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**Tax consequences of the digitalized economy — issues of
relevance for developing countries**

The digitalized economy: selected issues of potential relevance to developing countries

Note by the Secretariat

I. Introduction

1. The present note aims to summarize some of the unilateral measures taken by countries around the world, since the beginning of the Organization for Economic Cooperation and Development (OECD) base erosion and profit shifting project, in an attempt to adapt their domestic tax systems to the new cross-border business models which use cutting-edge technology to circumvent the need to establish a taxable presence in the country where profits arise or where a consumer market is located.

2. The term “unilateral action” refers to any one-sided attempt to capture “rents” deriving from a digital activity (i.e. through the application of direct and indirect taxes) without engaging in the renegotiation of a bilateral tax treaty or consulting with other countries. It is characterized by the adoption of new tax laws or the reinterpretation of existing domestic laws or treaty provisions to adapt to an increasingly digitalized and globalized way of doing business. It is a bottom-up approach initiated by countries, as opposed to the top-down approach of OECD, which in its 2015 report on the digital economy announced its decision to continue work on the topic and produce a final report in 2020.¹ Some involved in the OECD digital economy work prefer the term “digitalized” to “digital” in this context, reflecting the view that there is no distinct digital economy, but rather the global

* E/C.18/2017/4.

¹ OECD, *Addressing the Tax Challenges of the Digital Economy, Action 1: 2015 Final Report* (Paris, October 2015), p. 138, para. 361. Available from <http://dx.doi.org/10.1787/9789264241046-en>.



economy as a whole has been digitalized.² The use of the term “digital economy” in the present note should not be seen as a rejection of that proposition.

3. Interestingly, developed countries were the first to initiate legislation-based reform that would allow for the admission of unilateral actions to address the challenges of the digital economy. However, over time, some developing countries have picked up on that trend and have issued similar legislation.

4. The unilateral actions described in section II below are those of Australia, China, France, India, Israel, Italy and the United Kingdom of Great Britain and Northern Ireland. They can be divided into: (a) value added tax (VAT)-based measures, based on the geographical location of the consumer market; (b) presumed allocation of profits to a domestic jurisdiction (either by making use of a presumed permanent establishment approach as in the United Kingdom and Australian examples, or by requiring taxpayers to register in the country as a result of their digital presence); (c) taxes on the use of the country’s digital infrastructure (as in India’s equalization levy); and (d) transfer pricing-related measures (where transfer pricing rules are reformed to take into account the location of the consumer market, as in the Italian example). A further form of unilateral measure might be the application of border taxes to account for the digital activity, as in the recent tax reform proposal in the United States of America, although that is not referenced in any of the examples below.

5. Developing countries have the most to gain from the introduction of policies aiming to address the digital economy. For one, unilateral actions driven by the digital economy have greater emphasis on withholding-based structures, be they based on VAT, goods and services tax, income or profit, allowing countries to increase their revenue collection abilities through the mere “ownership” of a consumer market or a digital infrastructure. That is particularly interesting for countries with large consumer markets or countries facing a lag in development, because it attributes to the source country the right to tax without the need for physical presence.

6. A further argument is that this new way of doing business might lead countries to want to reinterpret or add on to the existing concept of permanent establishment (perhaps through the creation of a “digital permanent establishment”, following the example of article 12A, referring to fees for technical services, in the new version of the United Nations Model Double Taxation Convention between Developed and Developing Countries). This would require revision of the United Nations Model Convention, and is a question that developing countries may want to debate under the aegis of the United Nations, even if also discussed in other forums. The Committee of Experts on International Cooperation in Tax Matters is still widely regarded as the only body in the world where developed and developing countries have equal standing in the development of tax policy norms. The Committee of Experts would therefore provide an environment in which developing countries, and least developed countries in particular, could enjoy equal standing in analysing issues related to the regulation of unilateral actions in view of the demands of the digital economy and the rationalization of the concept of permanent establishment in the light of the unilateral developments. Developing rules that are fit for purpose for all nations is to the benefit of all stakeholders in tax systems.

² See, for example, <https://ion.icaew.com/taxfaculty/b/weblog/posts/oecdbepswebcastanupdateonprogress?Redirected=true>. The BEPS Monitoring Group addressed the difference between the use of the terms “digital” and “digitalized” in its response to the 2014 OECD public discussion draft of *Addressing the Tax Challenges of the Digital Economy, Action 1* (see <https://bepsmonitoringgroup.wordpress.com/2014/04/>, commenting on www.oecd.org/ctp/tax-challenges-digital-economy-discussion-draft-march-2014.pdf).

7. This topic is timely, and should be discussed now in the light of the unilateral measures introduced by countries across the world. These measures are only made possible by the lack of a common framework to regulate the distribution and allocation of taxing rights between countries. The result is to the benefit of some, but to the detriment of most, in particular those who are most fragile and least developed.

8. The present note does not provide an exhaustive list of examples; it merely aims to reflect the practices adopted by some countries, for purposes of illustration. Further work on the subject may be required if, for example, the Committee decides to create a subcommittee on the digital economy.

II. Country examples

Australia

9. Australia introduced the tax integrity multinational anti-avoidance law, which took effect on 1 January 2016.³ Although the legislation was not specifically directed to the digital market, the reform is said to have targeted multinational companies generating sales in the country by running local initiatives but remotely concluding contracts with customers.⁴

China

10. China has been implementing reforms on both the corporate income tax level and the VAT level. The Ministry of Finance, the State Administration of Taxation and the General Administration of Customs jointly issued a notice on 24 March 2016 concerning the tax policy on cross-border retail e-commerce. According to the notice, the import of retail goods through e-commerce (i.e. business-to-consumer) is subject to customs duty, VAT and consumption tax. The price of the transaction, including the price of the goods, freight charges and insurance premiums, forms the tax base. The e-commerce enterprise, platform or logistics enterprise can act as a withholding tax agent.⁵

France

11. According to a French proposal,⁶ a permanent establishment is deemed to exist when Internet user data are collected in a domestic market.

India

12. India's 2016 finance bill introduced an equalization levy.⁷ The tax includes a surtax of 6 per cent levied on payments to foreign companies for online advertising services when those companies do not hold a permanent establishment in India. The Indian resident taxpayer has the obligation to withhold the tax upon remittance of

³ Tax Laws Amendment (Tax Integrity Multinational Anti-avoidance Law) Bill 2015, The Parliament of the Commonwealth of Australia, 2015.

⁴ EY, *Global Digital Tax Developments Review*, April 2016, available from [www.ey.com/Publication/vwLUAssets/ey-global-digital-tax-developments-review/\\$FILE/ey-global-digital-tax-developments-review.pdf](http://www.ey.com/Publication/vwLUAssets/ey-global-digital-tax-developments-review/$FILE/ey-global-digital-tax-developments-review.pdf).

⁵ IBFD, "Tax policy on cross-border retail e-commerce clarified", 31 March 2016.

⁶ O. Popa, "Taxation of the digital economy in selected countries — early echoes of BEPS and EU initiatives", *European Taxation*, vol. 55, No. 1 (2016).

⁷ Central Board of Direct Taxes, Department of Revenue, Ministry of Finance, Government of India, "Proposal for equalization levy on specified transactions", report of the Committee on Taxation of E-Commerce (February 2016). Available from www.incometaxindia.gov.in/news/report-of-committee-on-taxation-of-e-commerce-feb-2016.pdf.

the payment abroad.⁸ The equalization levy was the response of the Government of India to the OECD report of October 2015 on the tax challenges of the digital economy⁹ and follows one of the reform options that OECD had discussed but not recommended in that report.¹⁰

Israel

13. In April 2016, Israel issued a circular regarding the taxation of foreign companies providing services in Israel through the Internet.¹¹ The circular emphasizes that income of foreign digital providers of services and goods to Israeli residents should be taxed even if they have no physical presence in Israel under the “conventional rules” (referring to the OECD report of October 2015⁹ on the tax challenges of the digital economy).¹² An amendment to the VAT legislation was also under discussion according to the circular.

Italy

14. Italy is discussing a proposal to modify its transfer pricing legislation and to apply a withholding tax on intermediates, also referred to as a “web tax”. The goal of the proposed legislation is to stipulate the use of valuation techniques other than cost-based indicators for determining the arm’s-length prices of digital transactions.¹³ The web tax, if accepted, will impose withholding taxes at source and modify the permanent establishment status by introducing a minimum threshold of revenues and costs test for multinational enterprises with a presence in Italy.¹⁴

United Kingdom

15. The Financial Act of 2015¹⁵ enacted the diverted profits tax in United Kingdom legislation. The regulation provides that all profits found to be “diverted” will be taxed at 25 per cent. Profits are deemed to be “diverted” where a non-United Kingdom company seeks to avoid trading through a United Kingdom permanent establishment and where a United Kingdom company enters into an intragroup transaction lacking “economic substance” which results in an effective tax mismatch.

III. Conclusion

16. As well put by Michael Devereux, the proliferation of a variety of uncoordinated measures implemented within the existing framework is unlikely to provide a long-term satisfactory solution to the challenges to the tax system

⁸ Marcel Olbert and Christoph Spengel, “International taxation in the digital economy: challenge accepted?”, *World Tax Journal*, vol. 9, No. 1 (2017), pp. 3-46. Available from www.ibfd.org/sites/ibfd.org/files/content/img/product/april_ppv_wtj_2017_01_int_4_international_taxation.pdf.

⁹ <http://dx.doi.org/10.1787/9789264241046-en>.

¹⁰ Manoj Kumar Singh, “Taxation of digital economy: an Indian perspective”, *Intertax*, vol. 45, No.6 (2017), pp. 467-481.

¹¹ Circular 4/2016 (available in Hebrew only).

¹² IBFD, “Taxation of foreign digital companies — circular issued”, 12 April 2016. Available from <http://taxinsights.ey.com/archive/archive-news/israel--taxation-of-foreign-digital-companies---circular-issued.aspx>.

¹³ G. Gallo, “Italy — budget law for 2014 — details” (News IBFD, 7 January 2014).

¹⁴ Marco Allena, *The Web Tax and Taxation of the Sharing Economy: Challenges for Italy*, *European Taxation*, vol. 57, No. 7 (2017).

¹⁵ The Financial Act 2015, United Kingdom, chap. 11, part 3.

presented by digitalization.¹⁶ For this reason, it is important to have an open debate regarding the options available for countries to deal with taxation of the digital economy in a treaty context, using a pre-defined framework that would increase governments' tax collection abilities while also being beneficial for business and the taxpayer.

¹⁶ Michael Devereux and John Vella, "Implications of digitalization for international corporate tax reform" (to be published).