Executive summary

Action 1 of the base erosion and profit shifting (BEPS) Action Plan deals with the tax challenges of the Digital Economy. Political leaders, media outlets, and civil society around the world have expressed growing concern about tax planning by multinational enterprises that makes use of gaps in the interaction of different tax systems to artificially reduce taxable income or shift profits to low-tax jurisdictions in which little or no economic activity is performed. In response to this concern, and at the request of the G20, the Organisation for Economic Co-operation and Development (OECD) published an *Action Plan on Base Erosion and Profit Shifting* (BEPS Action Plan, OECD, 2013) in July 2013. Action 1 of the BEPS Action Plan calls for work to address the tax challenges of the digital economy. The Task Force on the Digital Economy (TFDE), a subsidiary body of the Committee on Fiscal Affairs (CFA) in which non-OECD G20 countries participate as Associates on an equal footing with OECD member countries, was established in September 2013 to develop a report identifying issues raised by the digital economy and detailed options to address them by September 2014. The Task Force consulted extensively with stakeholders and analysed written input submitted by business, civil society, academics, and developing countries before reaching its conclusions regarding the digital economy, the BEPS issues and the broader tax challenges it raises, and the recommended next steps.

A. The digital economy, its business models, and its key features

The digital economy is the result of a transformative process brought by information and communication technology (ICT). The ICT revolution has made technologies cheaper, more powerful, and widely standardised, improving business processes and bolstering innovation across all sectors of the economy. For example, *retailers* allow customers to place online orders and are able to gather and analyse customer data to provide personalised service and advertising; the *logistics* sector has been transformed by the ability to track of vehicles and cargo across continents; *financial services* providers increasingly enable customers to manage their finances, conduct transactions and access new products on line; in *manufacturing*, the digital economy has enhanced the ability to remotely monitor production processes and to control and use robots; in the *education* sector, universities, tutoring services and other education service providers are able to provide courses remotely, which enables them to tap into global demand; in the *healthcare* sector, the digital economy is enabling remote diagnosis and the use of health records to enhance system efficiencies and patient experience. The *broadcasting and media industry* have been revolutionised, expanding the role in news media of non-traditional news sources, and expanding user participation in media through user-generated content and social networking.

Because the digital economy is increasingly becoming the economy itself, it would be difficult, if not impossible, to ring-fence the digital economy from the rest of the economy for tax purposes. Attempting to isolate the digital economy as a separate sector would inevitably require arbitrary lines to be drawn between what is digital and what is not. As a result, the tax challenges and BEPS concerns raised by the digital economy are better identified and addressed by analysing existing structures adopted by multinational enterprises (MNEs) together with new business models and by focusing on the key features of the digital economy and determining which of those features raise or exacerbate tax challenges or BEPS concerns. Although many digital economy business models have parallels in traditional business, modern advances in ICT have made it possible to conduct many types of business at substantially greater scale and over longer distances than was previously possible. These include several varieties of e-commerce, online payment services, app stores, online advertising, cloud computing, participative networked platforms, and high-speed trading.

The digital economy is in a continuous state of evolution and possible future developments need to be monitored to evaluate their impact on tax systems. The rapid technological progress that has characterised the digital economy has led to a number of emerging trends and potential developments. Although this rapid change makes it difficult to predict future developments with any degree of reliability, these potential developments should be monitored closely as they may generate additional challenges for tax policy makers in the near future. These developments include the *Internet of Things*, referring to the dramatic increase in networked devices; *virtual currencies*, including bitcoin; developments in *advanced robotics and 3D printing*, which have the potential to bring manufacturing closer to consumers, altering where and how value is created within manufacturing supply chains, as well as the characterisation of business income; the *sharing economy* which allows peer-to-peer sharing of goods and services; increased *access to government data*, which has the potential to improve accountability and performance, and to allow participation of third parties in government business; and *reinforced protection of personal data,* which is more widely available in the digital economy.

The digital economy and its business models present some key features which are potentially relevant from a tax perspective. These features include *mobility*, with respect to *(i)* the intangibles on which the digital economy relies heavily, *(ii)* users, and *(iii)* business functions; *reliance on data*, the massive use of which has been facilitated by an increase in computing power and storage capacity and a decrease in data storage cost; *network effects*, which refer to the fact that decisions of users may have a direct impact on the benefit received by other users; *the spread of multi-sided business models*, in which multiple distinct groups of persons interact through an intermediary or platform, and the decisions of each group of persons affect the outcome for the other groups of persons through a positive or negative externality; *tendency toward monopoly or oligopoly* in certain business models relying heavily on network effects; and *volatility* due to lower barriers to entry into markets and rapidly evolving technology, as well as the speed with which customers can choose to adopt new products and services at the expense of older ones.

The digital economy has also accelerated and changed the spread of global value chains in which MNEs integrate their worldwide operations. In the past, it was common for an MNE group to establish a subsidiary in each country in which it did business to manage the group's business in that country. This structure was dictated by a number of factors, including slow communications, currency exchange rules, customs duties, and relatively high transportation costs that made integrated global supply chains difficult to operate. Advances in ICT, reductions in many currency and custom barriers, and the move to digital products and a service-based economy, however, combined to break down barriers to integration, allowing MNE groups to operate much more as global firms. This integration has made it easier for business to adopt global business models that centralise functions at a regional or global level, rather than at a country-by-country level. Even for small and medium enterprises (SMEs), it has now become possible to be "micro-multinationals" that operate and have personnel in multiple countries and continents. ICT technologies have been instrumental in this major trend, which was further exacerbated by the fact that many of the major digital companies are young and were designed from the beginning to operate on an integrated basis at a global scale.

B. BEPS issues in the digital economy and how to address them

While the digital economy does not generate unique BEPS issues, some of its key features exacerbate BEPS risks. The Task Force discussed a number of tax and legal structures that can be used to implement business models in the digital economy. These structures highlight existing opportunities to achieve BEPS to reduce or eliminate tax in jurisdictions across the whole supply chain, including both market and residence countries. For example, the importance of intangibles in the context of the digital economy, combined with the mobility of intangibles for tax purposes under existing tax rules, generates substantial BEPS opportunities in the area of direct taxes. Further, the ability to centralise infrastructure at a distance from a market jurisdiction and conduct substantial sales of goods and services into that market from a remote location, combined with increasing ability to conduct substantial activity with minimal use of personnel, generates potential opportunities to achieve BEPS by fragmenting physical operations to avoid taxation. Some of the key characteristics of the digital economy also exacerbate risks of BEPS in the context of indirect taxation, in particular in relation to businesses that perform value added tax (VAT) exempt activities (exempt businesses).

These BEPS risks are being addressed in the context of the BEPS Project, which will align taxation with economic activities and value creation. Structures aimed at artificially shifting profits to locations where they are taxed at more favourable rates, or not taxed at all, will be addressed by ongoing work in the context of the BEPS Project. This will help restore taxing rights at the level of both the market jurisdiction and the jurisdiction of the ultimate parent company. Taxation in the market jurisdiction should be restored by preventing treaty abuse (Action 6, due by September 2014) and preventing the artificial avoidance of PE Status (Action 7, due by September 2015). Taxation in the ultimate residence jurisdiction should be restored by strengthening controlled foreign company (CFC) rules (Action 3, due by September 2015). Both market and residence taxation should be restored by neutralising the effects of hybrid mismatch arrangements (Action 2, due by September 2014), by limiting the base erosion via interest deductions and other financial payments (Action 4, due by September 2015), by countering harmful tax practices more effectively (Action 5, due by September 2014 and 2015), and by assuring that transfer pricing outcomes are in line with value creation (Actions 8-10, due by September 2015). In the context of VAT, under certain conditions opportunities for tax planning by businesses and corresponding BEPS concerns for governments may arise to the extent that the OECD's Guidelines on place of taxation for business-to-business (B2B) supplies of services and intangibles are not implemented.

Work on the BEPS Project also must examine a number of issues specifically linked to the digital economy, its business models and its key features. The Task Force has identified certain specific issues generated by the key features of the digital economy that warrant attention from a tax perspective. Work on the actions of the BEPS Action Plan will take these issues into account to ensure that the proposed solutions fully address BEPS in the digital economy. These include:

- **Ensuring that core activities cannot inappropriately benefit from the exception from permanent establishment (PE) status, and that artificial arrangements relating to sales of goods and**

services cannot be used to avoid PE status. The work on Action 7 (preventing the artificial avoidance of PE Status) should consider whether certain activities that were previously considered preparatory or auxiliary for the purposes of these exceptions may be increasingly significant components of businesses in the digital economy. If so, the work should also consider the circumstances under which such activities may be considered core activities and whether a reasonable, administrable rule to this effect can be developed. For example, that work should consider whether and under what circumstances the maintenance of a local warehouse may constitute a core activity such that it should be outside the scope of the exceptions in Article 5 of the OECD Model Tax Convention. In addition to broader tax challenges, these issues raise BEPS concerns when the lack of taxation in the market country is coupled with techniques that reduce or eliminate tax in the country of the recipient or of the ultimate parent. The work would also consider whether and how the definition of PE may need to be modified 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. This would be relevant where, for instance, an online seller of tangible products or an online provider of advertising services uses the sales force of a local subsidiary to negotiate and effectively conclude sales with prospective large clients.

- **The importance of intangibles, the use of data, and the spread of global value chains, and their impact on transfer pricing**: Companies in the digital economy rely heavily on intangibles in creating value and producing income. A key feature of many BEPS structures adopted by participants in the digital economy involves the transfer of intangibles or rights to intangibles to tax-advantaged locations. Further, it is then often argued 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. Often this is accomplished by arguing that other entities in the group are contractually insulated from risk so that a low-tax affiliate is entitled to all residual income after compensating other low risk group members for their functions even if this affiliate has no capacity to control the risk. In addition to the existing transfer pricing guidelines, the BEPS work in the area of transfer pricing should take these issues in account and also consider the relationship between that work and the heavy reliance on collection, analysis and monetisation of data that characterises many companies in the digital economy. In addition, work in this area should devote attention to the implications of the increased integration of MNEs and the spread of global value chains, in which various stages of production are spread across multiple countries. In this context, the work should evaluate the need for greater reliance on functional analyses (assets used, functions performed, and risks assumed) and on value chain analyses and should also address situations where comparables are not available because of the structures designed by taxpayers and the unique intangibles involved. In specific situations the functional analysis may show that the use of profit split methods or valuation techniques (e.g. discounted cash flow method) is appropriate. For these situations, it would be helpful to provide simpler and clearer guidance on the application of transfer pricing methods, including profit splits in the context of global value chains.

- **The possible need to adapt CFC rules to the digital economy**: Although CFC rules vary significantly from jurisdiction to jurisdiction, income from digital products 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. Accordingly, a multinational enterprise in a digital business can earn income in a CFC in a low-tax jurisdiction by locating key intangibles there and using those intangibles to sell digital goods and services without that income being subject to current tax, even if the CFC itself does not perform significant activities in its jurisdiction. In developing recommendations regarding the design of CFC rules, consideration should be given to CFC rules that target income typically earned in the digital economy, such as income earned from the remote sale of digital goods and services.
- **Addressing opportunities for tax planning by businesses engaged in VAT-exempt activities**: The digitisation of the economy has greatly facilitated the ability of businesses to acquire a wide range of services and intangibles from suppliers in other jurisdictions around the world and to structure their operations in a truly global manner. These developments have allowed exempt businesses to avoid or minimise the amount of unrecoverable VAT they incur on the inputs used for their exempt activities. The implementation of Guidelines 2 and 4 of the OECD's International VAT/GST Guidelines on place of taxation for B2B supplies of services and intangibles will minimise BEPS opportunities for supplies of remotely delivered services made to exempt businesses, including exempt entities that operate through establishments ("branches") in multiple jurisdictions.

C. Broader tax policy challenges raised by the digital economy

The digital economy also raises broader tax challenges for policy makers. These challenges relate in particular to nexus, data, and characterisation for direct tax purposes. These challenges trigger more systemic questions about the ability of the current international tax framework to deal with the changes brought about by the digital economy and the business models that it makes possible and hence to ensure that profits are taxed in the jurisdiction where economic activities occur and where value is generated. They therefore have a broad impact and relate primarily to the allocation of taxing rights among different jurisdictions. These challenges also raise questions regarding the paradigm used to determine where economic activities are carried out and value is generated for tax purposes, which is based on an analysis of the functions, assets and risks involved. At the same time, when these challenges create opportunities for achieving double non-taxation, for example due to the lack of nexus in the market country under current rules coupled with lack of taxation in the jurisdiction of the income recipient and of that of the ultimate parent company, they also generate BEPS issues. In addition, in the area of indirect taxes, the digital economy raises policy challenges regarding the collection of VAT.

The challenges related to nexus, data and characterisation overlap with each other to a certain extent. Although the challenges related to direct tax are distinct in nature, they often overlap with each other. For example, the collection of data from users located in a jurisdiction may trigger questions regarding whether that activity should give rise to nexus with that jurisdiction and regarding how data should be treated for tax purposes.

Evolving ways of carrying on business raise questions about whether current nexus rules continue to be appropriate. The continual increase in the potential of digital technologies and the reduced need in many cases for extensive physical presence in order to carry on business in a jurisdiction, combined with the increasing role of network effects generated by customer interactions, raise questions as to whether rules that rely on physical presence continue to be appropriate. The number of firms carrying out business transactions over the Internet has increased dramatically over the last decade. According to estimates, the size of total worldwide e-commerce, when global B2B and consumer transactions are added together, equalled USD 16 trillion in 2013.

Increasing reliance on data collection and analysis, and the growing importance of multi-sided business models raise questions about valuation of data, nexus, and profit attribution, as well as characterisation. The appropriate allocation of taxable income among locations in which economic activities take place and value is created may not always be clear in the digital economy, particularly in cases where users and customers become an important component of the value chain, for example in relation to multi-sided business models and the sharing economy. The growth in sophistication of information technologies has permitted companies in the digital economy to gather and use information to an unprecedented degree. This raises the issues of how to attribute value created from the generation of data through digital products and services, whether remote collection of data should give rise to nexus for tax purposes, and of ownership and how to characterise for tax purposes a person or entity's supply of data in a transaction, for example, as a free supply of a good, as a barter transaction, or some other way.

The development of new business models raises questions regarding characterisation of income. The development of new digital products or means of delivering services creates uncertainties in relation to the proper characterisation of payments made in the context of new business models, particularly in relation to cloud computing. Further, to the extent that 3D printing becomes increasingly prevalent, it may raise characterisation questions as well, as direct manufacturing for delivery could effectively evolve into licensing of designs for remote printing directly by consumers.

Cross-border trade in goods, services and intangibles creates challenges for VAT collection, particularly where such products are acquired by private consumers from suppliers abroad. This is partly due to the absence of an effective international framework to ensure VAT collection in the market jurisdiction. For economic actors, and in particular small and medium enterprises, the absence of an international standard for charging, collecting and remitting the tax to a potentially large number of tax authorities creates large revenue risks and high compliance costs. For governments, there is a risk of loss of revenue and trade distortion, and the challenge of managing tax liabilities generated by a high volume of low value transactions, which can create a significant administrative burden but marginal revenues.

The Task Force discussed and analysed a number of potential options proposed by country delegates and other stakeholders to address these challenges. Options discussed regarding nexus and data in particular range from changes to the definition of PE to the introduction of a new nexus based on a "significant presence" in a market, and also include the introduction of a withholding tax on sales of digital goods and services. Because of the overlap between the issues of nexus, data, and characterisation, the options to address each of them would inevitably affect the others. For purposes of evaluating potential options, the Task Force agreed on a framework based on the overarching tax principles of neutrality, efficiency, certainty and simplicity, effectiveness and fairness, flexibility and sustainability, in light of the proportionality of the changes in relation to the tax challenges they are intended to address in the context of the existing international tax framework.

D. Next steps: Undertake further work to complete evaluation of the broader tax challenges related to nexus, data, and characterisation and potential options to address them, and ensure that BEPS issues in the digital economy are tackled effectively.

Based on its discussion of these challenges and potential options to address them, the Task Force reached the following conclusions:

- The collection of VAT in business-to-consumer (B2C) transactions is a pressing issue that needs to be addressed urgently to protect tax revenue and to level the playing field between foreign suppliers relative to domestic suppliers. Work in this area by the Working Party No. 9 of the OECD CFA shall be completed by the end of 2015, with the Associates in the BEPS Project participating on an equal footing with the OECD member countries.
- The work in the context of Action 7 of the BEPS Action Plan (preventing the artificial avoidance of PE Status) shall consider whether activities that once may have been preparatory or auxiliary should be denied the benefit of the exceptions to the permanent establishment definition because they are core components of the business, and whether a reasonable, administrable rule to this effect can be developed.
- Working Party No. 1 of the CFA shall clarify the characterisation under current tax treaty rules of certain payments under new business models, especially cloud computing payments (including payments for infrastructure-as-a-service, software-as-a-service, and platform-as-a-service transactions,) with the Associates in the BEPS Project participating on an equal footing with the OECD member countries.
- The staggered time frame of the BEPS Project and interaction among the various BEPS outputs make it difficult at the time this report is delivered to analyse how effective the work on the BEPS Action Plan will be in addressing BEPS concerns in the digital economy, as well as to evaluate the ultimate scope of the more systemic tax challenges in the area of nexus, data, and characterisation, and potential options to address them.
- In that context, it is important for the Task Force to continue its work in order to ensure that work carried out in other areas of the BEPS Project tackles BEPS issues in the digital economy, and that it can assess the outcomes of that work, continue to work on the broader tax challenges and potential options related to nexus, data, and characterisation, evaluate how the outcomes of the BEPS Project impact their relevance, urgency, and scope, and complete

the evaluation of the options to address them. Specifically, the Task Force shall:

i. Continue to work on the broader tax challenges of the digital economy, including nexus, data, and characterisation, advance the work and refine technical details related to potential options to address those challenges, with appropriate focus on multi-sided business models and the participation of users and consumers in value creation, and evaluate how the outcomes of the BEPS Project affect these broader tax and administrative challenges.

ii. Act as a centre of expertise on the digital economy throughout the duration of the BEPS Project to ensure that work carried out in other areas of the BEPS Project tackles BEPS issues in the digital economy.

iii. Assess the degree to which completed work with respect to the other actions of the BEPS Project addresses BEPS with respect to the digital economy.

iv. Consider the economic incidence of VAT and corporate income taxation and its impact on the options to address the tax challenges raised by the digital economy.

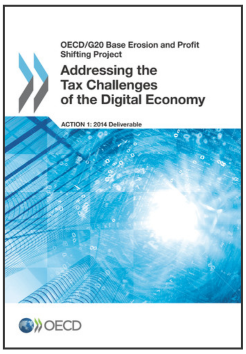
v. If further actions are necessary in the area of direct taxation to address BEPS concerns with respect to the digital economy, consider limiting the application of potential options to address broader tax challenges (either under tax treaties or through design of domestic law rules) to situations in which such BEPS concerns arise, for example in cases of double non-taxation of income from sales of digital goods and services.

Accordingly, the Task Force will:

- Advance the work on nexus, data, multi-sided business models, characterisation and potential options to address the broader tax challenges of the digital economy to ensure that these options are viable and fair, avoid double taxation, and can be implemented without exacerbating costs of compliance and administration.
- Provide input to the work carried out in the other areas of the BEPS Project to ensure that it appropriately takes into account and addresses the key features of the digital economy that exacerbate BEPS concerns. This work relates in particular to the work on the Artificial Avoidance of PE, on Transfer Pricing and on CFC rules and it will be carried out together with the work on the economic incidence of corporate income tax and VAT.

- Evaluate how the outcomes of the BEPS Project affect the broader tax challenges raised by the digital economy and complete the evaluation of the options to address them.

This work will be completed by December 2015 and a supplementary report reflecting the outcomes of the work will be finalised by that time.



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