ACCA

The digital economy: OECD's consultation on tax challenges

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This briefing paper reviews the OECD's March 2014 consultation to address the tax challenges of the digital economy.

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FOR MORE INFORMATION CONTACT

Chas Roy-Chowdhury
Head of Tax, ACCA
chas.roy-chowdhury@accaglobal.com

INTRODUCTION

Surprising as it is, tax has become a subject of popular debate – discussed by politicians and members of the public alike. It isn't only accountants who have an opinion to express, but also those without technical tax knowledge.

The UK seems to be at the epicentre of the debate and discussion. Many of the country's politicians appear to have made it their mission in life to talk about tax, even if their views are based on limited understanding of the subject. For example, one parliamentary committee, The Public Accounts Committee (PAC), has grilled big businesses such as Amazon, Google and Starbucks more than once about their tax affairs.

Various newspapers have also been keen to expose the rich and famous who may have sought to shelter their income from high rates of tax through the use of tax planning vehicles.[1] This has created a climate where everyone has their personal opinion on tax – how it should be charged and what might be a fair amount for individuals and corporations to be paying.

One such debate, which led to the Organisation for Economic Co-operation and Development's (OECD's) Base Erosion and Profit Shifting (BEPS) project,[2] was motivated by a letter to the *Financial Times* (FT) by the UK, German and French finance ministers.[3][4] The three ministers promised to take the lead in bringing the global tax rules into the twenty-first century for companies and tax jurisdictions, working through the OECD to achieve this. As highlighted in a responding letter in the FT by ACCA, it was not clear that the proposals would lead to more than merely a shuffling of the deckchairs among the highly developed economies[5]. Achieving substantial change will be elusive if no advanced economy is willing to give up a part of their tax take to one of the BRICs or any other less developed country.

Nevertheless, the OECD accepted the gauntlet and published its *Action Plan on Base Erosion and Profit Shifting* in the middle of 2013. In its 15-action plan, Action 1 is 'Address the tax challenges of the digital economy', with a deadline of September 2014.

1. http://www.independent.co.uk/news/uk/home-news/celebrities-hid-340m-in-icebreaker-tax-avoidance-scheme-used-by-gary-barlow-9367454.html

2. OECD (2013), Action Plan on Base Erosion and Profit Shifting, OECD Publishing. http://dx.doi.org/10.1787/9789264202719-en

3. http://www.ft.com/cms/s/0/5d2d8646-7793-11e2-b95a-00144feabdc0.html#axzz32XmzamYr

4. http://www.ft.com/cms/s/0/6b12990e-76bc-11e2-ac91-00144feabdc0.html?siteedition=uk#axzz32XmzamYr

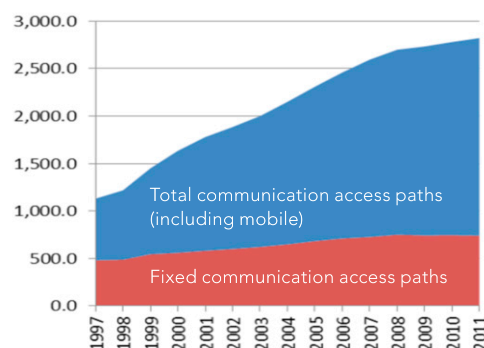
5. http://www.ft.com/cms/s/0/6ca4ceac-79e3-11e2-b377-00144feabdc0.html#axzz32XmzamYr

THE OECD CONSULTATION

On 24 March 2014 the OECD published its consultation document, *Public Discussion Draft, BEPS 1: Address the Tax Challenges of the Digital Economy.*[6] Its response deadline was tight, with comments being required by 14 April 2014.

The document provided an overview of how the digital economy has developed over time, and the situation in the here and now. It illustrated in graphic form (see Figure 1) how internet connectivity has dramatically increased.

Figure 1: Fixed and mobile internet connectivity



Source: *Public Discussion Draft, BEPS Action 1: Address The Tax Challenges Of The Digital Economy*, OECD, 2014.

The consultation highlighted the original importance of fixed-line computers and telephones for enabling interaction with the digital economy. Today, however, Wi-Fi is widespread and made use of by numerous gadgets, such as tablets, smartphones, watches, glasses, televisions, smart meters, smart fridges and smart heating systems. Consumers can programme home entertainment systems to record pay-per-view or other internet-based content from anywhere in the world, and can download and upload from sites anywhere any time. With the development of cloud computing, geographical boundaries become almost meaningless when it comes to accessing data.

6. *Public Discussion Draft, BEPS Action 1: Address The Tax Challenges Of The Digital Economy, 24 March 2014 – 14 April 2014.* http://www.oecd.org/ctp/tax-challenges-digital-economy-discussion-draft-march-2014.pdf

According to the paper, Cisco has estimated that between 10 and 15 billion devices are currently connected to the internet – but that figure represents less than 1 percent of the total devices that could ultimately be connected.

A significant part of the paper considered whether the digital economy could be compartmentalised so that it could be treated differently for tax purposes. One of the biggest problems concerns how to monetarise some, let alone all, of the activity that takes place within it. This is particularly challenging given that some parts of the digital economy use their own currency in the form of bit coins, or sell hardware which incorporates software marketing systems on-board, such as Amazon with its Kindle tablets. Consumers pay less for a Kindle which runs advertisements.

The consultation document then looked at value added tax (VAT) – which could provide the panacea for the debate over whether tax should be based on source or residence. Quite significant amounts of source-country tax revenues can be secured by the operation of VAT. The biggest issue is to establish sufficient measures and systems to ensure that the VAT is charged and paid across to the source country.

In the preceding parts of the paper, there appears a tendency to consider mismatching – or rather jumbling up or rewriting – the familiar certainties in terms of source and residence taxation. When the paper focuses on VAT, however, there seems to be an understanding that VAT rates, especially those in the European Union (EU), provide for a higher tax take than Corporation Tax. For instance, the UK will have a Corporation Tax rate from April 2015 of 20%, while the VAT rate is also 20%. In addition income tax is payable on the salaries of employees.

Another common theme across the EU is that VAT tends to produce much more tax revenues than Corporation Tax. According to figures produced by the Office for National Statistics, in the UK VAT yields over double the amount of Corporation Tax. Figures issued in May 2014 show the VAT yield as 21% and the Corporation Tax yield as 8%.[7]

The EU has been moving relentlessly towards applying VAT in the source country. Therefore, the end consumer who is a private individual would usually be taxed in the source country. This has not always been the case in business to business (B2B) transactions. For instance, a conference organiser in one EU state organising a conference in another country for a business situated in that other country might not in the past have always had to pay VAT in the country where the conference is being held. By 2015, however, all such activities will almost certainly be taxable in the source country.

Many years ago the EU recognised that there was a real issue with pure digital sales, ie downloadable software, music, films, books and anything else of such a nature. In order to remedy the issue of non-EU based companies (usually based in the United States) not paying any VAT at all, rules were introduced requiring such companies to register in just one EU country for VAT. They then pay the VAT across to just that single tax administration at the rate which applies in that country.

While this will not capture all third-country suppliers, it probably does catch most.

The OECD also suggests some fairly common sense ideas, which would help stop leakage or avoidance of VAT:

- Police artificial exempt business structures with little or no VAT payable (the down side of such structures is no input tax recovery)
- consider abolition of exemptions from VAT for low value goods (in the UK, for example, the small consignment stock rules changed in 2012)
- Disregard convoluted supply chains designed to not pay VAT.

7. *KAI Data Policy and Coordination, HMRC Tax and NIC Receipts, Monthly and annual historical record*, HMRC, May 2014, page 3. https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/312439/20140514_Aprilreceiptsbulletin_SJ.pdf

ARTICLE 5 (BUSINESS PROFITS) AND ARTICLE 7 (PERMANENT ESTABLISHMENT)

For many stakeholders the greatest concern in this section of the BEPS project is around Article 5 and Article 7.

Starting with Article 5, most politicians and those who like to dabble in tax consider there must be something wrong in the way that profits are being calculated, or they query why profits are not taxable in a particular location.

The biggest error by such people is always around the calculation of profits. They try to equate turnover with taxable profits. But clearly jurisdictions cannot just tax as they wish or want: there must be rules and agreements around taxable profits, so broadly speaking this is an area that cannot easily be changed.

Article 7, however, is considered to be a different matter. There is a widespread perception that multinationals are able to choose to place their taxable profits anywhere and, in particular, where they will not be taxable. This perception specifically applies to multinationals operating in the digital economy. The consultation draft discussed whether some of the exclusions within paragraph 4 of Article 7 were providing cover for digital economy companies to escape tax; for instance, marketing activities and storage are excluded and do not currently constitute a permanent establishment (PE).

Figure 2 suggests there are questions to be asked. Ireland, with a population of 4.5 million, is the second biggest global player in IT service exports, following India with a population of 1.3 billion.

CONCLUSION

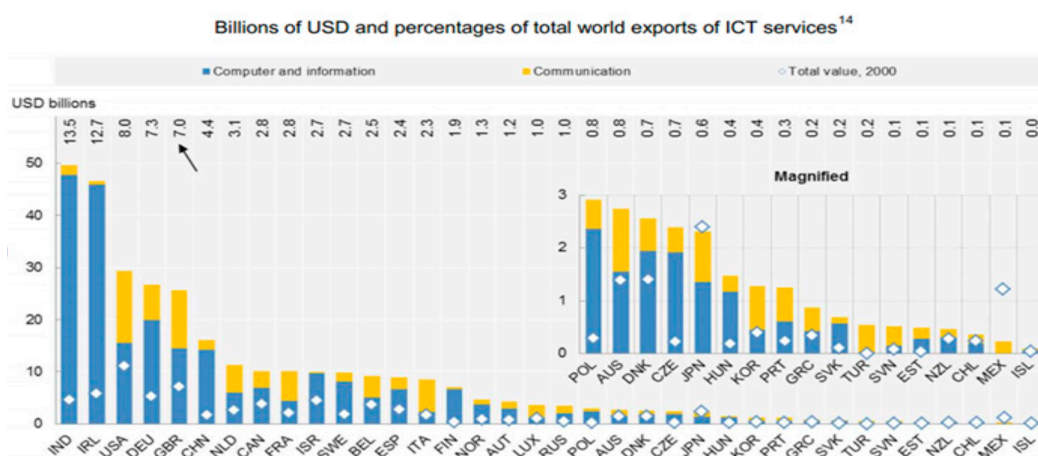
Broadly speaking the conclusions of the OECD paper were the same as those of the European Commission expert group looking at the digital economy,8 whose report was published on 28 May 2014. Neither document called for new or separate rules for the digital economy.

The OECD considered that there was some scope for looking further at the service nexus to see if that needed tweaking to create a permanent establishment in a jurisdiction more quickly. Otherwise the OECD digital economy working group outsourced much of the heavy lifting to the other areas already identified as requiring action, such as:

- prevent treaty abuse (Action 6)
- prevent the artificial avoidance of PE status (Action 7), and
- neutralise the effects of hybrid mismatch arrangements (Action 2).

It appears that work on the digital economy has to some extent been short circuited by the outsourcing of almost everything to the other work streams. This was, perhaps, always likely to be the outcome as it would be impossible to develop concrete, long-term answers by September 2014. It seems likely, therefore, that the digital work stream has effectively finished its deliberations.

Figure 2: OECD and major exporters of ICT services, 200 and 2012



Source: *Public Discussion Draft, BEPS Action 1: Address The Tax Challenges Of The Digital Economy*, OECD, 2014.

8. *Report of the Commission Expert Group on Taxation of the Digital Economy*, European Commission, May 2014. http://ec.europa.eu/taxation_customs/resources/documents/taxation/gen_info/good_governance_matters/digital/report_digital_economy.pdf

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ACCA 29 Lincoln's Inn Fields London WC2A 3EE United Kingdom / +44 (0)20 7059 5000 / www.accaglobal.com