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Taxing the digital economy

Lack of international consensus creates vacuum of uncertainty

Commerce is increasingly digital. Yet, the global tax system is still geared to the needs of a traditional 'bricks and mortar' economy. The OECD's Base Erosion and Profit Sharing (BEPS) Action Plan recognises the need for modernisation and has achieved quite a lot since the issue of its reports in October 2015. However, specific recommendations on digital taxation have been limited and the OECD's calls for an international consensus on the way forward have so far been unheeded.

Individual countries are filling the vacuum with their own varied set of tax measures, which continues to create uncertainty and heightens the risk and complexity of tax management for multinational enterprises (MNEs). And while it's the internet giants that the media and tax authorities have in their sights, it's also small and mid-size MNEs that are likely to bear the brunt of the changes and face the greatest challenges in managing them.

So, what's coming up on the horizon and how can your business deal with the implications?

Can the tax authorities keep up?

One-click and a product is on its way. Yet in the age of digitisation and globalisation, the product could be coming from a country anywhere in the world. Traditional definitions of products and services are also being challenged, with market disruptors finding new ways to deliver traditional offerings.

In addition, the ways in which 'value' is defined, generated and exchanged are also changing in areas such as the use of data analytics in customer profiling, targeted advertising and the development of customised products and services. A business can thus make significant amounts of money and build up sizeable market share without maintaining a physical presence within a given jurisdiction (eg web hosting or e-commerce transactions).

Yet, businesses still tend to be taxed where they have a physical rather than virtual presence and taxation continues to be built on traditional product and service lines. The digital economy also heightens the challenges of attributing and transferring costs and returns along the OECD-defined development, enhancement, maintenance, protection and exploitation (DEMPE) lifecycle of intellectual property and other intangible assets. The situation is further complicated by the fact that the sources of customer insight and resulting value might be obtained for free (eg 'like' clicks or interactive gamification), yet may still represent a source of cross-border value exchange.

“ A failure of the tax system to keep pace with changes in the economy has a knock-on impact on traditional businesses”

Implications

Both businesses and tax authorities are finding it difficult to define where value creation occurs and how to align that with traditional taxing standards.

Many tax authorities believe that they're missing out on significant amounts of tax from digital businesses that operate in their jurisdiction, but don't have the physical presence and hence permanent establishment status under current rules. Most have been playing catch-up in response, tweaking their creaking legislation, rather than engaging in a fundamental rethink of how to bring tax policies up to date.

Alongside the loss of tax, a failure of the tax system to keep pace with changes in the economy has a knock-on impact on traditional businesses. For example, 'bricks and mortar' retailers may be at a significant disadvantage when competing with their potentially lighter taxed online counterparts.

While taxing the digital economy is often portrayed as a game of cat and mouse between tax authorities and the internet giants, this is an issue for virtually every business, large and small. Thousands of the businesses that conduct cross-border trade directly over the internet or through marketplaces such as eBay, Amazon or Alibaba are small or mid-size enterprises. Add to that digital marketers, web hosting platforms and other remote operations, and the list of companies that are caught up in the current uncertainty over how digital business should be taxed becomes longer still. Even a company that doesn't engage in business to consumer e-commerce is likely to be using and drawing value from digital interactions.

For tax authorities, this vast and fragmented universe is virtually impossible to oversee in its entirety and a lot of value exchange goes under the radar. As we're already seeing, there are also risks for businesses, including a challenge to their non-physical/non-taxable status and resulting investigation and double taxation.

Actions

Think about where and how you create value within an increasingly digital economy, how this maps against your transfer pricing and profit attribution and the extent to which you might be at risk of challenge from the different tax authorities where you operate, virtually as well as physically.

The unstable new frontier of taxation

The digital economy is the new frontier of taxation. Yet, the OECD BEPS Action 1, 'Addressing the tax challenges of the digital economy' offers little in the way of specific guidance beyond asking its member states to come together to 'establish international coherence in corporate income taxation'. For example, Action 1 doesn't specify what would constitute a taxable presence (nexus). This international consensus hasn't yet materialised. Why?

1. No obligation
   In part, the slow response reflects the need to prioritise what is a long list of BEPS Actions. Action 1 is not one of the binding minimum standards included in the BEPS Inclusive Framework, which is most countries' initial focus.

2. Competing for revenues
   It's also a question of who benefits. Jurisdictions that already have access to the digital tax base are reluctant to share it, creating a difficult to resolve 'tug of war' internationally (eg the US versus the European Union (EU)).

3. Fundamental questions still need to be addressed
   Even if a commitment to consensus could be forged, a number of fundamental questions need to be addressed before agreement can be reached. These include how to build digital commerce into permanent establishment criteria and how revenues should be attributed. Other key questions include whether digital businesses should be treated separately for tax purposes or as part of an updated common framework applying to all businesses. While some, including the tax authorities in the US, argue that special treatment would create an uneven playing field and miss an opportunity for more fundamental modernisation, others might see it as redressing some of the potential tax advantages enjoyed by digital businesses.

Tax can be taxing

Although taxing, the difficulties of securing an international consensus on digital taxation doesn't mean that the issue can be ignored. Not only are individual states taking matters into their own hands, but tax issues surrounding the digital economy are being drawn into wider reforms.

1 Going it alone

With no prospect of imminent international agreement, many jurisdictions are coming up with their own rules. Examples already include India's equalisation levy on online advertising revenue earned by non-resident companies. In Australia and New Zealand, businesses selling to customers online now must register for goods and services tax (GST), while Singapore intends to adopt similar rules from 2020.

2 Targeting digital tax revenues

The EU has gone further through its proposed 'Fair taxation of the digital economy'.[1] In a key contribution to the debate over whether or not to apply specific tax rules for digital businesses, the proposals for the short-term include levying a 3% tax on gross revenue from digital services.

It remains to be seen whether the EU proposals will win backing from all member states, and in the meantime, some countries are going it alone. Italy has announced a 'web tax' and Spain is the latest to propose a 'digital services tax'. The UK has yet to make a move, but has proposed that 'user-generated value' should be recognised. These moves face pushback, especially from the US. Nonetheless, the radical nature of this framework demonstrates the readiness of tax authorities to press their case for what they see as their rightful share of the tax take. And while tax authorities are looking at a range of options to enable them to target digital business more effectively, it may not necessarily require changes in legislation and new technology to make this possible. The definition of physical presence may be broadened, for example (see following section).

3 Legal challenge

A number of high profile and hotly disputed cases highlight the extent to which tax authorities are seeking to regain revenues in the courts. What could be more significant in the long run are a number of recent legal rulings relating to cross-border digital businesses. These are broadening the scope of what constitutes a physical presence. For example, a court in India has ruled that MasterCard Singapore's remote operations in India constitute a permanent establishment.[2] Further landmark rulings include the Wayfair case in the US,[3] as part of which Wayfair Inc has been deemed to have established a nexus in South Dakota despite only operating remotely in the state and is hence liable to collect GST. Both rulings are being studied closely by businesses in similar positions to see whether their non-taxable status is still valid.

4 Influencing key reforms

The tax issues relating to the digital economy have a significant influence on the interpretation and implementation of the BEPS Action Plan in areas that could give rise to double taxation. These include transfer pricing, the attribution of profits and the permanent establishment criteria that cut across them.

While international consensus takes time, there are opportunities to agree bilateral and multilateral deals through the Multilateral Convention (MLI).[4] For example, we could see regional governments or countries with comparable economies coming together to create common rules. However, it's important to note that a number of countries, including the US, have not signed up for the MLI, and others have reserved their positions.

5 Added impetus for the shift from direct to indirect taxation

Questions over how to tax the digital economy are also one of the drivers for the shift from direct to indirect taxation and a related move from tax at source to taxing at destination. The OECD makes specific reference to the digital economy and BEPS Action 1 in its guidance on the collection of value-added tax (VAT/GST) on cross-border services.[5]

[1] www.ec.europa.eu – Fair Taxation of the Digital Economy

[2] www.grantthornton.in – MasterCard Singapore's India operations constitute permanent establishment – 29 June 2018

[3] www.grantthornton.com – Wayfair ruling overturns Quill physical presence requirement – 25 June 2018

[4] www.oecd.org – Multilateral Convention to Implement Tax Treaty Related Measures to Prevent BEPS

[5] www.oecd.org – OECD delivers implementation guidance for collection of value-added taxes (VAT/GST) on cross-border sales

Implications

Businesses face uncertainty, complexity and upheaval ahead.

While the details differ, the overall direction of travel would appear to be a move away from a physical presence as the defining feature of a taxable nexus towards an economic presence, which could be virtual.

If, as is likely, the shift to indirect taxation continues, this could have implications for the definition of goods and services, including those that are being reshaped by the digital economy. It could also accelerate moves towards real-time taxation.

Moreover, the questions over how to attribute profits and whether to treat digital services and digital businesses differently from the rest of the economy will eventually have to be settled.

Governments recognise the need to generate tax revenues without stifling digital innovation. They are therefore consulting widely. The larger MNEs are already lobbying hard and gearing up for the changes ahead. Mid-size MNEs will also feel the impact, yet may have less resources to lobby, prepare and adapt their operations.

Actions

Determine whether the permanent establishment status of your various operations, physical and virtual, are still valid as a result of legal rulings and local changes in tax rules. You may need to register in some new jurisdictions as a result and address issues relating to tax compliance and management. The big risk is being caught on the back foot.

The changes to the taxation of digital business should form part of a wider review of whether your current tax management is fit for purpose. The review should look at both upcoming developments and the possible scenarios ahead. Are your current structures still compliant and efficient? How would the move to a destination tax affect your liabilities? What are the implications for your business and operating model? How would you capture transactions within your supply chain that may now or eventually become liable for tax? With the taxation of digital business so fluid and so many moving parts to take into consideration, clear scenario planning and the ability to respond quickly and flexibly are key.

Lobby governments and tax authorities for a fair and workable approach. Stronger lobbying would help to make sure the legitimate interests and concerns of mid-sized MNEs are not drowned out by the political clamour over taxing larger groups.

As we've explored in previous articles in our Future of tax series, if the economy is becoming more digitised, there are opportunities to make tax management more digitally-enabled and efficient. These include greater use of automation and artificial intelligence to not only accelerate turnaround and reduce costs and risks, but also strengthen analytical capabilities and free up tax professionals to play a more up-front role in strategic management.[6] It also includes moving to real-time tax evaluation through the use of blockchain distributed ledgers.[7] The potential benefits include greater visibility of data and earlier identification of threats and opportunities, the insights from which would help shift tax from a cost to a profit centre. Digital connectivity would also allow your business to engage more transparently with tax authorities, with the payback being greater certainty over liabilities.[8]

Rather than looking at what technological tools are becoming available, it's better to focus on the big picture issues of where tax is heading, how this impacts on your operating and business models and what is your strategic response. You can then judge what tools and organisational changes would help you to get where you want to be most effectively.

[6] www.grantthornton.global/insights – Seizing opportunities with tax automation – 26 June 2017

[7] www.grantthornton.global/insights – Taxation in real-time: Gearing up for blockchain – 11 January 2018

[8] www.grantthornton.global/insights – Tax transparency – Steering through the new world – 12 July 2017

Taxing virtual currency commerce

Virtual currency is used as both a means of exchange and an investment in its own right. Being relatively new and developing at a rapid pace, it is incredibly challenging for legislators to keep their regulation up to date.

Approaches to taxation vary. Some countries such as Singapore and Germany treat virtual currency like any other currency. The value of goods exchanged in virtual currency is converted to local currency for tax purposes.

Others such as Australia, the Netherlands[9] and the US treat virtual currency as an asset or a commodity in its own right, and tax it accordingly. Increases in the value of the coin are treated as capital gains and profits from exchange like share trading. With the value of Bitcoin, the world's best known virtual currency, having shot up over the past year, the taxable gains could be considerable. The challenges are compounded by how much the value can fluctuate on a single day, including a specific tax date.

We asked the tax partners in our member firms across the globe about how their jurisdiction is dealing with taxing digital currencies. Our research shows that many countries have yet to adopt any specific legislation and in some countries digital currencies are not legalised or are even banned.

Further challenges include how to tax initial coin offerings (ICOs), the rate of which is likely to increase as banks and governments move to 'mint' their own virtual currencies. New Zealand is something of a pioneer in establishing specific tax guidelines for ICOs.

Eventually, as tax is managed in real-time and blockchain becomes increasingly important within tax reporting, record-keeping and collection, virtual currency could become a primary source of payment. This will certainly be an area to watch with developments on the horizon.

Has your jurisdiction issued any guidelines or enacted any legisligation on the tax treatment of ICOs (Initial Coin Offerings)?

Has your jurisdiction issued any guidelines or enacted any legisligation on the tax treatment of cryptocurrencies and the resulting profits/gains?

[9] www.grantthornton.nl – Bitcoin hits $10,000, what about cryptocurrency and taxes? – 29 November 2017

Up to speed

While the international consensus on taxation of digital revenues has yet to materialise, taxing the digital economy is very much a live issue and can't be ignored.

Legislative change is coming faster and faster. While some governments are looking towards fundamental reform, others are adopting a 'sticky plaster' approach, which can only heighten complexity.

It's important to judge whether your tax arrangements, including where you are registered for tax and how your attribute revenues are still valid and fit for purpose. At the same time, there are opportunities to digitise tax management in line with the increasing digitisation of your business.

It's also important to consider the impact of these tax developments on your operating model. What are the risks? Is your business flexible enough to respond to change?

Just as the economy is evolving at an unprecedented pace, tax can't stand still for ever. That's why it's so important to lobby for fair, consistent and workable rules on digital commerce, both now and as reforms come through in the future.

Clearly, these developments and their impact on business strategies and operations open up significant challenges. Yet, the ability to deal with these multifaceted challenges creates opportunities for tax functions to add more value to the business as a consequence have a positive impact on their status and influence within the organisation.

If you would like to discuss any of the areas raised in this article, please contact your local Grant Thornton adviser or one of the contacts listed.

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