

Global digital tax developments review

November 2015



“With the exception of certain exaggerated cases which basically go beyond what is allowed by the law, there is no point in bashing companies for doing things that are legal under current rules. The way I see the BEPS Project is actually an assumption of responsibility made by government policymakers in saying we don’t like this result and we recognize that in many cases, these results are based upon the rules, so we need to change the rules. And that’s exactly what we are trying to do with the BEPS Project.”

Raffaele Russo
Head of the BEPS Project – OECD Centre
for Tax Policy and Administration

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- ▶ Dive deep into the UK's controversial Diverted Profits Tax, **on page 10**
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Welcome

Welcome to the world of digital economy taxation. Perhaps we saw it coming, when the Organisation for Economic Co-operation and Development (OECD) declared in 2014 (and re-declared just recently) that “the digital economy is the economy itself.” Certainly, we all hope for the best out of the new global tax models they have been developing since. But hope is not a strategy. And tax uncertainty can act as a drag on corporate innovation, growth and profitability. So now it’s time to ask: are we ready?

In November, G20 leaders are expected to put their final seal of approval on the recent output of the OECD’s two-year-old base erosion and profit shifting project. This broad new global framework for taxation, released in early October, will profoundly change the international tax landscape across all industries as it addresses new issues created by their increasingly digital business models. In fact, change has already begun, with countries taking inspiration from the draft BEPS recommendations to institute their own domestic digital economy tax policies.

So, we now have the final BEPS recommendations in place, but clearly, global BEPS implementation will be no lock-step process, as countries choose their own timing, variations and even divergences from the OECD recommendations. Additionally, certain digital tax policies will continue to be developed, with the Task Force on the Digital Economy (TFDE), the group within the OECD tasked with developing BEPS Action 1, saying that a supplementary report reflecting the outcome of continued work on the overall taxation of the digital economy should be released by 2020. You can read our full analysis of Action 1 on page 4, as well as an interview with Raffaele Russo, leader of the BEPS project and co-chair of the TFDE. To analyze the 15 BEPS action items and the work still ahead, EY is conducting an open series of webcasts, in addition to providing ongoing analysis on our BEPS web page, and interested parties are invited to register here.

The ongoing challenge in the corporate world will be to run a robust, ever-changing global business amid such tax uncertainty. The most forward-looking corporate tax executives have engaged in the BEPS process, analyzed its implications and stockpiled scenario plans. They may well be ahead of the competition in protecting their bottom lines and their future prospects. But even they will find the coming months and years bedeviling. In reality, none of us is fully prepared. How could we be?

Knowledge will be key – which brings us to this global digital tax developments review. In it, EY’s global tax and industry specialists report tax changes on the ground, identify patterns emerging from one country to the next, and analyze their fundamental business implications.

Today, we are seeing corporate responses including a new trend toward “onshoring” intellectual property, as we describe in a companion piece titled *The dawning of digital economy taxation*. Looking ahead, technology innovation guarantees that horizon issues, such as 3D printing and its digital redefinition of global manufacturing and distribution, will continue to trigger new waves of tax deliberations, as we describe in a separate report titled *3D printing taxation issues and impacts*.

Through it all, the sheer volume, pace and complexity of tax change has become breathtaking. Expanded global business opportunities are, of course, the upside of the digital economy, and companies should pursue them with vigor. But tax knowledge, preparation and appropriate substance must all underpin strategic planning, to ensure that business decisions yield the desired outcomes.

Let us know your views on digital economy taxation. I welcome your emails and insights.

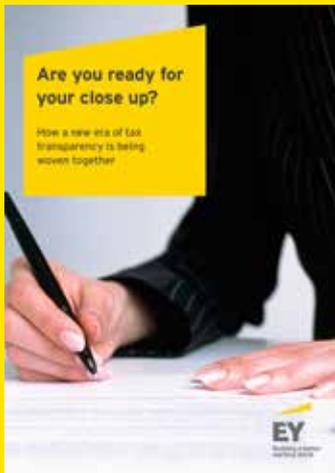


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Editorial

New thought leadership from EY



Are you ready for your close up? How a new era of tax transparency is being woven together

Multinational businesses face a multitude of different transparency and data disclosure requirements in the wake of the broad debate about how the international tax environment should reflect 21st Century ways of global business. Among other things, they face new transfer pricing documentation requirements; demands to publicly account for their tax and business activities on a country-by-country basis; and pressure in countries like the UK to disclose more information about their overall tax strategy. In this report from EY, we provide a snapshot of some of these new demands and offers those with responsibility for keeping business compliant some insights on the current and potential future trajectories of the debate.



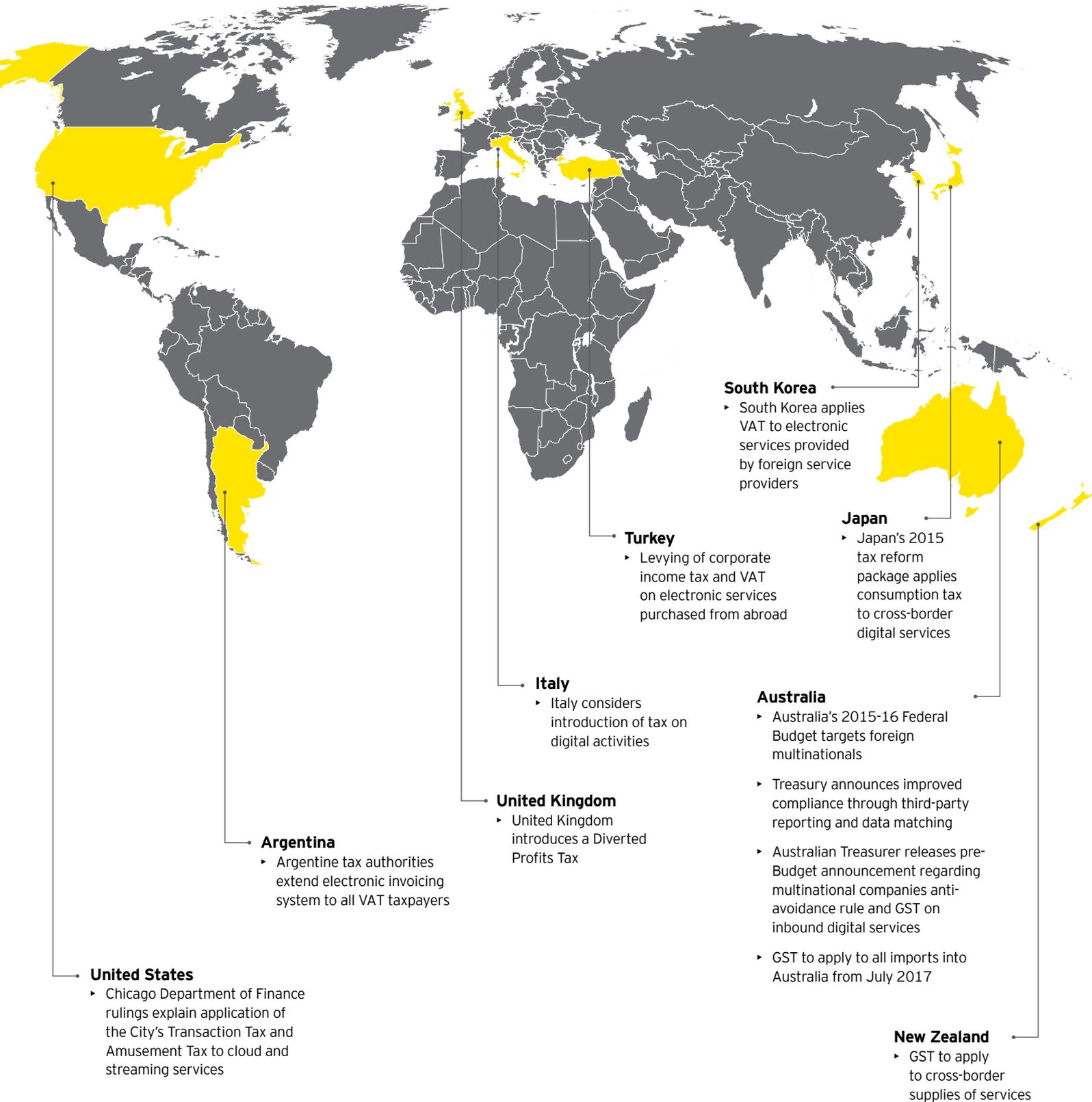
Global Tax Policy and Controversy Briefing

The November edition of our Global Tax Policy and Controversy Briefing comes just weeks after the delivery of the final recommendations of the OECD's Base Erosion and Profit Shifting (BEPS) project. In this special edition, we provide full coverage and analysis of each BEPS actions, as well as providing insight from Pascal Saint-Amans, leader of the OECD's Centre for Tax Policy and Administration and Raffaele Russo, leader of the BEPS project and co-chair of the OECD's Task force on the Digital Economy, the group with responsibility for Action 1 on the digital economy.

In addition to the work of the OECD, we bring updates and insights from the many tax related activities at the European Commission, as well as updates and information from many countries who continue to develop new tax policies and tax enforcement approaches.

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Map of recent developments



OECD issues report on the tax challenges of the digital economy under Action 1

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On 5 October 2015, the Organisation for Economic Co-operation and Development (OECD) released its final report on the tax challenges of the digital economy (Action 1) under its Action Plan on Base Erosion and Profit Shifting (BEPS). This report was released in a package that included final reports on all 15 BEPS Actions.

The document, *Addressing the Tax Challenges of the Digital Economy, Action 1: 2015 Final Report* (the Digital Economy Report or Report), largely follows the initial Action 1 deliverable on the digital economy released by the OECD on September 16, 2014 (the 2014 Deliverable). At 290 pages, the Report exceeds the 2014 Deliverable by 88 pages.

The Report provides the OECD's conclusions regarding the digital economy and recommended next steps to address the tax challenges presented by its evolution. The Report continues to acknowledge that special rules designed exclusively for the digital economy would prove unworkable, broadly stating that the digital economy cannot be ring-fenced because it "is increasingly becoming the economy itself." The Report summarizes key features of evolving digital business models that the OECD considers relevant for the overall BEPS analysis; in addition, the Report considers the broader direct and indirect tax challenges raised by the digital economy and evaluates the options to address those challenges.

To address the direct tax challenges, the Report does not recommend creating special rules; rather, it says those challenges will be effectively addressed by the work carried out under other BEPS Action items.

In that regard, the Report:

- (i) Recommends modifying the list of exceptions to the definition of Permanent Establishment ("PE") regarding preparatory and auxiliary activities as they relate to a digital environment, and introduces new anti-fragmentation rules to deny benefits from these exceptions through the fragmentation of certain business activities;
- (ii) recommends modifying the definition of a PE to address artificial arrangements through certain "conclusion of contracts" arrangements (See also EY Global Tax Alert on Action 7);
- (iii) recommends a correlative update to the Transfer Pricing Guidelines (see also EY Global Tax Alert on Actions 8-10); and;
- (iv) recommends changes to the controlled foreign corporation ("CFC") rules addressing identified challenges of the digital economy.

The Report also addresses the indirect tax treatment of certain digital transactions, recommending that countries apply the principles of the OECD's International VAT/GST Guidelines as well as consider the introduction of the collection mechanisms included therein. Each of the above recommendations is discussed in more detail in this alert.

Future work in the area of Action 1 will be conducted in consultation with a broad range of stakeholders, and on the basis of a detailed mandate to be developed by the OECD during 2016 in the context of designing a globally inclusive post-BEPS monitoring process. A supplementary report reflecting the outcome of continued work on the overall taxation of the digital economy should be released by 2020. The OECD intends to develop implementation packages to enable countries to implement the OECD's International VAT/GST Guidelines in a coordinated manner.

Detailed discussion

Similar to the 2014 Deliverable, the Report is organized into a number of different chapters: Fundamental principles of taxation (Chapter 2);¹ Information and communication technology and its impact on the economy (Chapter 3); The digital economy, new business models and key features (Chapter 4); Identifying opportunities for BEPS in the digital economy (Chapter 5); Tackling BEPS in the digital economy (Chapter 6); Broader direct tax challenges raised by the digital economy and the options to address them (Chapter 7); Broader indirect tax challenges raised by the digital economy and the options to address them (Chapter 8); Evaluation of the broader direct and indirect tax challenges raised by the digital economy and the options to address them (Chapter 9); and Summary of the conclusions and next steps (Chapter 10).

The report also includes: Annex A, which discusses prior work on taxation and the digital economy; Annex B, which illustrates typical tax planning structures in integrated business models; Annex C, which contains the text of a report on possible approaches for implementing a more efficient collection of VAT/GST on imports of low-value goods; Annex D, which presents Chapter 3 of the International VAT/GST Guidelines; and Annex E, which provides an overview of the expected economic incidence of the three proposed options to address the broader tax challenges of the digital economy. Annexes C, D and E are new and were not contained in the 2014 Deliverable.

Fundamental principles of taxation

The Report starts by examining overarching tax policy considerations that have traditionally guided the development of taxation systems. The Report makes references to the Ottawa Taxation Framework Conditions of Neutrality, Efficiency, Certainty and Simplicity, Effectiveness and Fairness, and Flexibility.

Following the discussion of tax policy considerations, the Report goes on to describe the typical forms of taxation on income and consumption. This includes an overview of the principles underlying corporate income taxes under both domestic law and in the context of tax treaties, as well as an overview of value-added tax (VAT) systems. The Report addresses the taxation of cross-border income through a discussion of CFC rules, the potential for double taxation in the allocation of cross border income, and the rules related to the taxation of PE's under tax treaties.

Information and communication technology and the emergence of new business models

The Report includes a discussion of the evolution and expansion of information and communication technology (ICT) across the economy, the key features of the new business models that have emerged as a result of this evolution, and their impact on the economy. Building on this discussion, the Report identifies some key trends in the evolution of ICT and new business models that are viewed as contributing to the tax challenges of the digital economy. The following features are noted in the Report as examples of new business models resulting from the evolution of ICT:

- ▶ Ecommerce (including business-to-business, business-to-consumer, and consumer-to-consumer models)
- ▶ App stores
- ▶ Online advertising
- ▶ Cloud computing (including infrastructure-as-a-service, platform-as-a-service, software-as-a-service, content-as-a-service, and data-as-a-service)
- ▶ Payment services
- ▶ High frequency trading
- ▶ Participative networked platforms

¹ Chapter 1, *Introduction to tax challenges of the digital economy*, briefly discusses the background leading to the adoption of the BEPS Action Plan, including the work to address the tax challenges of the digital economy.

The Report identifies the key features of the digital economy and new business models that are potentially relevant from a tax perspective:

- ▶ Mobility, including mobility of intangibles on which the digital economy relies, mobility of users of the digital economy, and mobility of business functions resulting from a decreased need for local personnel to perform functions as well as flexibility to choose the location of servers or other resources
- ▶ Reliance on data (collection, analysis and storage)
- ▶ Network effects (understood with reference to where user participation, integration and synergies are important)
- ▶ Use of multi-sided business models (a business model in which the two sides of the market may be in different jurisdictions and interact through an intermediary or platform increasing flexibility and reach)
- ▶ A tendency toward monopoly or oligopoly in certain business models
- ▶ Volatility (resulting from relatively low barriers to entry and rapidly evolving technology)

Emerging technologies (such as Internet of Things, virtual currencies, robotics, and 3D printing) are also identified and underscore that the landscape is still moving rapidly, therefore making it a challenge to anticipate all potential issues.

Identifying planning opportunities and tackling BEPS in the digital economy

The Report states that the Task Force on the Digital Economy² (task force or TFDE) discussed how some of the tax and legal structures used to implement business models in the digital economy can create BEPS planning opportunities. The Report notes that while many strategies used by digital businesses may be similar to those used by more traditional businesses, some of the key features of the digital economy may exacerbate BEPS risks in the context of both direct and indirect taxation. The Report illustrates how planning strategies in a direct tax setting take advantage of those key features and how the digital economy places pressure on VAT systems.

In the context of direct taxation, the Report provides more detail on the four core elements of planning strategies identified in the OECD's February 2013 report *Addressing Base Erosion and Profit Shifting*:

- ▶ Minimization of taxation in the market (source) country (through the minimization of functions, assets and risks or other avoidance of a taxable presence by contractually allocating risk and legal ownership of intangibles, or in the case of a taxable presence, by shifting profits or maximizing deductions)
- ▶ Reduction or elimination of withholding tax at source
- ▶ Reduction or elimination of taxation at the level of the recipient (achieved through low-tax jurisdictions, preferential regimes, or hybrid mismatch arrangements) with entitlement to substantial non-routine profits often built-up via intra-group arrangements

- ▶ Elimination of current taxation of low-tax profits at the level of the ultimate parent

The Report states that the work developed under other BEPS Actions took into account the digital economy's key features to ensure that the proposed solutions effectively address BEPS in the digital space. It notes that while all of the BEPS recommendations will tackle the challenges raised by the digital economy by restoring taxation on "stateless" income, the deliverables regarding CFC rules (Action 3); artificial avoidance of PE (Action 7); and transfer pricing (Actions 8 through 10) will be particularly relevant.

In the context of indirect taxation, the Report identifies the tax planning opportunities that may be created when countries do not fully implement the OECD's international VAT/GST guidelines for the collection of VAT on cross-border business-to-consumer supplies and services and intangibles. BEPS concerns could therefore arise in two types of VAT transactions:

- ▶ Remote supply of digital goods and services to VAT exempt businesses
- ▶ Remote supply of digital goods and services to a centralized location for resupply within a multinational group not subject to VAT

The Report concludes that implementing Guidelines 2 and 4 of the OECD's international VAT/GST Guidelines will minimize those planning opportunities.

² A group within the OECD with whom the responsibility for developing Action 1 sits.

Addressing the broader tax challenges raised by the digital economy and potential options to address those challenges

The Report discusses the broader, more systemic direct tax and indirect tax challenges and evaluates potential options to address those challenges.

Direct taxation

In the area of direct taxation, the Report identifies the three main tax policy concerns raised by the digital economy:

- ▶ Nexus – Ability to have significant digital presence without being liable to tax
- ▶ Data – How to attribute value created from the generation of data through digital products and services and determining the share of profit attributable to these value drivers
- ▶ Characterization – Proper characterization of income in the context of new business models

In relation to the above challenges, the Report sets out key recommendations in a number of areas, centering on the following:

(1) Permanent establishment

In respect of modification to PE rules, the Report states that it was agreed under the work carried out in relation to Action 7 to modify the list of exceptions to the definition of PE in Article 5(4) of the OECD Model Tax Convention to ensure that each of the exceptions included therein is restricted to activities that

are of a “preparatory or auxiliary” character, and to introduce a new anti-fragmentation rule to ensure that it is not possible to benefit from these exceptions through the fragmentation of business activities among closely related enterprises.

The Report provides an example which describes the maintenance of a very large local warehouse in which a significant number of employees work for purposes of storing and delivering goods sold online to customers by an online seller of physical products (whose business model relies on the proximity to customers and the need for quick delivery to clients) would constitute a PE for that seller. Some countries, however, believe there is no need to modify Article 5(4) and that the list of exceptions in subparagraphs a) to d) of Article 5(4) should not be subject to the condition that the activities referred to in these subparagraphs be of a preparatory or auxiliary character. Those countries may adopt a different version of Article 5(4) as long as they include the new anti-fragmentation rule. The changes to the definition of PE in the OECD Model Tax Convention are included in the document *Preventing the Artificial Avoidance of Permanent Establishment Status, Action 7: 2015 Final Report*, and the OECD expects the new rules to be implemented across the existing tax treaty network in a synchronized and efficient manner via the conclusion of the multilateral instrument that modifies bilateral tax treaties under BEPS Action 15.

(2) Modifying the definition of a PE to address artificial arrangements through certain “conclusion of contracts” arrangements

In addition to the above changes within Action 7, the OECD also agreed to modify the definition of PE in Article 5(5) and 5(6) to address circumstances in which artificial arrangements relating to the sales of goods or services of one company in a multinational group effectively result in the conclusion of contracts, such that the sales should be treated as if they had been made by that company.

The Report sets out a second example to illustrate this concept, describing a scenario where the sales force of a local subsidiary of an online seller of tangible products or an online provider of advertising services habitually plays the principal role in the conclusion of contracts with prospective large clients for those products or services, and those contracts are routinely concluded without material modification by the parent company.

(3) A correlative update to the OECD's Transfer Pricing Guidelines

In the context of the OECD's work on transfer pricing in Actions 8-10, it was noted that companies in the digital economy rely heavily on intangibles in creating value and producing income, and that many BEPS structures adopted by participants in the digital economy involve the transfer of intangibles or rights in intangibles to tax-advantaged locations, coupled with the position that these contractual allocations, together with legal ownership of intangibles, justify large allocations of income to the entity allocated the risk even if it performs little or no business activity.

The Report also noted that improvements in information and communication technology have accelerated the spread of global value chains, thereby enabling multinational companies to become more integrated and better able to maximize opportunities in a global economy. The Report states that attention should be devoted to the implications of this increased integration and the need for greater reliance on value chain analyses and transactional profit split methods.

It was concluded that the BEPS work in the area of transfer pricing took those issues into account under the revisions to the guidance on intangibles and the agreement to further examine the practical application of transactional profit split methods. The Report notes that the latter work will take the Action 1 conclusions into account and will address the application of transactional profit split methods to highly integrated business operations, as well as address situations where the availability of comparables is limited.

(4) Controlled Foreign Company rules

The Report notes that the work on designing effective CFC rules under BEPS Action 3 may also contribute to restoring taxation in the jurisdiction of the ultimate parent company.

The report states that although CFC rules vary significantly from jurisdiction to jurisdiction, income from digital goods and services provided remotely is frequently not subject to current taxation under CFC rules. Such income may be particularly mobile due to the importance of intangibles in the provision of such goods and services and the relatively few people required to carry out online sales activities.

The OECD work on BEPS Action 3 resulted in recommendations in the form of six building blocks, including a definition of CFC income which sets out a non-exhaustive list of approaches or combination of approaches that CFC rules could use for such a definition.

In respect of Action 1, the Report states that countries may implement those approaches to design CFC rules that would subject income that is typically earned in the digital economy to taxation in the jurisdiction of the ultimate parent company. For instance, countries could use the categorical analyses to define CFC income to include types of revenue typically generated in digital economy transactions such as license fees and certain types of income from sales of digital goods and services. If countries adopted the excess profits approach this could characterize any "excess profits" generated in low tax jurisdictions, which may include profits attributable to IP-related assets, as CFC income. Both approaches may be combined with a substance analysis aimed at verifying whether the CFC is engaged.

(5) Options that were considered but not recommended

The TFDE also considered several options to address the broader tax challenges raised by the digital economy. None of the following additional options were recommended at this stage:

- (i) A new nexus in the form of a significant economic presence
- (ii) A withholding tax on certain types of digital transactions
- (iii) An equalization levy

While these options were not recommended, the Report does state that countries could introduce any of them in their domestic laws as additional safeguards against BEPS, provided they respect existing treaty obligations, or in their bilateral tax treaties. Adoption as domestic law measures would require further calibration of the options in order to provide additional clarity about the details, as well as some adaptation to ensure consistency with existing international legal commitments.

A determination will be made by the OECD as to whether further work on the above options should be carried out. This determination will be based on a broad look at the ability of existing international tax standards to deal with the tax challenges raised by developments in the digital economy.

Indirect taxation

In the context of indirect taxation, the Report identifies as the main policy concerns the ability of private consumers to acquire goods, services and intangibles from remote suppliers, and the use of exemptions for imports of low-value goods.

The Report recommends that countries apply the principles of the International VAT/GST Guidelines and consider introducing the collection mechanisms included in those guidelines.

A determination will be made by the OECD as to whether further work on the above options should be carried out. This determination will be based on a broad look at the ability of existing international tax standards to deal with the tax challenges raised by developments in the digital economy.

Next Steps

The Report notes that the conclusions may evolve as the digital economy continues to develop, which means it will be important for countries to monitor developments in the digital economy and to review and analyze data that will become available over time. The Report states that continual monitoring will enable the task force to assess the extent of the broader direct tax challenges and determine whether future work on the three additional options listed should be carried out.

The task force agreed that follow-up work will be carried out in consultation with stakeholders and on the basis of a detailed mandate that will be developed during 2016 in the context of designing a globally-inclusive post-BEPS monitoring process. The task force will produce by 2020 a report reflecting the outcome of the continued work on the digital economy.

In addition, Working Party 1 will clarify the characterization under current tax treaty rules of some payments made under new business models, particularly cloud computing payments. The task force OECD will develop implementation packages to ensure that countries can implement the International VAT/GST Guidelines in a coordinated manner.

Implications

While there still remain certain areas of disagreement among stakeholders (e.g., importance of data in driving value for tax purposes), the Report shows there is consensus that more work should be done in a variety of areas, including addressing PE issues in the digital economy and consumption taxes on business-to-consumer transactions.

In light of the interaction among all the focus areas in the BEPS Action Plan, the OECD's work on the taxation issues within the digital economy will continue into 2015 and beyond. However, countries are already taking national action with respect to the tax treatment of activity in the digital economy. Companies should therefore consider putting in place or increasing their efforts to monitor change at both multilateral and national levels.



Interview

Interview with Raffaele Russo: Head of the BEPS Project – OECD Centre for Tax Policy and Administration

How to tax digital products and services in the increasingly borderless global economy is one of the most vexing questions facing policymakers today. Raffaele (Rafa) Russo of the OECD Centre for Tax Policy and Administration sits down with Channing Flynn, EY's Global Technology Industry Leader for Tax and Rob Thomas, a director in EY's Tax Policy & Controversy network, to discuss the nuances and future of the policy debate.

Rob: Rafa, could you give us some high-level context, setting the scene around the overall role of the Task Force on the Digital Economy?

Rafa: The Task Force is a new subsidiary body of the OECD's Committee on Fiscal Affairs (CFA), created when the BEPS Action Plan was approved by the CFA and then endorsed by the G20 Finance Ministers. Its mandate is to carry out the work on Action One of the BEPS Project. These issues are cross-cutting and therefore there was a need for mixed expertise, comprising, for example, tax treaty experts, transfer pricing experts, anti-avoidance experts and consumption tax specialists.

The Task Force is chaired by France and the United States and has met several times since the beginning of the BEPS Project. The work pace has been pretty fast. The first interim report was issued in September 2014 and the final report is about to be issued together with the remaining BEPS output in time for the G20 Finance Ministers meeting on 8 October 2015.

Channing: I have a question about how the Task Force is defining the digital economy. In the September 2014 report you just mentioned, there was lots of background and some very good economic insight into the digital economy, but do you think that the Task Force, for purposes of the policy guidance that the OECD is bringing forward, is going to try to define it? Is that one of the objectives?

Rafa: The main objective of the work was to actually introduce some clarity into a very complex debate. So one of the first conclusions of the Task Force was that actually the digital economy is the economy itself. Even when you look at sectors of the economy that are considered to be more "traditional," like agriculture and health care, you see that basically everyone is being transformed by the digital economy.

So it is not possible to ring-fence the digital economy for the purposes of tax policy. Any provisions that will be adopted in order to deal with the digitization of the economy should apply across the board. This is a key conclusion of the Task Force, in my view, which will most likely be confirmed in the final report, and that was widely shared by stakeholders. Whether they were from business, from academia, from the advisory community, or from civil society, the messages were pretty consistent that it would not make sense to ring-fence the digital economy for tax purposes.

Action 1 of the BEPS Project is unique in a sense, because it does not only deal with the issues of Base Erosion and Profit Shifting, understood as cases where profits are artificially shifted to low-tax locations, divorced from where the economic activity and value creation take place, or where due to mismatches in the tax treatment of certain transactions the end result is that of double non-taxation. Action 1 also refers to issues related to VAT (value added tax), and also requires an analysis of what we have called the broader tax challenges of the digital economy. And these challenges relate chiefly to nexus, data and revenue characterization for tax purposes.

These challenges intersect with some of the BEPS issues but, at the same time, are much wider than those, because ultimately they affect the allocation of taxing rights among different jurisdictions.

Channing: If you look at some of the companies that have been at the forefront of the discussion of the digital economy, there clearly are global brands, companies that have defined new ways of making money. And of course they tend to be quite profitable. Some of those companies are also incredibly disruptive to the way things have been done historically.

Many are using digital platforms to earn money. One of the points that these companies raised to me, that I think would be incredibly helpful for the OECD to at least acknowledge, is that so very few of these companies make money in their first 5 or 10 years of operation.

If you look at the profitability of your cloud computing company, for example, unless they're one of the behemoth companies, meaning a Fortune 100 or a FTSE 100 company, most of them make losses. The concept of modified nexus or digital PE would be very interesting when you have complete and total losses in the global system. I was just wondering if that's something that the policies of the individual countries are considering when they say OK, this brand-named digital company has nexus in this country and we're going to bring these profits to it because of the nature of their digital reach?

But, in so doing that and setting that policy, they might open a Pandora's Box of 10 times the amount of losses from all the other companies that are doing business there. I just wonder if the working group has thought of that, because I think it would be good to acknowledge it.

Rafa: This is something that was made clear from the very beginning, that when we talk about income, we talk about profit. And let me add that it is a question that it would be mistaken to answer only from the perspective of direct taxation, without taking into account the fact that since the days when the economies of the League of Nations crafted the basis of what then became the OECD model, most countries have introduced consumption taxation. This is a very important point; the big question that the digital economy raises is that in my view, most people do tend to picture it as a debate between source countries and residence countries. For me, it is actually a debate about what is source, or even better, what is the best proxy to use to determine what source is.

Channing: I think it's important because if you remember many years ago, the German government severely limited German taxpayers from using their losses; they just said we need the money and so your losses are no longer available. I think that there would be a lot more equity in such policies if a start-up company, say a disruptive technology, digitally enabled start-up company, was pulled in to modified nexus or digital nexus, however that's defined, and given the ability to "bank" losses for the start-up years and then when they turn profitable because of the nexus or however that's defined, they are able to claim those losses. So I think that the taxpayers and the countries that are the source countries, or the home country, would say "that's fair." But I don't think it would be fair to say you only have digital nexus when you make money and we're just going to take a piece of it.



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“There is now, I think, full agreement that in particular in relation to cross-border business to consumer transaction, VAT should be collected in the market jurisdiction.”

Rafa: First, you have to establish whether there is enough connection with the economy of a country to justify taxation in that country. You can discuss the details of what that threshold is, what that threshold should be and whether, and if so, how the existing threshold should be amended. And then the next step, once you have decided on that, should be how much income to allocate to that nexus.

Rob: Can you give us a general picture of where the work of the Task Force stands now? And can you kind of give us some idea of potential outcomes that we might see in the short- to medium-term?

Rafa: We have identified two macro categories: BEPS issues and more systemic issues. And within the second category you have issues that relate to value added tax or consumption tax, and issues that relate to direct taxation. Regarding consumption taxes, there is now full agreement that in relation to cross-border business to consumer transaction, VAT/GST should be collected in the market jurisdiction, meaning in the jurisdiction where the customer is located, with recommended mechanisms that countries can consider introducing in order to ensure the effective collection of that tax.

Channing: I think that is in line with the policy that the EU has, at least the EU and some other countries, for electronically supplied services, correct?

Rafa: That is similar to the MOSS (Mini One-Stop Shop) in the EU, which according to the Commission is producing very positive results since its introduction at the beginning of the year with thousands of registered businesses that went for the simplified registration. Similarly, positive experience has been shared by a number of other countries that have introduced these types of mechanism – South Africa comes to mind, and a number of other countries that have been introducing the same, like Japan.

That shows that actually there is something important there, particularly in terms of the level playing field between domestic and foreign suppliers, in addition to the revenue loss that countries have been facing because of the lack of rules on the one hand, and perhaps the lack of mechanisms to enforce these rules on the other. So that's a subset of the type of macro issues, the broader tax challenges.

The second subset is the one about the direct tax challenges and in that context the Task Force has received a number of proposals from countries and stakeholders, ranging from a new nexus based upon a significant economic presence test, a withholding tax or a “so-called” excise tax to equalize the tax treatment of resident and nonresident taxpayers.

The work that the Task Force has been doing so far has been on the analysis of the technical issues that these proposals raise, and possible solutions. And of course, there has been a lot of debate on how to determine the income that would be attributable to such a new nexus, including the issues of compatibility with international norms and bilateral tax treaties. The work is ongoing and our hope is to be able to issue a consensus report on these options by the time of the delivery of the full BEPS package.

Rob: How do you see the digital economy agenda that the OECD is moving forward on remaining true to the Ottawa Convention's premises? I thought it was fantastic in the September 2014 report that there was acknowledgement that there was an adherence to it, but unfortunately as individual countries over the last six months, I think beginning with the United Kingdom, announced their own “teeth,” if I can use that phrase, to take a bite of the digital economy, they seem to steer away from the five core principles of the Ottawa Convention about fairness and not isolating a single piece of the economy.

Methods of making money change and policy should be equal across those evolving business models; what's your reaction? Do the individual countries of the world want to adhere to the Ottawa Convention? Or do they just want to raise money?

Rafa: The Ottawa principles have been the backbone of the work since its start, and there is some feeling that they are still relevant today, providing the basis on which you can make an evaluation of the options that have been developed to tackle the tax challenges raised by the digital economy. The way I understand the UK DPT, is that it is an anti-avoidance measure, which would not affect any of the broader tax challenges raised by the digital economy which we just discussed.

In other words – again the way I understand it – the DPT would not apply unless you have a physical presence in the UK, while we're talking about the ability of companies to be part of the economic life of another country but without necessarily having a taxable, physical presence in that country.

We have worked on that, that's what we have been trying to do. First, we have to analyze the extent of the challenge, particularly because if you look at, as you said, the big players, the ones that in the collective imagination are the ones that have raised concern, in most cases they do have a physical and a taxable presence in the countries concerned. The issues related to nexus and physical presence should not be overestimated, but at the same time they should not be underestimated because it is clearly a trend that is not going away.

Channing: You used the phrase physical presence with respect to the digital economy, and I think that digital and physical in many people's minds are opposite terms, because it's digital, it's ethereal, it's not physical.

If we could, as a working group of highly competent tax professionals, including companies, define what physical and digital meant and where do they converge, where do those two concepts converge, if there was clarity or at least a working group of principles there, I think that people would say yes, that's a good policy, that makes a lot of sense, because sometimes digital has to be physical, but other times it isn't. And as technology evolves, keeping track of how those two terms are defined by how businesses make money and then having a corporate income tax and a VAT or indirect tax element to that, that policy I think people would get behind, including companies.

Rafa: Yes, and that's something that we are doing, it's something that in my personal view should be debated in the future. And as I said, there should be a more relaxed discussion about the world in which we live today and the world in which we will live in the next 10, 15 or 20 years. We need to have a conversation on what is the best way for countries to fund government expenses in an economy that is increasingly digitalized. I'm not only thinking about what we see today, but more at trends like 3D printing, which will completely change manufacturing, at the sharing economy, where basically individuals who are not in a paid relationship with the enterprise, who are not employees or agents, effectively contribute to the value chain of these enterprises.

When you square all that, I think you realize that there may be room for some deep thinking about the tax system of the new millennium.

Channing: Recently, Bob Stack, from the US Treasury Department, spoke in Washington, DC at a USCIB meeting. He said "before we evaluate whether the taxpayers of the world have done something wrong with respect to digital economy or BEPS [we need to acknowledge] it's us that created the laws. And most of the companies are following laws. We need to change the laws." Just last week the US Congress had a hearing on inversions, which I know is not a BEPS topic, but the same point was made that the lawmakers in US Congress basically said "look, we're talking about something and blaming companies but the blame really falls on the lawmakers themselves for allowing this to go on." What's your view, sitting on top of this massive project, about it's not the companies that have done something so much, it's the landscape that's been created by the patchwork of global tax law?

Rafael: I wasn't at the USCIB event due to personal reasons, but I do think that Stack's remarks were interpreted too negatively by some people, while actually if you read the remarks carefully (and it is actually possible to do that because they were later published in full), you realize that they are actually a rather positive judgment on most of the BEPS action items, with an invitation to do more, collectively, on certain items.

Regarding your specific point, absolutely yes, and this was faced squarely at the beginning of the BEPS Action Plan. With the exception of certain exaggerated cases which basically go beyond what is allowed by the law, there is no point in bashing companies for doing things that are legal under current rules. The way I see the BEPS Project is actually an assumption of responsibility made by government policymakers in saying we don't like this result and we recognize that in many cases, these results are based upon the rules, so we need to change the rules. And that's exactly what we are trying to do with the BEPS Project.

The dawning of digital economy taxation



From the outset, technology companies have been in the vanguard of globalizing new digital business models that may challenge sovereign borders. As such, they have also found themselves under the spotlight from policymakers and the media as tax issues have risen to new prominence.

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“Multinational technology companies need to be fully aware that global effective tax rates are trending upward – how much remains an open question. Those tax practitioners and international finance executives that prepare now will be in the best position to influence the answer for their own companies.”

Page 7 of the report

Five months into the DPT: a review of lessons learned

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Matthew Mealey is EY's International Tax Services leader for Europe, the Middle East, India and Africa. In this discussion with Rob Thomas, a director in EY's Tax Policy and Controversy network, he reflects on the first five months of experiences with Her Majesty's Revenue and Customs (HMRC) in relation to the UK's Diverted Profits Tax.

Rob: You're now almost five months into the DPT. Are there any early signs of what structures might be acceptable within DPT?

Mat: As you know, DPT is very widely drawn, but the policy intent is that it should focus on structures where there's lots of profit in low substance and low tax entities. HMRC are being generally efficient at dealing with structures that are technically potentially within the rules but not within the policy intent. For example where you have profits in high substance entities or high tax entities, but for some technical reason you might be in the DPT, they're being effective in confirming that you are low risk.

A more interesting point is in high risk structures where there are system losses, again they're basically accepting the DPT does not apply. So that would be an IP structure where, because of the evolution of the business, the entity was loss-making. For example because it was investing in IP and it wasn't yet making a profit or return on the IP investment. That's exactly the kind of structure that the DPT is targeting, but you can't really divert profits if there aren't any profits. HMRC are being pragmatic with those kinds of circumstances.

Then when you get to genuine high risk arrangements which are profitable, right in the heart of the DPT, the arrangements that they are getting comfortable with are those ones where there is a full transparency APA reflecting a two-sided transfer pricing analysis.

Rob: Have you managed to bed down any kind of consistent methodology of how you're dealing with HMRC, both the policy team and the APA team? Is there some kind of flow that you're following now?

Mat: I think it's important to define a clear process of communication with HMRC, because they can leave it relatively open. Obviously DPT is potentially a very wide tool for HMRC, so I think there's a lot of benefit in defining the process and trying to agree it with HMRC. The way that DPT works is that you have got two charges, which are law changes, which are extending the UK tax basis. That's the PE avoidance charge and the recharacterization charge.

Then wrapped up in the same legislation, you've got an administrative change that is designed to rebalance the negotiating position between the tax authority and the taxpayer in high risk transfer pricing cases. What we've been doing with our DPT cases is to first tackle the two law changes. We try to take the PE avoidance case and the recharacterization case off the table. Because if we can do that based on an analysis of the facts – and we can do that in a lot of cases – the only question that remains is “is the transfer pricing right?” as there's no extra territorial increase in the UK tax base.

Then, if we can do that, we can move the dialogue quickly onto the transfer pricing question. We can normally avoid the punitive assessment mechanics which rebalance the playing field between the tax administration and the taxpayer on high risk transfer pricing cases.

We can normally have a good prospect of avoiding the onerous assessment provisions if, once we've concluded it's all about transfer pricing, either we can agree with HMRC to enter into the APA program or the degree of transparency and degree of openness over the international value chain

“I think that if we leave it to HMRC or we try to deal with everything at once, then if we don't agree on a particular point, you can rather quickly get diverted into the assessment mechanics. Once you're in assessment mechanics and they raise the punitive assessment, you're on the back foot.”

is increased. So by breaking it down into those two steps, we maximise the efficiency with which we get through the process.

I think that works, and I think that if we leave it to HMRC or we try to deal with everything at once, then if we don't agree on a particular point, you can rather quickly get diverted into the assessment mechanics. Once you're in assessment mechanics and they raise the punitive assessment, you're on the back foot.

Rob: As you go through that process Matt and it's not like you need a completely new APA, is there any sign yet of how long that process takes to set through?

Mat: If we follow the process I described, getting through the legal bits, i.e., there's no re-characterization, there's no PE avoidance, and we're finding we can get through that in a few weeks. That leads to the conclusion it's all about transfer pricing and if it's all about transfer pricing, then the solution really is similar whether it's APA or whether it's a full transparency review. In both those cases it can be time consuming because the market standard or the practice has not been to do a two-sided transfer pricing analysis, so companies don't have them readily available, they have traditional one-sided analysis.

So that second phase of agreeing the transfer pricing is much more open-ended. An APA on a complex value chain is going to take you 12 months, really.

Rob: I know it's early days, but has there been any kind of preference within the DPT team to reject a request for an APA where they foresee a high DPT risk?

Mat: Yes, so if you're in a re-characterization or you're in a PE avoidance case, it is quite possible that HMRC instinct will reject an APA request. That makes sense because while the APA confirms the arm's length transfer pricing it doesn't tackle the two statutory extensions

in the UK tax base which arise from the deemed PE or the re-characterization cases. If you've got re-characterization the default position is they're quite likely to reject the APA. If you have a PE avoidance case you will have to work quite hard to wrap those up into the APA program. For sure you will need to demonstrate equivalence between transfer pricing and PE profit attribution which can be difficult on some fact patterns. If you get through the discussion around the statutory charge and you agree it's not PE avoidance, you agree it's not re-characterization, so it is just about the transfer pricing, then you should be able to use an APA to avoid any DPT risk. It is important though to recognize that APAs are not a clearance process for the DPT. They need to be evaluated on their merits and they need to make sense for the taxpayer and for HMRC.

But the practical matter if you approach the APA expression of interest meeting in the right way, recognizing HMRC's concerns about the way the APA program is used and making sure that it's used for the right reason – which is to minimize risk for the tax administration and for the taxpayer in complex and high risk cases – and you show that you will be open about the international value chain, and you are respectful of the needs of UK treaty partners (so you have a point of view on if it's not bilateral, why it's not bilateral), in practice that should all be capable of being managed in the execution.

So you should be able to get into the APA program, but it's definitely the case – and we've seen examples of it – that if you get that communication wrong, HMRC could conclude at stage one that they don't think you should be in the APA program. If that happens I think you are in a more difficult position because then the transfer pricing is dealt with through the DPT mechanism and the punitive assessment mechanics become much more likely to be used.

Rob: Some people had voiced early concerns that the APA team might get bogged down with these kinds of new requests. Is there any sign of that happening?

Mat: I wouldn't say so yet; it's been resourced up and indeed HMRC draw in people who've got TP expertise supervised by people from the APA team when they need to. The problem hasn't risen yet. It might of course, but it hasn't yet.

Rob: Any signs yet of how companies are treating having this for FIN 48 or provision now that we're a few months into it?

Mat: It's hard to generalize; a lot of companies are looking at their tax provision. There is a point that the types of arrangement which will or potentially fall within the DPT are a big policy concern for quite a lot of countries. There's the “E6” initiative that grew out of JITSIC and the members of that are France, Germany, Australia and the UK for sure. There have been conflicting reports about who the other two members are, with commentators guessing between Japan, Canada, Italy and Spain.

To some degree all those countries have similar concerns about the structures targeted by the DPT and they firmly believe that there is likely to be more source territory taxing jurisdiction in cases where there are significant profits arising in an IP-rich value chain, in a low tax jurisdiction. The countries are not only communicating with each other and joining up with each other on the best way to tackle the structures, but also that they're designing their own response strategies, whether that relates to different inquiry processes, litigation or to the law changes, like the UK DPT and the Australian changes to their anti-abuse rule.

“I think the generic point of all this is that this is a major, major policy issue for those countries, and they are tackling it in a concerted, systematic, and joined up way. Companies need to be aware of that and reflect it in their response strategy.”

As a matter of fact, the UK was not the first mover in seeking to address this issue. Some of the other countries started a process towards tackling these structures probably two or even three years ago. The point is that this isn't a new phenomenon, and it's not just a UK phenomenon, so companies tax reserves may reflect that.

Rob: Do you see all this being impacted by information exchange?

Mat: Absolutely, and we're already seeing that play out. We think it is very clear that countries – particularly the E6 group – are doing knowledge exchange in relation to what the structures are and how they work, so it's more than just the “traditional” information exchange of hard data. The knowledge exchange might encompass how they most successfully audit certain structures, how they have successfully identified PEs, and so on.

As well as sharing experience around inquiry practices, there is certainly information exchange on particular transactions. For business, management of the audit and enquiry defense needs to be joined up across countries because the countries themselves are sharing more knowledge.

We have seen examples where a company gets a tax raid or a very aggressive audit in one country. In some countries, undeclared PEs can create the possibility

of criminal sanctions. Companies might be glad to settle a very aggressive audit in a relatively small market. Suppose they accept a PE and accept a profit attribution at 5% of sales but that settlement might create a very unhelpful benchmark in another country where there are much higher sales and possibly much greater functionality. I think the generic point of all that is that this is a major, major policy issue for those countries, and they are tackling it in a concerted, systematic, and joined up way. Companies need to be aware of that and reflect it in their response strategy.

Rob: I think you just described the future there, Mat, and I'm not sure if a lot of people are really thinking on that basis, but they'll certainly need to be, going forward. Now what about DPT as a long-term proposition? Is it safe to assume that the DPT will stay, whatever the outcomes of BEPS Action 7 or other actions may be?

Mat: If you think about what DPT does, it extends the PE construct and it introduces the re-characterisation construct. If the OECD work on Action 7 and Action 11 advances and is widely implemented around the world, I can see a case to say that we replace the PE extension and we replace the re-characterization provisions with the OECD guidelines. I can see a good case for that, and it's plausible that that could happen. However, and separately from

that, the most important practical impact of the DPT is the changed administrative mechanics which force high risk taxpayers, those with lots of profits in low substance low tax entities – to do a two-sided transfer pricing analysis and that is here to stay for the UK. Philosophically, the UK has become convinced and I believe that its peer countries in the E6 have become equally convinced, that the traditional one-sided analysis often leads to a low-quality estimate of an arm's-length transfer price in high risk cases.

The DPT is the lever to force companies to undertake a two-sided or multi-sided analysis in high risk cases. I cannot see any prospect of that going away. I think you'll see administrative protocols and procedures proliferating along these same lines wholly independent of BEPS Actions 7 and 8-10.

In my view the paradigm has already shifted and you need to do a two-sided transfer pricing analysis in higher risk cases. One way or another, a lot of countries are going to force you to do that. It all means that the transfer pricing analysis and risk management approach needs to be much more comprehensive.

3D printing taxation issues and impacts



"3D printing has not transformed the economy quite yet. It's too early to answer the countless questions this disruptive new technology will raise. But it is certainly not too early to start defining these questions and influencing the policy surrounding the answers."

Channing Flynn
EY Global Technology
Industry Leader
Tax Services

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Exchange of extensive corporate taxpayer information between E6 nations drives new tax risks for both digital and “old economy” companies

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The tax authorities of a large number of countries, led and supported by the G20, have been stepping up the exchange of information among one another for some years now. In principle, this should facilitate and ensure taxation in the individual countries.

The fact that tax audit notes relating to expenses asserted by a taxpayer are routinely sent to the tax office of the (purported) payee or the exchange of information relating to investment income is now likely to be familiar to every company with international business.

A new approach is currently being pursued by Australia, Germany, France, the UK, Japan and Canada (the so-called “E6” group).¹ These countries and their respective tax authorities have agreed in a non-bureaucratic manner – i.e., without intergovernmental agreements – to exchange extensive information relating to multinational companies in the digital sector. Regardless of whether it relates to current taxation in the participating countries, information which could provide insight into the entire business models of the companies concerned and their structure is being exchanged. This also includes information relating to the current taxation of the company in the respective country providing the information.

Where's the problem?

The distribution of nonpublic information by certain tax authorities to third parties is not necessarily permitted among all countries. In Germany, for example, tax secrecy laws protect the taxpayer's data, and noncompliance is punishable under German law. This would seem to make sense; the taxpayer has to submit data in detailed form to the tax office as part of disclosure obligations and other duties to cooperate, in order to be accurately assessed for tax purposes. These data may also include trade secrets, such as transfer prices between group companies. In Germany, tax secrecy is based on the view that the taxpayer can be reasonably expected to disclose confidential information only if he or she can rely on it being treated confidentially by the tax office.

Noncompliance with tax secrecy laws for the purpose of exchanging information with foreign countries is permissible – along with other requirements – only if this is necessary for taxation abroad. While the tax authority does not have to perform its own comprehensive audit under foreign law before submitting the documents, it must still establish whether the documents to be submitted are at all relevant for taxation abroad. Based on consistent precedents set by the German courts, inquiries that resemble mere “fishing expeditions” or that are not relevant in relation to overseas taxation are not permitted.

A first cautionary example can be taken from fast-track proceedings successfully conducted by EY before the Cologne Fiscal Court.

The claimant is a German company (the Company) within an international group of the digital economy. The Company has no business relationships or other points of contact with the countries participating in the E6 exchange of information. The Company was informed that information relating to group structures, tasks and remuneration at the individual group companies, as well as the resulting taxation and any specific features, would be passed

¹ The non-formal nature of the E6 group means that its exact composition continues to be debated.

In the lately terminated proceedings, the Federal Central Tax Office [“Bundeszentralamt für Steuern:” BZSt] was therefore able to make only a blanket assertion that the documents were likely to be relevant for taxation abroad. It did not provide a substantiated justification.

on to the other countries in the E6 group. The Company did not receive any further explanation as to which specific information is to be passed on in this regard.

During the administrative procedure, the Company was denied access to any of the files of the tax office and was thus unable to obtain its own picture of the scope of the information to be exchanged. The Company was able to acquire access to the file in order to gain an overview of the information to be exchanged only after it had applied for a preliminary injunction from the Cologne Fiscal Court. The file to be passed on included 16 pages of preliminary information. The documents also revealed that additional specifically pre-defined requests and additional related notifications should have been made after the preliminary information has been submitted.

Information relating to tax matters dating back many years, as well as inaccurate assumptions made by tax officials in prior tax field audits was supposed to be exchanged. What was particularly surprising was that the assumptions concerned had been rejected by the tax authorities a long time ago, and current relevance and accuracy did not seem to be the decisive criteria when compiling the information.

Counsel did not identify any specific indications in the file as to which specific tax situation(s) in the other countries the information could be relevant for. Indeed, if the information had been relevant for taxation in other countries, it would seem to have made sense to check the information to be submitted as to its relevance for the respective recipient country. The submission of identical data to all other countries – imminent in the case at hand – cannot be reconciled with this course of action.

What's the underlying objective?

This course of events made it even more apparent that the objective of the current exchange of information merely lies in achieving a better understanding of companies' business models and structures

in general, as opposed to tackling any specific perceived case of abuse. Based on the information exchanged, the countries intend to prepare studies and related suggestions for the adjustment of applicable tax regulations.

In the lately terminated proceedings, the Federal Central Tax Office [“Bundeszentralamt für Steuern:” BZSt] was therefore able to make only a blanket assertion that the documents were likely to be relevant for taxation abroad. It did not provide a substantiated justification.

Such an unbridled exchange of information, it would represent a continuing further erosion of tax confidentiality. The exchange of information with such a large number of recipients could make it difficult to ensure confidentiality. Inaccurate information could easily lead to suspicions against the taxpayer abroad and make it more difficult for it to enter a new market at a later stage, for example.

In its very recent decision in the fast-track proceedings, the competent court shared EY's view that an information exchange on this basis was illegal. In particular, the blanket assertion of the tax authorities that the exchange of documents with other countries was necessary for taxation abroad did not provide sufficient cause to justify such exchange. Therefore, the competent tax court issued a preliminary injunction that the information must not be exchanged prior to an eventual binding final decision regarding the information exchange between the taxpayer and the Federal Central Tax Office.

However, due to the nature of an interim relief decision, it is not yet clear whether the Federal Central Tax Office will definitively accept this decision and its implications for the information exchange regarding other taxpayers. Due to the political background of the information exchange within the E-6 group, the Federal Central Tax Office might not refrain from such broad information exchange in other cases.

For German taxpayers, if there is a threat (or indication) of an exchange of information, a provisional injunction may be appropriate.

Where to next?

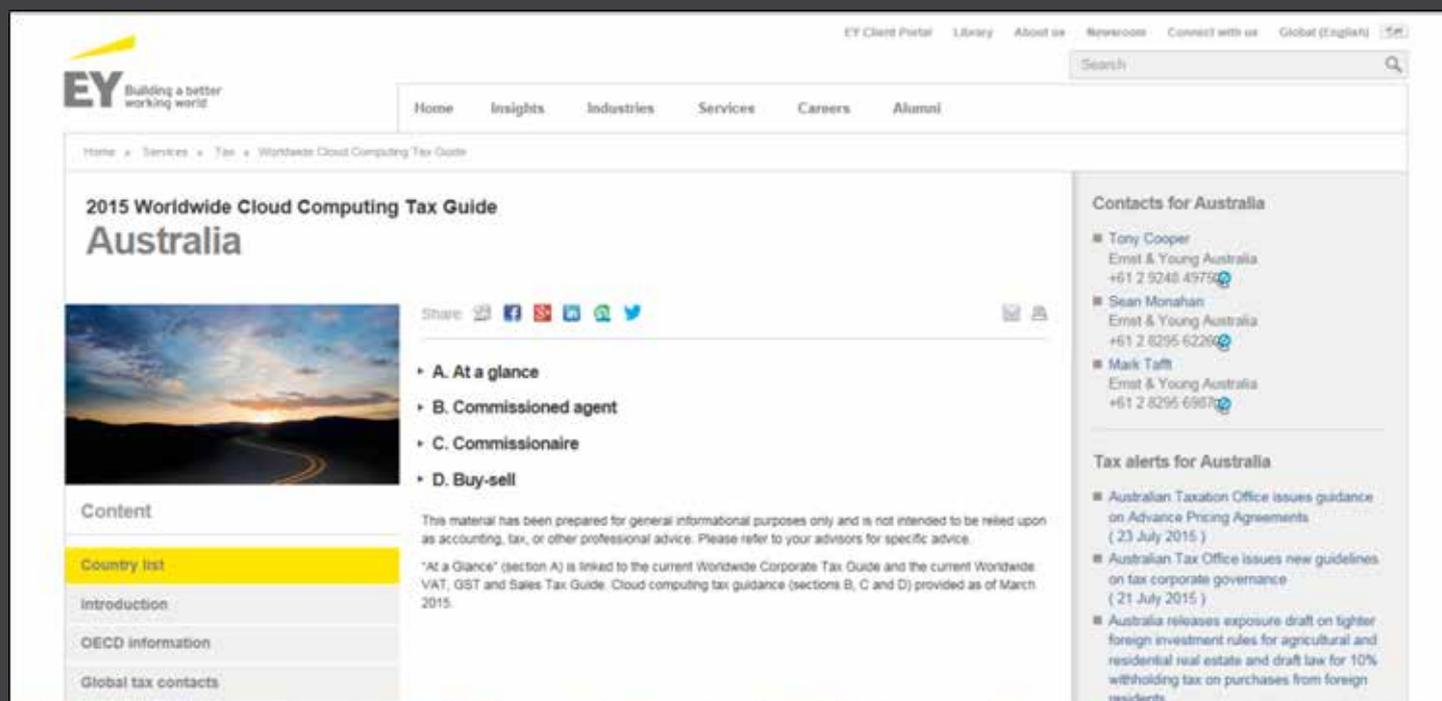
In the future, the exchange of information will also assume greater importance for “old” economy companies. The appetite of the respective countries for information does not by any means stop at companies that generate almost exclusively “digital” revenue. Conversely, the number of companies that do include some element of digital activity in their business is continuing to increase.

In addition, the exchange of information within the European Union will expand in the future, with proposed amendments to the EU Mutual Assistance Directive for the automatic exchange of tax rulings, as discussed on page 16 of this publication, coming into force as early as 2016.² According to the proposed amendments, rulings issued by the German tax authorities are to be submitted automatically to other Member States, despite the fact that the situation to which the application for a ruling relates frequently contains sensitive information such as trade secrets. As noted in the same article, Germany and the Netherlands also recently signed a Memorandum of Understanding to spontaneously exchange tax rulings regardless of the expected amendment to the EU Mutual Assistance Directive.

This development impacts all companies operating in more than one Member State of the European Union, regardless of sector or business model. For this reason, it is not just companies in the digital sector that should monitor developments relating to the exchange of information and the resulting consequences for their company.

² Though in all likelihood, this date will be delayed.

2015 Worldwide Cloud Computing Tax Guide



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Country articles

Australia's 2015-16 Federal Budget targets foreign multinationals

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On 12 May 2015, the Australian Treasurer delivered the 2015-16 Federal Budget. With Australia's tax revenue collections down significantly, the budget focuses on tax measures to enhance integrity and fairness of the tax system. The budget introduces a number of targeted measures impacting multinational enterprises (MNEs) operating in Australia:

- ▶ Measures to counter perceived tax avoidance by MNEs (draft law released)
- ▶ Measures designed to level the playing field for goods and services tax (GST) between offshore and local digital content providers (draft law released)
- ▶ Enhanced transfer pricing documentation requirements consistent with Organisation for Economic Co-operation Development (OECD) country-by-country reporting

New anti-avoidance measures for multinationals

The government has announced a change to the General Anti-avoidance Rule (Part IVA) to tackle perceived tax avoidance by MNEs. The draft law it has released has measures clearly directed at US technology companies but will require consideration by many other foreign enterprises operating in the Australian market. The new rules will affect global groups with annual revenue exceeding A\$1b based on accounting principles.

This change comes ahead of the conclusion of the OECD base erosion profit shifting (BEPS) projects and any recommendations for a globally coordinated response to the issue. It also precedes the conclusion of any of the high profile tax audits that the Australian Tax Office (ATO) has publicized in the technology sector. Since it has yet to be established whether foreign MNEs operating in Australia are, or are not, paying the right amount of tax, there are no revenue estimates of collections from this measure.

Importantly, the change does not create a new tax similar to the UK style Diverted Profits Tax. Although Part IVA can override Australia's various double tax treaty obligations, it appears that these new rules will operate within the existing framework of Australian tax law. Whether treaty protection will be available to protect against an assessment of tax will need further consideration.

The change raises many questions that hopefully will be clarified when the revised legislation is introduced into the Australian Parliament in September following public consultation to be followed by ATO published guidance.

GST on offshore supplies of digital products and services

The budget papers include draft law to level the playing field for GST around digital products and services sold in Australia by offshore suppliers. The draft law contains amendments to the GST law to make all supplies of things other than goods or real property connected with Australia subject to GST where they are made to an Australian consumer, generally an individual consumer that does not acquire the digital product or service in the course of carrying on an enterprise.

This change will result in supplies of digital products, such as streaming or downloading of movies, music, apps, games and e-books, as well as other services such as consultancy and professional services receiving similar GST treatment whether they are supplied by a local or foreign supplier.

In some circumstances, responsibility for GST liability that arises under the amendments may be shifted from the supplier to the operator of an electronic distribution service.

The draft law also amends the GST law to permit regulations to provide for a modified GST registration and remittance scheme for entities making supplies that are only connected with Australia.

Submissions on the draft law were due 7 July 2015.

Implementation of OECD country-by-country reporting (CbCR) transfer pricing documentation requirements

The government will implement documentation standards in line with OECD CbCR guidance. Large companies with global revenue of A\$1 billion or more that operate in Australia will have to provide the ATO for income years commencing on or after 1 January 2016 with the following:

- ▶ A country-by-country report showing information including global activities, location of income and taxes paid
- ▶ A master file containing an overview of the global business, organizational structure and transfer pricing policies
- ▶ A local file that provides detailed information about the local taxpayer's intercompany transactions

Administrative guidance including timelines and how this information will be shared with other revenue authorities will follow.

Cross-border supply of goods and services to Australia and New Zealand – the game has changed

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Currently, goods imported into Australia with a value of less than A\$1,000 are not subject to goods and services Tax (GST) or customs duty. At the recent meeting of the Council of Federal Financial Relations Tax Reform Workshop on 21 August 2015, Australia's State and Territory Treasurers unanimously agreed to reduce the low-value threshold for GST to nil with effect from 1 July 2017. The announcement does not specifically deal with the threshold for customs duty purposes, which may well stay in place at the current level.

The abolition of the low-value threshold follows in the wake of the government's announcement (on 11 May 2015) to seek to impose GST on offshore supplies of digital products and other services to Australian consumers, also from 1 July 2017. Together, these measures represent a significant shift in an attempt to tax imported goods and services consumed in Australia.

Under the proposed changes concerning digital products or other services, nonresident offshore suppliers (or in certain circumstances their intermediaries) with sales to Australian customers that exceed the GST turnover threshold of A\$75,000 per annum will be under an obligation to collect and remit GST to the Australian Taxation Office (ATO). Similarly nonresident offshore suppliers shipping goods to end-consumers in Australia also will be encouraged to collect and remit GST. The New Zealand (NZ) Government also has released a discussion draft looking at changes to the NZ GST on digital goods and services supplied by nonresidents to NZ consumers. In addition, they are considering reducing the importation threshold (currently NZ\$400) under which goods imported are not subject to GST. Nonresidents supplying goods, digital products or services directly to Australian consumers should start work now to consider how the proposed changes are likely to impact their operating models.

How the Australian model may work in practice

Collection of GST on cross-border supply of goods

There is no detail available on the exact administration and enforcement of these proposed changes, but overseas precedents exist.

In relation to importation of goods, Australia may adopt the UK model encouraging nonresidents to register. The Federal Treasurer has stated that he expects ATO personnel to visit overseas businesses making supplies directly to Australian consumers in order to encourage those businesses to register for Australian GST. It is anticipated that those would be large businesses shipping large numbers of goods to end-consumers in Australia.

Where nonresidents do not “volunteer” to register, goods will not be released until GST is paid by the consumer, plus likely an additional administration fee upon collection of the goods. The combination of the delayed delivery, the administration fee and the inconvenience to the customer will put pressure on overseas suppliers to register if they do wish to retain and grow their Australian customer base.

Collection of GST on cross-border supply of digital goods and services

The proposed taxation of cross-border supplies of digital goods and services relies upon a proposed vendor, or intermediary, registration model as the mechanism to collect the GST. Consistent with existing GST legislation, it is expected that only vendors with an Australian turnover of or exceeding A\$75,000 will be required to register, collect and remit GST.

Discussion document released in New Zealand

The New Zealand Government released a discussion document on 18 August containing proposals to require overseas suppliers to register and return GST when they sell “remote-services” to NZ consumers. “Remote-services” may include digital services that are typically electronically delivered (such as e-books, music videos), as well as more traditional cross-border services supplied remotely by a business offshore (such as professional advice). The registration requirement may also apply to intermediaries, who market and sell services on behalf of a nonresident supplier, considered to be “electronic marketplaces.” Draft legislation is expected later this year.

In addition, the NZ GST “de minimis” threshold on imported goods (typically goods below the value of NZ\$400 depending on duty levels) is also under review. However, no specific recommendations were made in the discussion document. Further detail is expected in October 2015.

Brazil's digital economy challenges

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Brazil has a very unusual tax system; approaches and transactions that may be applicable in other countries are not necessarily the best option considering the Brazilian reality. At its heart, the main challenge in Brazil is how to bring rules that work worldwide to our specific daily transactions.

Though Brazil is not an OECD country, its tax practitioners, both in the private and public sectors are connected to the evolving debate on BEPS. The government, for its part, is “fully on board” on such discussions as the OECD’s Pascal Saint-Amans has recently confirmed. Hopefully in the near future, Brazilian taxation can be better understood and adapted to the new global tax landscape.

Regarding the taxation of the digital economy, the principles underlined by the OECD such as neutrality, efficiency, certainty and simplicity, effectiveness and fairness and flexibility are also in need for Brazil. It is important to note that Brazilian authorities have shown growing concern regarding both internet regulation¹ and tax controls.²

¹ Law 12.965/2014 deals with principles to be observed in internet activities such as privacy as well as observance to users rights.

² An example of control is SISCOSERV where Brazilian corporate taxpayers importing or exporting should report such transactions. This also applies to transactions conducted abroad through a commercial presence abroad related to the Brazilian entity. This so-called “commercial presence abroad” encompasses transactions conducted through branches, subsidiaries and controlled entities of the Brazilian taxpayer. Law 12.546/2011 and Normative Instruction 1.277/2012.

Digital economy taxation in Brazil

Brazil has indirect taxes at the federal level (such as the manufacturing tax known as IPI), the state level (VAT on goods, transport and communication services – known as ICMS)³ and municipal levels (known as ISS, a tax on services where the services subject to taxation are on a specific list set out in legislation).

Brazil’s main debate regarding the digital economy is whether ICMS or ISS should be applied on software and whether such software should be classified as merchandise, service or right (license). In this sense, it is important to separate tailor-made software from shrink-wrapped software.

³ Electronic commerce has given rise to discussions and lawsuits regarding which Municipality should receive the ICMS as well as questioning of various State laws.

In relation to physical software, tailor-made software would be subject to ISS, as it is considered a service,⁴ while shrink-wrapped software would be subject to ICMS, due to its off-the-shelf nature. In this sense, the importation of tailor-made software would be subject to the import of service taxes,⁵ while importation of shrink-wrapped software would be subject to import of goods taxation.⁶

Downloadable software is also subject to controversy in Brazil, and different states have demonstrated conflicting behaviors regarding its taxation. The State of Rio de Janeiro, for example, does not usually levy ICMS on downloads, while the State of Mato Grosso taxes downloads such as those of computer programs. This taxation has been questioned in the Supreme Court,⁷ where a definite decision has not yet been given. We understand that until the Supreme Court has a final decision, this issue will remain controversial.

Another aspect to be taken into consideration relates to software licensing, where, according to a ruling by the federal tax authorities, a license is not a service, and therefore no PIS/COFINS⁸ would be applicable.⁹

Recent decisions/interpretations by tax authorities demonstrate the following:

- ▶ Cloud computing is considered a service by the Municipality of São Paulo¹⁰
- ▶ Data centers are considered services, and are therefore subject to service taxation¹¹
- ▶ According to the São Paulo Federal Court, under the Brazil – Argentina treaty, technical service fees should be remitted from Brazil to Argentina without withholding tax being applied¹²
- ▶ No withholding tax should be collected on remittances to France regarding the rendering of technical services¹³

However, notwithstanding the above mentioned recent decisions, the topic of digital economy is still very much under debate. Other issues attracting such debate include the tax treatment of music downloads and the revenue streams derived from the delivery of advertisements on internet pages.¹⁴ Both issues do not yet have definite decisions on tax treatment at the municipality level.

It is therefore important to understand that the debate in Brazil in relation to taxing the digital economy is still far from being resolved, and for business, a case-by-case analysis is therefore recommended before implementation of any transaction or structure.

⁴ Supreme Court rulings in appeals 176.626/SP and 199.464-9/SP.

⁵ WHT, ISS, PIS/COFINS and IOF, while CIDE is only applicable if there is a transfer of the source code. Note however that tax authorities' interpretation of withholding tax on cross-border service payment controversial in light of double tax treaties (ADI 5/14: Art. 12, 14 or 7).

⁶ Import Duty – II, IPI, PIS/COFINS and ICMS.

⁷ Appeal 1945/98 which has no definite decision yet relates to ISS or ICMS on downloads.

⁸ PIS and COFINS are federal taxes, collected either every month or every three months, on the gross revenue of legal entities.

⁹ Ruling COSIT 11/11. Note that these arguments could be used to exclude ISS but an injunction would be necessary.

¹⁰ Consultation 40/2013. There are some projects to add cloud computing to the ISS legislation.

¹¹ Interpretative Act 7/2014.

¹² Appeal 2015.03.00.001406-1/SP.

¹³ Consultation 153/2015.

¹⁴ In decision 27/2013, the Municipality of Sao Paulo states that the mere rental of advertisement space on an internet page is not subject to ISS. However, if there is a service rendered, there should be an ISS charge.

Digital sales into Germany – the withholding tax puzzle

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In many tax audits of German companies, withholding taxes on royalties and license fees have become a focus area, leading to significant additional taxes following the audit.

This increased scrutiny mainly results from a law change for years 2008 onward, according to which 6.25% of all royalty and license fee expenses should be treated as nondeductible for trade tax purposes.¹ Even though it took tax auditors a little while to become familiar with the new rules, it appears that some groups within the tax authority specifically trained their tax auditors in this area of law. The motivation for such training is quite clear: Findings in this area may lead to a “double-dip” for tax auditors – on the one hand they may lead to an increase of the trade tax payable (because of the partial nondeductibility) and on the other hand, they may also lead to an assessment of withholding taxes if royalties are paid to nonresidents because of a secondary liability of the entity paying the royalties.

Practical difficulties taxpayers are currently facing in Germany

Under German domestic law, a cross-border “payment in consideration for the temporary use of a right” or “payment for a transfer of know-how” should give rise to withholding taxes in a business-to-business (B2B) situation. Based on the prevailing view, business to consumer (B2C) transactions should not give rise to withholding taxes.

Taxpayers engaged in these types of transactions currently face considerable uncertainties resulting from their day-to-day activities. On the one hand, the tax technical classification of a payment continues to be addressed controversially in many tax audits, i.e., whether the payments should give rise to withholding tax at all under domestic law. Controversy exists as to whether payments for software should give rise to German source income and trigger withholding tax because they meet the aforementioned definition. The way the rule is currently worded under domestic law is extremely broad and does not necessarily allow for a distinction along the general guidelines of the OECD according to which the mere use of copyrighted content (e.g., software, publications, pictures and the like) should be outside the scope of the definition of royalties so that royalties should only be given if a customer can actually exploit the copyright (e.g., in the case of software: by modifying it, reproducing it, or publicly displaying it or distributing it).

The only published view of the tax authorities on software payments is very brief guidance released by the tax authority of Munich in 1998, which broadly states that payments for standardized software should not give rise to withholding taxes, whereas payments for customized software should give rise to a withholding obligation upon payment. Needless to say, this view is extremely challenging to apply in practice as there is no further guidance (i.e., definition) as to what constitutes standardized vs. customized software, and because it fails to address new activities, business models, etc., which have evolved over the past 17 years in this highly dynamic environment.

¹ An exception for royalties that are exclusively passed-through the respective entity without any right to use the license fees/royalties in the taxpayer’s own business applies. Payments in consideration for the transfer of know-how remain fully deductible.

Similar uncertainties arise in connection with payments for the transfer of know-how/digital content that may also give rise to withholding tax under domestic law. In many tax audits, cases dealing with payments for financial market data by external service providers have come to pass, where the tax auditors hold that the remuneration should be subject to withholding taxes under domestic law. Unlike in the case of other findings, the authorities are typically unable/unwilling to negotiate, and reach a compromise with taxpayers as these cases are viewed as "high-profile" cases within the tax administration that other taxpayers could take as a precedent.

In addition, procedural aspects of the German withholding tax rules often present German customers and their vendors with a complex situation. Under German domestic law, a customer may only refrain from levying withholding taxes (or withhold at a lower treaty/Directive rate) if the transaction was cleared with the Federal Tax Office (FTO) in advance, and the vendor has presented a valid withholding tax exemption certificate issued by the FTO before the payment is made. If such a situation does not exist, the customer of the nonresident vendor may be held secondarily liable for withholding taxes if the tax auditor successfully argues in a tax audit that a payment should give rise to withholding tax under domestic law. Such a withholding tax exemption certificate is specific to the contract under which the remuneration is paid and to the counterparty to the contract. Essentially, this means that a withholding tax exemption certificate has to be obtained for each contractual relationship that triggers withholding tax. Needless to say, in situations where a non-resident digital business has a large number of clients in Germany, obtaining withholding tax exemption certificates may be a huge challenge from a pure practical perspective.

Reaction of the tax authorities

With effect from 1 January 2014, taxpayers no longer remit withholding taxes for royalties paid to nonresidents to their local tax office, but to the FTO instead. In response to the ongoing technical discussions, the FTO has put the withholding tax treatment of payments for software and digital content on its agenda and has been working together with the Federal Ministry of Finance to try and find a practical solution for what is perceived by companies and their advisors to be an issue of increasing significance. It is now rumored that the German tax authorities intend to publish guidance on the withholding tax treatment of payments for software, cloud computing activities and database information. Unfortunately, the timing of such guidance remains unclear at present.

In the meantime, the FTO (which is also the competent authority issuing withholding tax exemption certificates) has started to take a reasonably liberal approach when issuing withholding tax exemption certificates. The FTO now issues exemption certificates in software and digital content cases without further examining whether the underlying payment actually gives rise to withholding taxes in the first place, in cases where (i) Germany would not have a right to tax the remuneration under the applicable tax treaty/Directive anyway and (ii) the treaty entitlement of the recipient is clear (and anti-treaty shopping rules are not an issue). Even though this practice does not address the issue that a withholding tax exemption certificate is needed for each contractual relationship, it makes life easier for nonresident vendors who have a handful of customers or distributors in Germany that request withholding tax exemption certificates to minimize their risk of secondary liability.

Actions for taxpayers to consider

If possible from a practical perspective, obtaining withholding tax exemption certificates is certainly the best option for nonresident vendors as well as their customers. If withholding tax exemption certificates are not an achievable option (e.g., because of the number of German customers), nonresident vendors should review whether they may be able to take other actions to address the increasing uncertainty resulting from the classification of the payments received from their German customers.

In very exceptional cases, it may be possible to discuss with the FTO whether there may be a possibility to issue a blanket withholding tax exemption certificate (typically any such agreement would require the consent of the Federal Ministry of Finance). If this is not an option, vendors may consider contractual agreements with their customers, shifting the financial risk to their customers to limit their own exposure or indeed to serve the German market through a German resident distribution entity and thus avoid the withholding tax obligation on customer payments completely.

Outlook

It remains to be seen whether the forthcoming guidance issued by the Federal Tax Office will provide for a practical solution to the currently existing tax technical and practical issues in selling software and digital content into Germany. While it should be possible to address the technical uncertainties mentioned above in the guidance, relief for the procedural difficulties may be harder to eliminate.

Given the clear definition of the process for treaty relief in German law, any fundamental change to this process making it easier to apply in cases where a non-resident has a large number of customers in Germany may require a future law change.

Greece retroactively repeals 26%-29% withholding tax on cross-border transactions

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On 14 August 2015, the Greek Parliament repealed the withholding tax adopted earlier this year on specific transactions between entities resident in Greece and entities resident in noncooperative countries or privileged tax regime countries (such countries include, among others, three EU Member States – Bulgaria, Ireland and Cyprus).

The repeal takes effect retrospectively as of 21 March 2015, the day the tax was enacted. Because the ministerial decision required for the tax to enter into force was never issued, in practice this withholding tax never applied.

The repealed provision had provided that in order for a taxpayer to deduct expenses from certain transactions, the taxpayer would be required to withhold and pay to the Greek State an amount equal to the income tax benefit corresponding to the deduction of such amount (the corporate income tax rate was 26% through tax year 2014 and is 29% for tax years starting 1 January 2015 and after). This repeal came, in part, as a reaction to the reasoned opinion issued on 3 August 2015 by the European Commission in favor of Bulgaria, which stated that the application of the Greek withholding tax would violate several principles of the Treaty on the Functioning of the European Union.

The repeal reinstates previous rules, under which the deduction of expenses paid to persons resident in noncooperative countries or privileged tax regime countries (other than Member States of the EU or the European Economic Area having an agreement with Greece providing for the exchange of tax information) requires the Greek taxpayer to evidence that such expenses relate to “real” and “common” transactions and are not driven by tax avoidance or tax evasion objectives.



Israeli Tax Authorities publish draft circular regarding internet activity of foreign companies in Israel

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The Israeli Tax Authorities (ITA) have published an important draft circular on the subject of services provided by foreign corporations to Israeli clients via the internet addressing the related income tax and value added tax (VAT) implications.

Regarding income tax, it is stipulated in the circular that the rules existing in the "old" economy regarding permanent establishment apply also to internet transactions. It should be noted, however, that the interpretation given in the circular is very broad, and its implications may be far-reaching as to effect the creation of permanent establishments outside the internet market as well.

Regarding VAT, the ITA categorically states that in a case where the advertiser and the consumer are both in Israel, there is an obligation to register for Israeli VAT, and related transactions should be subject to Israeli VAT. Here as well, the ITA's approach seems to touch upon issues that are much broader than the internet economy aspect.

Companies providing services to Israeli residents, and especially those with Israeli subsidiaries, should examine the circular's implications on their activity in Israel.

The ITA has recognized that in recent years, the global economy has undergone changes as a result of the ever expanding use of the internet. The internet "platform" has developed with increasing momentum in all areas of commerce and service provision and has come to provide the basis for what is known as the "digital economy." Transactions executed via the internet are conducted by multinational companies for Israeli clients, while the services or goods being provided are actually provided, directly or indirectly, by related Israeli companies and/or certain Israeli subcontractors.

According to Israeli tax law, the business income of a foreign corporation is subject to tax in Israel if it is generated in Israel. If the relevant corporation is resident in a treaty country, Israeli tax should be levied on that corporation's activity in Israel, only if said activity is considered to constitute a permanent establishment (PE) for that corporation, in accordance with its definition in double tax avoidance treaties. The ITA sensed that the reality of the digital economy provides a challenge in the application of traditional taxation methods, which causes the need for the reevaluated interpretation of these methods.

As such, the ITA issued a draft circular in which they lay out their view regarding the proper application of existing tax principles in order to expand and adapt these to fit the digital economy.

Income tax

In referencing the Organisation for Economic Co-operation and Development (OECD) Model Convention, the ITA states that a corporation may be deemed to have a PE in another country if it maintains a fixed place of business or a dependent agent in that other country.

Fixed place of business

While traditionally a fixed place of business may be determined via the placement of servers, in the digital economy, a PE may be established in Israel even in the absence of local servers.

In this respect, the ITA has given its opinion that in cases where a foreign corporation's core activity is conducted through the internet and some or all of certain terms (such as the internet site's connection with the Israeli market) are found to exist, that the corporation's activity should constitute a PE for the corporation.

The ITA goes further to state that, in accordance with the base erosion and profit shifting (BEPS) report regarding the digital economy, it may be adopted that corporations that have a "Significant Digital Presence" in Israel may be subject to tax in Israel on this activity. The ITA understands this term to generally mean that while a given corporation may have no physical presence in a certain location, it may be considered as having a PE if it has the digital presence necessary to maintain client relations and a close relationship with clients.

Dependent agent

In the digital economy, if the activity of foreign corporation service providers is carried out through related Israeli companies and/or other Israeli subcontractors, these service providers may be considered a dependent agent of the foreign corporation.

The ITA circular directs ITA officials to consider certain terms in this respect, such as the dependent agent's authority in different situations and in respect to certain transactions.

Profit allocation to the PE

Once the conclusion has been reached that a PE exists, the ITA stipulates in its circular that the approach of the 2010 OECD Report on the Attribution of Profits to Permanent Establishments should be adopted.

Issues to be implemented: separate reporting

In those cases where it may be decided that a foreign corporation's activity is managed via a PE, both the PE and the Israeli company (assuming one exists) should be required to file tax returns in Israel. These tax returns should be considered separately and as pertaining to separate entities in every regard.

VAT

Israeli VAT law views any service as provided in Israel if it is provided by one whose business is in Israel, one who has an agent or branch in Israel or if the service was provided to an Israeli resident or with respect to an asset located in Israel. Additionally, the Israeli VAT law requires such a business to register for VAT and, in the case of a foreign corporation, the appointment of an Israeli representative.

Additionally, if it has been established that a foreign corporation's services are provided in substantial part via the internet to Israeli clients and are connected to Israel, it may be claimed that the foreign corporation should be subject to the provisions of the Israeli VAT law. Such a claim may be established via certain parameters, such as the fact that the services are directed and aimed at Israeli consumers. The ITA also provides examples to this effect.

It is noted by the ITA, that a foreign corporation that provides internet services to Israeli clients, and if the corporation should register for Israeli VAT in accordance with this circular, this foreign corporation will not be considered a foreign resident for certain VAT issues. As such, an Israeli business conductor that sells an intangible asset or provides services to the foreign corporation, in relation to the foreign corporation's transactions that are liable to tax in Israel, will be subject to full VAT.

Japan's 2015 tax reform package applies consumption tax to cross-border digital services

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As a result of Japan's 2015 tax reform package, new consumption tax rules will apply to cross-border digital services provided by overseas businesses to the Japanese market, starting on 1 October 2015.

The Consumption Tax Basic Circular (i.e., the interpretation by the Japanese Tax Authorities) was partially updated on 26 May 2015 and the National Tax Agency issued a Consumption Tax on Cross-border Services Q&A on 3 June 2015. A Q&A pamphlet outlining the new rules was also released. This article focuses on the effects of the new consumption tax rules on overseas businesses that provide cross-border digital services to the Japanese market and introduces the main points of the Basic Circular revisions and the Q&A pamphlet.

Scope of services subject to the new rules

In the revised Basic Circular, the following services are presented as examples of digital services subject to the new rules. It should be noted that in addition to cloud services and the distribution of digital content or online advertisements, the downloading of software and the provision of consulting services and IT support services via the internet are also likely to be treated as digital services subject to the new rules. Businesses involved in cross-border e-commerce should review the revised Basic Circular and Q&A to confirm whether their services are subject to the new rules as digital services:

- ▶ Distribution of e-books via the internet
- ▶ Services allowing users to listen to music or watch videos via the internet

- ▶ Services allowing the use of software via the internet
- ▶ Services that provide other businesses with an online space to sell products
- ▶ Services that post online advertisements
- ▶ Continuous consulting services via phone or email

The Q&A also provides other examples of potential digital services, such as services that allow customers to use cloud-based software or databases; services that provide a cloud-based space to store electronic data; and online English lessons. The Q&A also provides the following examples of services that are not expected to be treated as digital services subject to the new rules:

- ▶ Usage of telephone, fax, telegram, data transmission or internet to transmit information between parties (telecommunication services)
- ▶ Software development: There may be cases in which a request is made to an overseas business to develop a piece of copyrighted work, for example software. The instructions are given via the internet and the deliverable is also received via the internet. If the use of the internet is incidental to the transaction (the development of copyrighted works), such services are not classified as provision of digital services.
- ▶ Management or investment of assets located overseas (including internet banking): The internet is used to give instructions, status reports, or results relating to the investment of assets or movement of funds. If the use of the internet is incidental to the transaction (the management or investment of assets), such services are not classified as provision of digital services. However,

for example, if the overall transaction generates separate usage fees for the use of cloud-based asset management software, such service portion would be classified as provision of digital services.

- ▶ **Data collection/analysis requested of a foreign business:** The internet is used to report the results of data collection or analysis based on the request of the recipient. If the use of internet is incidental to the transaction (the collection or analysis of data based on the request of the recipient), the services are not classified as provision of digital services. However, if a foreign business charges fees for the browsing or usage of data collected or analyzed by the foreign business itself (i.e., the data collection and analysis are not based on the request of another company), such transaction would be classified as provision of digital services.
- ▶ **Overseas litigation handled by overseas legal experts:** The internet is used to give instructions or status reports related to litigation. If the use of the internet is incidental to the transaction (the handling of overseas litigation), such services are not classified as a provision of digital services.
- ▶ **Transfer/licensing of copyright:** The owner of a copyright transfers or licenses copyrights to a business which will duplicate, screen or broadcast such copyrighted material. If the transfer and receipt of such copyrighted works is done via the internet and the use of the internet is incidental to the transaction (the transfer or licensing of copyrights), such services are not classified as provision of digital services.

The new rules will apply if recipients of digital services have either an address or their head office (or main office) in Japan. The new rules are therefore expected to apply when an overseas business provides digital services to the foreign branch of a Japanese corporation that has its address in Japan. It is also important to understand that foreign corporations with a branch in Japan are also covered under the definition of overseas business. When the Japanese branch of a foreign corporation provides digital services to a Japanese corporation including its foreign branch, the new rules are expected to apply.

Even with the release of the latest Basic Circular and Q&A, there are still many types of services where it may be difficult to judge whether their services are to be treated as digital. In such cases it is highly recommended that companies consult with your local tax authority or tax advisor far in advance of the effective date.

Mechanics of the new rules

Place-of-supply criteria for the provision of digital services

The place-of-supply will be determined based on whether the address of the recipient of digital services is in or outside of Japan. For example, in the case of services that allow the downloading of e-books, music, games, etc., via the internet, it is necessary to make an objective and rational assessment for each transaction, such as by cross-checking the address that the customer stated at the time of purchase with the country of issue of the credit card used to make the purchase.

Introduction of a reverse charge mechanism

With respect to the provision of Business-to-Business (B2B) digital services, a reverse charge mechanism will be implemented which shifts the obligation of paying consumption tax to the business receiving the B2B digital service. It is necessary to determine whether the service is classified as a B2B digital service based on the nature of the service (e.g., distribution of advertisements, provision of an online space to sell games or software).

When it is difficult to determine the classification based on the nature of the service, it is necessary to determine whether the contractual provisions (confirmed via contract, correspondence during the contract process, etc.) could classify the service as a B2B digital service (e.g., a cloud service).

An overseas business that provides B2B digital services has an obligation to inform, in advance, the domestic business which is the customer in the transaction that the reverse charge mechanism is applied to the B2B digital services. When the reverse charge mechanism is applied, the amount billed by the overseas business will not include consumption tax.

When a business receiving digital services has a taxable sales ratio of 95% or greater for the taxable period under regular consumption taxation, or when a business adopts the simplified consumption taxation for the taxable period, there is no current requirement to report the reverse charge consumption tax in the tax returns.

A reverse charge will only apply for businesses that have a taxable sales ratio of less than 95% for the taxable period under regular consumption taxation.

Limitations on input tax credits for B2C digital services performed by overseas businesses

As a provisional measure, input tax credits will not currently be available for businesses receiving business-to-consumer (B2C) digital services. However, input tax credits may be available for businesses receiving B2C digital services that are provided by a "registered overseas business" (see section below).

Digital services that are not classified as B2B digital services will be classified as B2C digital services. B2C digital services, for example, include the distribution of e-books, music and movies to consumers. If, for example, digital services are shown on the website of the overseas business as targeted only for businesses but the overseas business cannot restrict individual consumers from buying such services, such services are also treated as B2C services.

Based on the request of the customer, the registered overseas businesses have an obligation to issue invoices that state their overseas business registration number and notify the fact that they have an obligation to pay consumption tax on taxable sales of B2C digital services.

Input tax credits may only be applied when the business receiving B2C digital services keeps the invoices that include the registration number of the registered overseas business.

The establishment of the overseas business registration system

Overseas businesses that fulfill the following requirements may become registered overseas businesses by applying at the Commissioner of the National Tax Agency via the District Director of the Tax Office under whose jurisdiction such business falls. Information regarding such businesses, such as name, address or head office location, and registration number will be published on the National Tax Agency website. This will apply when:

- ▶ The overseas business is subject to consumption tax.
- ▶ The overseas business provides or plans to provide B2C digital services.
- ▶ The overseas business has an office in Japan that provides B2C digital services.
- ▶ If the overseas business has no office in Japan that provides B2C digital services described in c), the overseas business has designated a tax agent for consumption tax.
- ▶ If the overseas business has no office in Japan, the overseas business has designated a tax representative.
- ▶ The overseas business is not delinquent in the payment of national taxes.

Applications for registration will be accepted beginning 1 July 2015.

Actions and considerations

The new rules will apply to transactions conducted on or after 1 October 2015. As the new rules can have a significant impact on service provisions, it is advisable to promptly assess the current situation, the potential future consequences and to consider the necessary steps to prepare for the change. The following steps may be considered in that regard:

1. Confirm whether a transaction is affected by the new rules

- a) Is the transaction considered a provision of digital services?
- b) Is the digital service being provided to Japanese customers?
- c) If a) and b) apply, is the transaction based on an agreement concluded on or before 31 March 2015, and will it be considered a continuous provision of digital services both before and on or after 1 October 2015? A provisional measure applies in this case and the current (i.e., pre-revision) consumption tax law will apply to such service provisions until the end of the service contract term. (For example, agreements that are renewed each month will be considered as if a new agreement is concluded each month and will not be eligible for this provisional measure.)

2. Confirm the classification of a transaction

- a) Based on the nature of the service, can the recipients of the digital service normally be restricted to businesses?
- b) Based on the transaction terms, can the recipients of the digital service normally be restricted to businesses? (For example, if the contents of the digital service provision are separately negotiated and are part of an agreement concluded between the parties to such transaction, and it is clear that the recipient of the digital service will use the provided service as a business, the digital service will be considered B2B.)
- c) Can the online registration for the digital services by nonbusiness entities (consumers) realistically be restricted? (If not, the digital service will be considered B2C.)
- d) Regarding b), if negotiations are necessary, identify potential issues and negotiate and conclude/revise the agreements.

3. For overseas businesses that provide B2B digital services

- a) Assess obligation to state that a transaction is subject to reverse charge. (For example, when introducing the details of a transaction online or in documents presented at the time of negotiations regarding the transaction details, it is necessary to notify that the transaction is subject to reverse charge in a manner that makes it easy for the other party (service recipients) to understand that reverse charge applies.)
- b) Revise contents or forms of agreements (if necessary, refer to 2 b) and d).

4. For overseas businesses that provide B2C digital services

- a) Confirm whether there is a filing obligation by confirming past taxable sales amount and whether tax exemption for small businesses applies. (It should be noted that the provision of B2B digital services is excluded from taxable sales when considering the eligibility of the overseas business for the tax exemption for small businesses.)

- b) Registration as a registered overseas business. (In order for the overseas businesses to provide B2C digital services that are eligible for input tax credits at the level of domestic businesses, they must be registered as overseas businesses.)
- c) Select a tax representative
- d) Prepare tax returns and cash management of tax payments

5. Other points to consider

- a) Impact analysis of the new rules on the business
- b) Consider a price setting policy for transactions subject to the new rules
- c) Consider IT system compatibility with new processes necessary under the new rules

Robert B. Stack, Deputy Assistant Secretary (International Tax Affairs) at the US Treasury, discusses the progress made so far on, and the future of, the OECD's base erosion and profit shifting project

On the BEPS project generally

"I open with the fact that there's almost a paradox in BEPS is the way I see it because there can be no denying that the G-20 BEPS project has changed the landscape in international tax. On the other hand, in many respects, the US is extremely disappointed in the output and the collective failure to do more and to do better than we've done. When BEPS started, we at Treasury often noted that it's hard to imagine that anyone would have designed an international tax system in which large amounts of income were taxed nowhere. And we set out in good faith to work on that very real problem, that causes a lack of stability and also a lack of trust in the system around the world."

On country-by-country reporting

"We worked with the multinational community and we ended up with a template that companies can live with and also provides governments with the information that they think they need in order to do risk assessment, and with strong safeguards so that if countries misuse the information, and there is great worry they might, the United States under international law can suspend it."

On measuring the BEPS project's success

"When will we know that countries got enough money so they can kind of call off the BEPS dogs? More critically, how much revenue do they need to get according to what rules? Or do the rules even matter anymore? And if the rules don't matter, what is the role of a standard setting body, such as the OECD? Do we really need a standard setter to say "Tax administrators will use the pornography test of 'we know it when we see it' and 'we'll get you when we want to'?" If that's the environment we are in, do we really need a standard setting body to write that rule? I don't know the answer to these questions. And it struck me as I was preparing today, that they are kind of fundamental questions, and it's embarrassing at some level to not know the answer, but I don't."

On unilateral developments

“The UK diverted profits tax and similar proposals by Australia point in a disturbing direction, I think, with respect to these questions. Let me begin by noting that these approaches came not from India or China or Brazil or South Africa, the countries that one might traditionally consider the main proponents of the debate of source and residence. No, these rules are coming from strong traditional allies, traditional residence countries, where we know the political forces just described are potent. Now I don’t want to dwell on the weedy aspects of those rules, but I want to make a few observations that will inform our thinking about BEPS-related issues going forward. Boiled down to their essentials, and now I’m speaking essentially with respect to the “avoidance of permanent establishment” aspect of these regimes, these countries are shouting out loud that they do not believe they will get their estimation of what they deserve under either the current agreed rules or under any rules to come out of the BEPS process and they will be going their own way.”

“At the end of the day, that claim I think ran head on into conflict with domestic political pressure, austerity, and good old-fashioned national self-interest. Diverted profits taxes are stark reminders of the presence of those forces inside the OECD and beyond. There was, in fact, little appetite for fundamental change in the BEPS process.”

On permanent establishment

“When a company limits its activity in another jurisdiction so as not to have a PE in that jurisdiction, it is playing by the rules, and if countries want to change those rules, they’re free to seek to negotiate a new treaty with their partners. As you see, and as you’ll hear later in the panel, we’re not sure those discussions are as easy in a room with 40 countries, but at a minimum, you can go back to your partner and say you would like a new treaty. The UK DPT and the Australian Multinational Integrity Tax Avoidance Law both claim as a premise that a multinational can contrive to avoid the application of the PE rules by purposefully conducting activities outside the jurisdiction. Now let’s stop there for a moment because there’s an important point to make as the US. The US came into the BEPS project recognizing that certain activities in a country might be carried out in such a way to artificially circumvent the PE provisions. For example, we believe the use of commissionaires, fragmentation of activities, and splitting up of contracts can in certain circumstances run afoul of the purposes of the provision and of the convention. But the UK and Australian approaches turn PE on its head because they focus not on what happens in the country but what happens outside the jurisdiction. They ask whether what goes on outside the jurisdiction is relevant to determine their taxing rights. Further, in various ways, each jurisdiction is taking the view, that this assertion of taxing rights jurisdiction is not even reviewable in a MAP procedure, and the Australian use of GAAR in this respect is especially troubling, because it takes out of the MAP process something that is addressed squarely in the treaty: the PE rule.”

On moving forward

“We need to slow down the pace of this work substantially. Having the same number of meetings in 2016 as we did in 2012 is important to us, a good gauge, simply because we have competing priorities at Treasury and frankly cannot afford to have our resources commandeered by the OECD. Turning to substance, it’s critical that at the OECD, we do a much better job of highlighting the need for clarity and administrability in the rules we write. You know, as I wrote these words, I’m reminded of the parenting part of my life, where you repeat things over and over again until they utterly lose force and persuade or convince no one of anything, certainly not to take any action. Maybe I should come up with better words. But I will report that I have been personally shocked and appalled at the lack of attention clarity and administrability gets at the OECD and I think it’s motivated by the fact that tax administrators after all, the people sitting around me, like having whatever tools they can to go after taxpayers. It’s not an argument to say that large MNEs have gamed clear rules when we write them and that therefore they should be vague to have this constant *in terrorem* effect in the tax world. That means we’re not doing our job as tax policy folks. That is an abdication of our responsibility and deeply undermines the role of the OECD as a standard setting body as I said earlier.”

Robert B. Stack’s remarks were addressed to the June 10 OECD/US Council for International Business Tax Conference in Washington, DC, and were published by Tax Analysts.

New Zealand: GST to apply to cross-border supplies of services

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A New Zealand government discussion document released on 18 August 2015 seeks feedback on proposals for the collection of goods and services tax (GST) on online purchases of services and intangibles. It also discusses the collection of GST on low-value imported goods.

New Zealand Revenue Minister Todd McClay's *discussion document* also foreshadows future changes to the "de minimis" threshold on imported goods (typically goods below the value of NZ\$400). Although it is not expected that the GST will apply until 2016, businesses will need to prepare themselves ahead of the changes.

5 key areas for business to consider

1 Determining which digital products are subject to New Zealand GST

Businesses that supply digital products will need to identify the type of services subject to New Zealand GST.

The government proposes to collect GST on "remote services" – that is, services where it is not necessary for the supplier and customer to be in the same location when the services are supplied.

Lots of services will be included, both digital (for example online supply of digital content, digital data storage, and online gaming) as well as more traditional services, such as insurance, financial services, accounting and consultancy services.

We don't know yet whether the government will exclude business to business supplies of cross-border services. If it does, businesses that make supplies to GST registered customers will need to identify those registered customers. Customers who misrepresent themselves as registered persons may be required to register and account for GST or face penalties.

Further, the discussion document proposes that business customers who are charged GST by mistake are expected to seek refund directly from the overseas supplier. Businesses would not be able to claim GST back in their normal GST return. Under the current law, GST may be charged by nonresidents on services performed in New Zealand if certain conditions are satisfied. Therefore, businesses that acquire a range of services from abroad will need to ensure the GST treatment of the acquired services is correct before claiming it in their normal GST return.

2 Who has the responsibility to account for GST?

There are a number of parties within any supply chain. The discussion document has proposed that in some situations, an electronic marketplace or intermediary may be required to register instead of the principal offshore supplier.

An electronic marketplace will be expected to register if it:

- ▶ Authorizes the charge to the customer
- ▶ Authorizes the delivery to the customer

Or

- ▶ Sets the terms and conditions of the transaction

What happens if more than one intermediary finds itself with a GST liability on the same supply isn't yet clear. Given the uncertainty, you need to consider the legal, commercial and practical issues relating to your business's supply chain. You will need to consider GST legislation regarding intermediary supplies as part of this review. Otherwise there could be a nasty surprise about who is eventually held responsible for accounting for GST.

3 Where are your customers located?

Many nonresident suppliers will need to determine where consumers are located in order to account for the correct rate of GST.

In the digital world where services are increasingly mobile, this is not a simple task. The discussion document proposes to use objective proxies including the billing address, home address, IP address and bank details to determine the residency status of the customer.

Gathering customer information may sound like a straightforward commercial exercise, but there are practical questions to resolve. For example, which pieces of information do suppliers ask for? Will customers be willing to provide this information when it has not, to date, been a requirement of receiving the supplier's service? What happens if none of the information collected matches?

4 Who suffers the tax hit?

Businesses selling digital products will need to decide whether they are prepared to either take a margin hit or to vary their pricing. If you choose not to take the hit, then you must ask yourself a series of questions: how do we change our pricing? Do we increase prices for everyone and still have a single price? How elastic is the price of the goods/services that we are selling?

5 Business systems will need to change

From a system point of view, every site or app through which a company sells has to identify where each customer is based. Previously, some companies may have simply hard coded pricing into their website. However, a modern flexible pricing engine will be required to deal with dynamic pricing. Storing proof of a customer's location in a manner that complies with the record-keeping and privacy requirements needs to be considered. The tax engine and accounting system must be capable of calculating and filing New Zealand GST.

GST on low-value imported goods

The document also makes it clear that the collection of GST on low-value imported goods will change. We could have a lower threshold; we could end up with a different system. But no specific recommendations have been made.

Further details will be released after October 2015, when Customs is expected to report back to the government. We think there will be a consultation paper, specifically focusing on the GST treatment of low-value imported goods, before the government makes its final call.

Preparing for the GST changes is a great business opportunity

These GST changes will have a wide impact. They reach way beyond your company's tax function.

Meeting the challenge is not just a piece of compliance. It is an opportunity for your business, as a provider of digital services, to improve your pricing strategy, re-evaluate the markets in which you operate, work better with third parties, upgrade your systems and re-engage with your customers.

Tax teams in digital businesses face a unique challenge over the coming years. The pace of change in this industry, combined with evolving GST changes, means the cost of indirect tax compliance is likely to increase. Companies that provide e-services will need to be well prepared for these changes and act quickly to fully understand the implication for business.

Saudi Arabian tax authorities introduce Virtual Service PE concept

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Saudi Arabia's Department of Zakat and Income Tax (DZIT) recently changed its approach to the interpretation of the permanent establishment (PE) concept with respect to services rendered by nonresidents in the Kingdom of Saudi Arabia (the Kingdom). DZIT has introduced the concept of a "Virtual Service PE," which may result in the denial of the withholding tax (WHT) relief claimed by nonresidents under the applicable double tax treaties of the Kingdom.

DZIT's new approach is not in line with the Kingdom's Income Tax Law (ITL) and the PE concept outlined in the double tax treaties concluded by the Kingdom, as well as the Organisation for Economic Co-operation and Development (OECD) and the United Nations (UN) Model Conventions. Nevertheless, it will likely affect most multinational enterprises that have concluded or plan to conclude service arrangements with customers in the Kingdom. Taxpayers should carefully consider the matter in advance, taking into account the wording of tax indemnity clauses and other provisions of service agreements.

DZIT has issued internal guidelines for processing requests for WHT exemptions and refunds made by nonresidents having no legal registration, and consequently having no PE, in the Kingdom. Although these guidelines are not publicly available, EY is aware that the new approach was expressed by DZIT in several response letters to requests for WHT relief under the applicable double tax treaties signed by the Kingdom.

DZIT's guidelines provide a new interpretation of the Service PE concept, which takes into account only the duration of the contract itself, rather than the actual activities of the service provider in the Kingdom. In particular, DZIT introduces a "Virtual Service PE" concept, according to which a nonresident is deemed to have a PE in the Kingdom if the following conditions are met:

- ▶ A nonresident furnishes services to a person in connection with the latter's activity in the Kingdom
- ▶ The period during which such services are rendered according to the contract, exceeds the threshold period under the applicable tax treaty (most often the 183-day period threshold is used following the UN Model Convention)

DZIT's approach does not consider the physical presence of employees or contractors of a nonresident service provider for establishing the nexus to the source country, although such threshold condition is clearly provided by both the OECD and UN Model Conventions, and applied in many countries. Consequently, any work or services performed under cross-border agreements, which are concluded by a customer in the Kingdom with a nonresident for a period longer than the tax treaty threshold (e.g., 183 days) will, prima facie, create a Service PE in the Kingdom. This will be created even if employees of the former are not present there and perform their activities entirely offshore.

The new interpretation provided by DZIT is based on a few statements made by representatives of some developing countries during the 8th and 10th Session of the UN Committee of Experts for Tax Cooperation earlier in 2012 and 2014. According to the available public information on the hearings of the committee, those representatives expressed a view that when applying the concept of a Service PE in Article 5 (3) (b) of the UN Model Convention, the “physical presence” test is not required to be fulfilled.

Such conclusion is the result of an unusual interpretation of Article 5 (3) (b) of the UN Model Convention, which uses a term “furnishing” with respect to services, and not the term “rendering” or “performing.” In their view, “services furnished within the source country without the physical presence of personnel or employees in that country are covered by that provision if the furnishing of services within the country lasts more than 183 days or the threshold period in the applicable tax treaty.”¹

However, other representatives of the same committee of experts in both mentioned committee sessions did not support such viewpoint.

The majority of experts stated that such an interpretation would bring an unacceptable degree of uncertainty as to the proper meaning of the terms of the tax treaty and would frustrate their uniform understanding among the states. They also agreed that states insisting on such an interpretation must make it clear in the text of the bilateral treaties being concluded.

In addition, the committee expressed an intention that the next update of the UN Model Commentary will reinstate the traditional understanding of Article 5 (3) (b) “Service PE,” that the physical presence in the source state constitutes a prerequisite for creation of the PE in the source state. Finally, it is anticipated that the next update to the UN Model Commentary will also include the provision stating that no profits can be attributable to a PE as a result of activities performed outside of the PE state.

Implications

The immediate implication of the foregoing is that, as a result of the issued guidelines, the applicability of tax treaty-based WHT exemptions or refunds with respect to cross-border services has become highly uncertain.

It is questionable whether the guidelines are in line with the legislation as currently enacted, and one may question whether they represent a type of “treaty override” through a unilateral interpretation of tax treaty terms. The majority of the double tax treaties of the Kingdom contain a so-called Service PE provision: a PE is deemed to exist if a service provider furnishes services in a source state for a period or periods aggregating more than the threshold period under the applicable tax treaty. Under the literal interpretation of the provision, the physical presence of the service provider in the Kingdom is required. However, under the new interpretation provided by DZIT, it is not necessary, effectively removing the required PE threshold for similar projects.

Both foreign service providers and their customers in the Kingdom, who order services from nonresidents, should be prepared to face challenges when seeking advance exemption or filing refund applications from WHT on payments for technical and consulting services payments to nonresidents in tax treaty situations.

Some of the local customers could be reasonably expected to be on a safer side and apply the domestic WHT rate when making payments to nonresidents for their work or services provided, leaving the latter to deal with a tax refund vis-à-vis DZIT. Following the guidelines has become quite an onerous issue.

In practice and over time, several customary contractual legal remedies that could protect the financial interests of foreign suppliers of services in case of foreign WHTs being applied by the local counterparty or government have been developed. These include tax indemnity (gross-up) clauses and other provisions. Such provisions become increasingly important in the context of mentioned changes.

¹ or whichever is the threshold period in the applicable tax treaty.

South Korea applies VAT to electronic services provided by foreign service providers

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Effective 1 July 2015, the Republic of Korea's (Korea) revised Value Added Tax Law (VATL) requires a foreign service provider to register for and charge VAT on the supply of electronic services to customers in Korea.

Electronic service means the supply of: (1) games, audio, video files, electronic documents or software, or similar items that are processed by optical or electronic means and produced or modified in the form of codes, letters, audio, and video, and any similar items; and (2) the upgrade of such electronic products or services.

Registration requirement

The registration requirement applies to a foreign service provider who provides electronic services directly to its Korean customers without or through a permanent establishment (PE) in Korea. The registration is made with the Korean National Tax Service (NTS) in a simplified way through the NTS website¹ within 20 days from the date of business commencement.²

Compliance

A registered foreign service provider must file VAT returns and pay VAT on a quarterly basis. The due date of filing is on or before the 25th day, following a quarter-end month. The foreign service provider is not required to issue a VAT invoice.

However, if the electronic services to Korean customers are provided through an open market (e.g., open market app stores) or an intermediary agent for payment, the foreign service provider is no longer treated

as a supplier of the services since it is shifted to the open market or intermediary. Accordingly, the foreign service provider is not subject to the VAT requirements.

Implications

While this VAT regime seems to have been introduced for open market business operated for business to consumer services but would exclude a case where a nonresident or foreign corporation provides electronic services to businesses of a Korean entrepreneur.

Since no detailed guideline on the scope of covered services is yet issued, the term "software" may be interpreted very broadly. As a result, most information technology (IT) services could be covered by the new VAT regime for electronic services, which may significantly affect foreign IT businesses that provide electronic services to Korean customers.

Because the foreign service provider subject to the VAT regime is not required to issue a VAT invoice, it is unclear how Korean customers would be able claim the input VAT charged by the service provider.

Further clarification for the above issues is expected in the form of subordinate law by the Ministry of Strategy and Finance (MOSF). Foreign IT companies or group IT service providers may be significantly affected by this new VAT regime; accordingly, they may consider providing comments to the MOSF or seeking a tax ruling if subsequent provisions issued by the MOSF are still unclear.

¹ [https:// www.hometax.go.kr/](https://www.hometax.go.kr/).

² If the first day of business commencement is prior to 1 July 2015, the registration must be completed by 20 July 2015.

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EYG no. DL1485
1508-1593740
ED None

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