Skadden

Skadden, Arps, Slate, Meagher & Flom LLP
& Affiliates

If you have any questions regarding the matters discussed in this memorandum, please contact the following attorneys or call your regular Skadden contact.

Paul W. Oosterhuis
Washington, D.C.
+1.202.371.7130
paul.oosterhuis@skadden.com

Hal Hicks
Washington, D.C.
+1.202.371.7290
hal.hicks@skadden.com

Tim Sanders
London
+44.20.7519.7039
tim.sanders@skadden.com

James Anderson
London
+44.20.7519.7060
james.anderson@skadden.com

David F. Levy
Chicago
+1.312.407.0831
david.levy@skadden.com

Chris Hutley-Hurst
London
+44.20.7519.7176
chris.hutley-hurst@skadden.com

Jonathon Egerton-Peters
London
+44.20.7519.7159
jonathon.egerton-peters@skadden.com

Nathan W. Giesselman
Palo Alto
+1.650.470.3182
nathan.giesselman@skadden.com

* * *

This memorandum is provided by Skadden, Arps, Slate, Meagher & Flom LLP and its affiliates for educational and informational purposes only and is not intended and should not be construed as legal advice. This memorandum is considered advertising under applicable state laws.

Four Times Square, New York, NY 10036
Telephone: +1.212.735.3000

WWW.SKADDEN.COM

March 27, 2014

OECD Draft Report: The Digital Economy and Its Tax Challenges

On March 24, 2014, the Organisation for Economic Co-operation and Development (OECD) published a discussion draft report on the tax challenges facing the digital economy (the DE Report). This draft report is issued in connection with the deliverables pledged under the OECD's Action Plan on Base Erosion and Profit Shifting (BEPS).

Against a background of analysis on how information and communication technology (ICT) has evolved, how it may continue to evolve and how it has impacted the digital economy and given rise to a number of evolving business models (such as consumer-to-consumer e-commerce and app store models), the DE Report identifies a number tax challenges raised by the digital economy and potential options to address those challenges.

The tax challenges identified in the DE Report relate to four key areas:

- Nexus — ICT allows a business to have a significant presence in a country without either being liable to tax in that country because of a lack of sufficient physical presence, or being liable to a small amount of tax because of a limited low-profit generating physical presence;
- Valuable data creation — ICT allows a business to generate marketable location-relevant data through the use of digital products and services in a particular country. While this data creates value for the business, it may be that little to no profit is attributed to the country from which the data was gathered;
- Characterization of income derived from new business models — payments arising from new business models do not always readily fit into a particular class of income or profits for domestic or treaty purposes. For example, payments for cloud computing could be classified as royalties (and therefore be subject to withholding tax subject to any applicable treaty) or business profits (and therefore generally, at least where there is an applicable treaty, only be subject to tax in a country to the extent they are attributable to a permanent establishment (PE));
- VAT collection — consumers' increasing ability to buy products and services from businesses all over the world presents VAT collection issues. The two main issues are:
  - Low-value consignment relief — for administrative and cost reasons, many countries that have VAT do not charge it on the import of goods below a certain threshold. This allows online retailers selling goods that fall below the threshold to establish themselves offshore and sell goods into a country without attracting VAT, which often gives these retailers a competitive advantage over their competitors in that country; and
  - Remote digital sales to consumers — because of the strong growth of cross-border business to consumer digital sales, businesses established outside a particular country can sell digital products and services to consumers

in that country, but the country may have limited means to enforce VAT compliance by the business. Any mechanism to collect VAT direct from the consumer would create administrative and cost burdens.

The OECD's view (which recently was stated in similar terms by the U.K.) is that ring-fencing the digital economy as a separate sector and applying specific tax rules to it would be neither appropriate nor feasible. The options that are proposed by the DE Report are therefore meant to apply to businesses generally, although there is a clear focus on businesses that operate within the digital economy. The options proposed in the DE Report are:

- Modifications to PE rules to remove certain exceptions from PE status, generally relating to activities of a preparatory or auxiliary nature, such as those fixed places of business used solely for warehousing goods or data collection. There are a range of options, from eliminating the exceptions altogether to making them subject to the condition that the activities are not core activities of the business. Such modifications could mean that an online retailer that maintains only a storage warehouse in a particular country to facilitate delivery of products brought in from outside that country could become subject to tax in that country;

- Creation of a new taxable nexus based on "significant digital presence" in a country, rather than physical presence in that country, for businesses that engage in "fully dematerialized digital services." A number of elements for these concepts are proposed. For example, a business could have a "significant digital presence" in a country where its digital products or services are widely used, or where the business does a significant business in the country using personal data obtained by the regular and systematic monitoring of Internet users in that country; and elements of "fully dematerialized digital services" could include payments made solely via credit cards or other electronic payments through the business's website, or lack of involvement of physical products in providing the digital product or service, other than a computer, mobile device or other information technology tools;

- Creation of a "virtual PE" in a country by having a server located in that country ("virtual fixed place of business PE"), habitual conclusion of contracts through technological means with persons located in that country ("virtual agency PE") or economic presence in that country in circumstances in which the business provides on-site services or other business interface at the customer's location ("on-site business presence PE");

- Introduction of a final withholding tax on payments made by consumers for digital products and services sold by an e-commerce provider from outside the country of the consumer. The withholding tax would be collected by the financial institutions that process the consumer payments;

- Lower thresholds for VAT low-value consignment relief; and

- Requirement that suppliers of digital products and services register and account for VAT in the countries in which their consumers are located, even if the supplier is not located in that country.

The proposed options are not exhaustive and further options may be included in the OECD's final report, which is expected to contain an in-depth analysis of the pros and cons of the various options.

The deadline for comments on the discussion draft of the DE Report is April 14, 2014 and a public consultation will be held on April 23, 2014.

Background

The development of ICT has caused business models and consumer habits to change significantly over the years. While some businesses always have been able to sell products and services into a country without having a physical presence, ICT has increased the scope for businesses to do so significantly.

These evolved business models and consumer habits generally are subject to a framework of tax rules that did not envisage them, so the application of these somewhat dated rules means that certain tax "gaps" arise. In particular, existing PE rules are based on the assumption that a business generally will have a physical presence in a jurisdiction where it trades, whereas developments in ICT mean that such physical presence is not required.

Comment

It generally was viewed as inevitable that the OECD would propose material amendments to the PE concept, as original PE rules never envisaged digital economy business models. PE status is an area that countries likely will want to amend to bring businesses that sell to consumers within a particular country within that country's charge to tax. France already has started that process. However, there will be significant potential for disagreement on implementation of the OECD's PE proposals between technology exporting or development jurisdictions and "consumer" jurisdictions, particularly as treaty rules once implemented likely will dictate that both jurisdictions need to avoid double taxing their resident businesses' income.

Moreover, as the proposals apply to all businesses, and not just the obvious digital economy participants, the proposals will have far-reaching implications. For example, the potential elimination of the PE exception for preparatory or auxiliary activities could mean that nondigital businesses, such as retailers who sell via catalogues and maintain only a warehouse in a particular country, have a PE in that country. It also could mean that the electronic delivery of a blueprint to a consumer's 3D printer (a transaction that involves no warehouse or physical supply line) potentially creates a PE in the country where the printer is located. Further, the proposed revised PE concepts, and the new proposed "significant digital presence" concept, could impact on co-location trading by high frequency hedge funds, as well as television and radio advertisers, that have no significant local presence in a particular country.

The proposed final withholding tax is concerning as it will place burdens on the financial institutions that process the payments to levy and account for the withholding. This is likely to increase compliance costs for a group of taxpayers that already are subject to an increasing level of costly tax compliance.

From a VAT perspective, the DE Report highlights two sensible proposals that countries can consider. In 2012, the U.K. repealed low-value consignment relief on goods imported from the Channel Islands, a measure which was expected to raise approximately an additional £95m for the U.K. exchequer each year. Countries wishing to take action to reduce or repeal low-value consignment will have to consider the increased tax collection costs.

The proposal that suppliers of digital products and services register and account for VAT in the countries in which their consumers are located is probably the most readily workable solution for the indirect taxation of the digital economy. EU member states currently adopt this approach for digital products and services supplied by non-EU suppliers and will move to this VAT model from

January 1, 2015, for digital products and services supplied made by EU suppliers (putting EU and non-EU suppliers of digital products and services on an equal footing). To reduce administrative burdens for businesses, the EU is working on a "one-stop shop" whereby a business registers for VAT in only one EU member state, and accounts for all the VAT arising in other EU member states to that home state for onward payment. Recognizing that the EU has shown this proposal to work, the OECD appears to favor this as the most viable option for VAT generally on digital products and services.

It should be noted that, separate from the OECD's work in relation to BEPS, the EU Commission has set up an expert group to review and report on the taxation of the digital economy. This group's work is being carried out in parallel to the OECD's, and there is collaboration between the two institutions with the aim of ensuring a coherent and complementary approach to digital taxation at the EU and international level.

About Skadden's Global Tax Controversy and International Tax Practices

Skadden's Global Tax Controversy Practice combines the skills of experienced tax practitioners and dispute resolution lawyers. The group provides its clients with tactical and technical advice to ensure that tax disputes and investigations are resolved as effectively as possible through various methods such as negotiation, expert determination, or a hearing before the tribunals or the courts. The group also provides preventative advice allowing clients to ensure that their tax affairs are legally compliant with a view to avoiding lengthy and costly disputes. Members of the group are named as leading tax controversy lawyers in *International Tax Review*'s 2013 Tax Controversy Leaders Guide.

The firm's International Tax Group has extensive experience in strategic tax planning and tax implementation issues associated with multijurisdictional, cross-border transactions. With tax attorneys resident in the United States, France, Germany and the United Kingdom, the firm is capable of providing advice in various jurisdictions on a multitude of issues. We are one of the few international law firms that provides a combination of both domestic and cross-border tax advice within the major European jurisdictions. For those jurisdictions in Europe in which we do not have attorneys resident or licensed, we have established a network of local counsel to whom we refer matters.