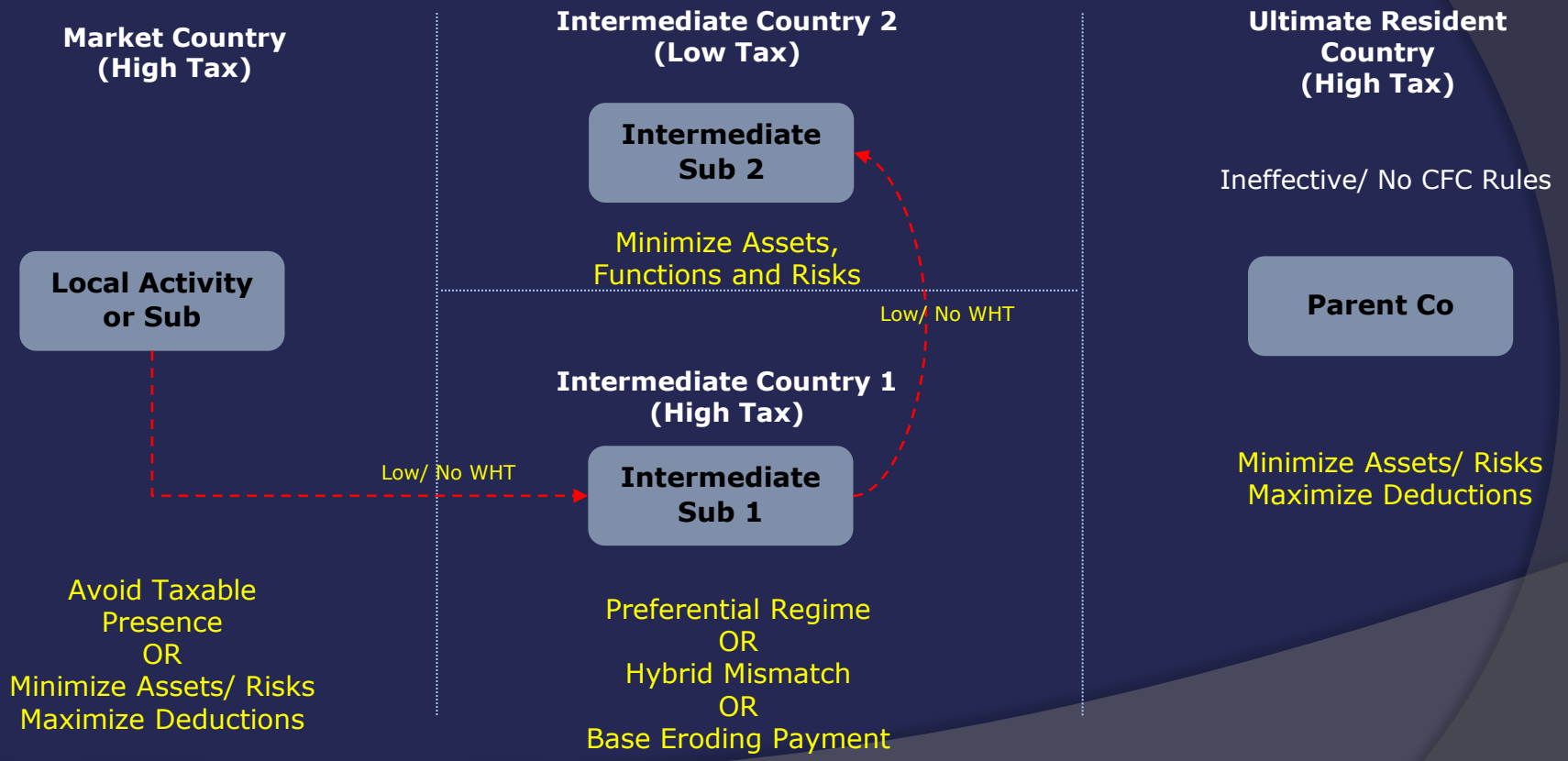
Characterisation of income derived from new business models – whether royalty / FTS / FIS

BEPS In The Context Of Direct Tax

Elements of Co-ordinated Strategies Associated With BEPS

- Minimisation of taxation in the market country by avoiding a taxable presence
- In case of taxable presence, shifting gross profits via trading structures or by reducing net profit by maximising deductions at the level of the payer
- Low or no withholding tax at source
- Low or no taxation at the level of the recipient (achieved via low-tax jurisdictions, preferential regimes, or hybrid mismatch arrangements) with entitlement to substantial non-routine profits often built-up via intra-group arrangements
- No current taxation of the low-tax profits at the level of the ultimate parent

Tax Planning Illustration (Adopted From BEPS Report)



CONCERNS

Eliminating/ reducing tax in the market country

- Not creating taxable presence (this possibility is highest in digital economy)
- Creating fragmented presence so as to not create a PE or avoid PE threshold

Minimising income allocable to functions, assets and risks in market jurisdictions

- Contractually creating a FAR in market country entity which is inconsistent with actual conduct and is merely guided by tax considerations

Maximising deductions in market jurisdictions

- Shifting the profits to low tax jurisdictions in the form of royalty, interest or any such other deduction

Avoidance of withholding tax in market country

- Doing treaty shopping to take advantage of favourable tax treaty

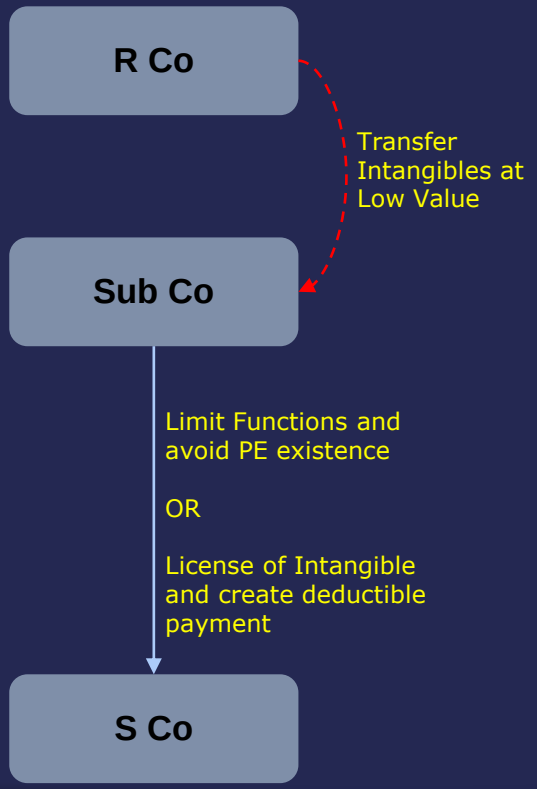
Eliminating or reducing tax in intermediary jurisdictions

- Contractually allocating more FAR to low tax countries
- Availing preferential tax regimes
- Maximising deductions by claiming management fees or head office expenses

Eliminating or reducing tax in the ultimate parent's country

- By artificially/ contractually stripping it off of FAR, inconsistent with actual conduct of activities

Tax Planning Illustration (Adopted From BEPS Report)



Reduction of Tax in R Co Jurisdiction

- The IP is sold to an affiliate in a low tax jurisdiction – at the time of transfer this IP is undervalued
- However, it is also claimed that Sub Co is entitled to have large portion of MNE's income allocated to it on the basis of legal ownership of the undervalued IP, as well as on the basis of the risks assumed and the financing it provides
- In most cases, R Co performs work related to development of IP, and Sub Co has minimal or no employees. However, operations of R Co are contractually stripped of risk
- CFC rules in R jurisdiction also prove to be ineffective

Reduction of tax in S Co Jurisdiction

- S Co's activities are curtailed – marketing, technical support, no authority to conclude contracts. This ensures that Sub Co does not create a taxable presence in S jurisdiction. Only minimum compensation paid to S Co is taxed in S jurisdiction
- Alternatively, S Co could receive a license to the IP and perform substantive functions for itself, though its taxable profits would substantially be offset by the royalty expenditure that S Co pays to Sub Co for using the high-value IP

Work Done Under BEPS Project

Points To Note Under Action Plan 1

- **Ring-fencing not desirable**
  - Digital economy is increasingly becoming the economy itself
  - Special tax rules would require drawing of arbitrary lines

- **Recognizes importance of digital data and challenges in attributing value**
  - Appropriate allocation of taxable income amongst locations in which economic activities take place and value is created may not always be clear in the digital economy, particularly in cases where users and customers become an important component of the value chain

- **Impact of overall BEPS project**
  - Other actions are expected to result in substantial changes to existing international tax rules – issues of stateless income and artificial avoidance should get addressed
  - Application of considered options for digital economy may thus be premature at this stage

Options Provided By Action Plan 1

Significant economic presence

- Enterprises in fully dematerialized digital activities shall be **deemed to have a taxable presence** if maintains significant digital presence
  - significant number of contracts for provision of digital products remotely signed;
  - Digital products are widely used or consumed in the country;
  - Substantial payments are received as part of enterprise's core business;
  - Existing branch in country offering secondary functions (marketing, consulting) are strongly related to the core business of the enterprise
- Nexus based on **consumption activity rather than value generation activity**
- Radical departure from long standing principles
- If adopted, it may lead to ring-fencing of digital economy?

Equalization levy

- Levy on **transactions concluded with in-country customers.** Applicable only where business **maintains significant business presence**
- Feasible only where **no / low tax in home jurisdiction** or **availability of credit against corporate tax**

Withholding tax

- **Withholding tax** on gross basis in case of certain payments made for digital goods or services provided by foreign e-commerce provider
- **Obligation upon intermediary financial institutions** that process these payments

Conclusions Based On Options Recommended

- None of the options analysed were recommended at that stage
- Expected that measures developed in the BEPS Project will have a substantial impact on BEPS issues previously identified in digital economy
- Certain BEPS measures will mitigate some aspects of broader tax challenges
- Consumption taxes will be levied effectively in the market country
- Countries could, however, introduce any of the options in their domestic laws as additional safeguards against BEPS, provided they respect existing treaty obligations

Recommendations Under Other Action Plans That Apply To Digital Economy

Preparatory or Auxiliary Exemption (Action Plan 7)

- Each of the exceptions to satisfy 'preparatory or auxiliary' criteria
- Anti-fragmentation rule
- Example: Local warehouses – to be considered

Dependent agent PE (Action Plan 7)

- PE constituted if local person plays a principal role in conclusion of contracts and these contracts are routinely concluded without material modification
- Entities having standard online contracts with customers – to be considered

Anti-abuse Rule (Action Plan 6)

The anti-abuse rule in the form of principal purpose test will tackle abuse of tax treaties and treaty shopping arrangements.

Transfer pricing rules (Action Plan 8-10)

Appropriate allocation of profits – not based on legal ownership but performance of important functions and contribution of important assets

CFC rules (Action Plan 3)

- Definition of CFC income to include income from Digital economy
- Income from Digital economy to be taxable in ultimate home jurisdiction

These options have no binding effect on the countries and more work is expected regarding Digital economy and profit attribution.

INDIAN TAXATION REGIME

Equalisation Levy

- Insertion of Chapter VIII in Finance Act, 2016 on Equalisation Levy, on specified services provided on or after 01.06.2016

- Equalisation Levy of 6% of the amount of consideration for specified services received or receivable by a non-resident not having PE in India from a resident in India who carries out business or profession, or from non-resident having PE in India

- Specified services include:
  - Online advertisement
  - Any provision for digital advertising space or any other facility or service for the purpose of online advertisement
  - Any other service as may be notified by the Central Government

Significant Economic Presence

- Recently, through Finance Act 2018, India has introduced the concept of 'Significant Economic Presence' (SEP) under 'business connection'

- Expands the definition of nexus for business income in India, to include:
  - Transaction in respect of any goods, services, or property carried out by a non-resident in India, including the provision of download of data or software in India, if the aggregate of payments arising from such transactions during the previous year exceeds the prescribed threshold; **or**
  - Systematic and continuous soliciting of its business activities or engaging in interaction with such number of users as may be prescribed in India, through digital means

- Above mentioned criteria would constitute SEP of an enterprise in India, whether or not the non-resident has a residence or a place of business in India or renders services in India

- Transactions or activities shall constitute SEP in India whether or not the agreement for such transactions or activities is entered into in India

Significant Economic Presence

- There however, may not be any immediate impact in case of non-residents wherein India has executed DTAA
- Existing PE rules in DTAAs will continue to apply till the DTAA is renegotiated since restrictive PE definition in DTAA would override the definition of 'business connection'
- SEP will thus, have an impact on situations which are not covered by DTAAs

OECD's Interim Report 2018 On Tax Challenges Arising From Digitalisation

Critical Features in Highly Digitalized Business Models

- Interim Report 2018 highlights critical features which have significant impact on taxing rights and profit allocation
  - Cross-jurisdictional scale without mass, which is the ability of business to be deeply involved in the economic life of a country/ jurisdiction without having significant physical presence
  - Heavy reliance on intangible assets including Intellectual Property (IP), which are central to such business models
  - The role of data and user participation including network effects and their synergies with IP

- Countries have different views on, as to, whether and to what extent these features contribute to value creation by enterprises

Views of Members of Inclusive Framework

- Countries forming part of the Inclusive Framework have different views on data and user participation being the basis of contributing to an enterprise's value creation. Members can fall into three broad groups:
  - Those that see no need to change the existing system
  - Those that believe there are pressures on the existing international tax standards because of the unique features of digital economy and seek change; and
  - Countries such as USA that are open to discussing improvements to international tax rules, but only if the discussion is not limited to taxation of digital firms

- Member countries have however agreed to undertake a coherent and concurrent view of the 'nexus' and 'profit allocation' rule to seek a consensus-based solution by 2020

Global Tax Policy Developments

Tax Policy Developments To Address Challenges of Digital Economy

- **Italy** – introduced a web tax @ 3% starting January 1, 2019, on certain internet transactions with certain modifications to the concept of PE

- **United Kingdom** – published four papers concerning the taxation of the digital economy regarding evidence on the role of online platforms in the collection of tax, on VAT split payment mechanisms and an update paper on Government's current thinking around new rules for taxation of digital economy

- **Singapore** – proposing a GST on certain imported digital services

- **New Zealand** – From October 1 2016, GST at 15% applies to cross-border remote services and intangibles supplied by non-resident suppliers to New Zealand resident consumers

- **France** – From January 1, 2019 France will introduce a "GAFA" tax which is expected to bring in an estimated 500 million euro

Tax Policy Developments To Address Challenges of Digital Economy

- **Russia** – Effective from 1 January 2019, the application of the reverse charge mechanism in relation to companies and individual entrepreneurs receiving digital services from foreign suppliers will be abolished. Foreign suppliers of digital services will be liable to register with the tax authorities and pay VAT when providing services to individuals as well as to companies and individual entrepreneurs. At the same time, companies and individual entrepreneurs receiving digital services from foreign suppliers will be able to deduct input VAT, previously paid by foreign suppliers.

- **Australia** – From July 1, 2017 GST at 10% made applicable on supply of digital services. Introduced "Multinational Anti-Avoidance Law" in lines with UK's 'Diverted Profits Tax' to tax transactions that make sales in Australia but book that revenue offshore and CbCR reporting.

- **Japan** - Japan's 'consumption tax' levied at 8% on digital services provided by foreign electronic service providers on RCM basis. Japan Court considers E-commerce activities to constitute PE and endorsing BEPS Action Plan 7

Tax Policy Developments To Address Challenges of Digital Economy

- **European Union** – put forth two proposals to ensure that digital business activity are taxed in a fair way in EU
  - First proposal aims to reform corporate tax rules so that profits are registered and taxed where businesses have significant interaction with users through digital channels
  - Second proposal is an interim tax on certain revenues from digital activities

However, it is pertinent to note that Ireland, Netherlands, and Luxembourg among others, have expressed strong reservations over new plans by the European Commission to tax digital companies

Concluding Remarks

Concluding Remarks

- Way of doing business is evolving at an extremely fast pace
- Taxation rules/ laws should keep pace with the developments rather than play catch up
- In today's world, internet of things and artificial intelligence is becoming an integral part of our daily lives
- Interesting to see whether OECD would address the concern of taxing digital economy futuristically in its final report expected to be released in 2020


ANY
QUESTIONS
?

THANK YOU

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