Taxation of Digital Transactions

Lee Burns

Graduate School of Government

University of Sydney

Income Tax Issues

- PE and digital business
- BEPS Action 1
  - Taxation of income from digital business generally
- BEPS Action 7
  - Digital business and avoiding PE status
- UK’s diverted profits tax and Australia’s multinational anti-avoidance law

Taxation of Business Profits

- International norm – source country has right to tax business profits provided there is a sufficient economic presence in the jurisdiction to support the taxing right
  - Sufficient economic presence defined by the concept of "permanent establishment" (PE)
  - PE taxing rule developed in 1920s and 1930s through the work of the League of Nations
    - Fixed place of business in the jurisdiction
      - "Bricks and mortar" world
    - Agency PE – physical presence through an agent in the jurisdiction
    - Services PE – based on physical presence in jurisdiction (UN Model)

BEPS Mantra

- MNEs should pay tax where they derive their profits
- Where do digital businesses derive their profits?
  - Location of customers?
- Digital businesses can derive substantial profits from dealing with customers in a jurisdiction through a "digital" presence rather than a physical presence
- Pre-BEPS - OECD's position is that a digital presence in a jurisdiction (such as a website) does not satisfy the existing definition of PE
  - See paras 42.1-42.10 of the Commentary to Article 5 of the OECD Model DTA

Common Digital Business Model to Avoid PE

- Common digital business model to avoid PE
  - No physical presence in the jurisdiction
  - Contract conclusion and services delivered online
  - Engage a person (related or unrelated) in the jurisdiction to provide support in relation to contract negotiation and/or on-going technical support
- Person providing support services is not an agency PE as it is not contracting in the name of the provider of the digital services
  - Noted that, if the provider of the digital services did this work itself through a place of business in the jurisdiction, then that would constitute a PE
  - Business model highlights the narrowness of the agency PE concept
- Only income in the jurisdiction is the income of person providing support services, but the fee is based on the services being a low risk activity

BEPS and Digital Business

- The common digital business model was a driver for the BEPS project
- 2013 BEPS document stated a need to revisit the earlier position taken by the OECD on PEs and digital transactions
- Several BEPS actions relevant to taxation of digital business
  - Action 1 – fundamental review of basis of taxing digital transactions
  - Action 3 – treating income from digital transactions as CFC income
    - Note: this would tax the income to the residence country not source country
  - Action 7 – avoiding PE status
  - Actions 8-10 – transfer pricing and intangibles
- Focus on Actions 1 and 7

Action 1

- “Identify the main difficulties that the digital economy poses for the application of existing international tax rules and develop detailed options to address these difficulties, taking a holistic approach and considering both direct and indirect taxation”
- Issues to be covered included -
  - Ability of a company to have a significant digital presence in a country without having a PE
  - The characterisation of income derived from new business models and the application of related source rules
  - Ensuring the effective collection of VAT/GST with respect to the cross-border supply of digital goods and services

Action 1 – Direct Tax

- Identifying a significant economic (digital) presence
- Ongoing work in developing new rules on economic connection when the interaction with the economy is through technology and other automated tools
  - Revenue factors - revenue that is generated on a sustained basis from a country is one of the clearest indicators of the existence of a significant economic presence
  - Digital factors evidencing an online presence – local domain name; local digital platform; and local payment options
    - Note: these factors are mobile
  - User-base – regular active users of company's digital platform on monthly basis; online contract conclusion; and level of digital data collected in jurisdiction

Action 1 – Direct Tax

- Attribution of profits to significant economic (digital) presence
  - FAR not a meaningful concept for a digital as opposed to physical presence
  - Fractional apportionment rejected
  - Deemed profits method
- How do we collect the tax?
  - Withholding tax – final or non-final
    - Practical for B2B transactions
    - Not practical for B2C transactions
      - Consumers not likely to comply
      - Intermediaries processing payments – but no access to transaction specific data
      - Mandatory registration of non-resident suppliers and dedicated bank account requirement
      - Link with foreign supplier registration for VAT?

Action 7 Concerns and Digital Transactions

- With no new approach to the taxation of digital transactions developed under Action 1, focus then shifts to Action 7
- Some of the Action 7 concerns are relevant to digital transactions, particularly when the support services provided by the in-country company relate to negotiation of contracts
- However, the Action 7 concerns do not go to the core of the digital business model outlined above which is aimed at avoiding PE status
  - No fundamental change in the scope of the agency PE concept
- UK and Australia have moved forward independently of BEPS to deal with arrangements to avoid a PE

UK Diverted Profits Tax (DPT)

- Became known as the "Google Tax" (although not limited to digital business nor to the Google structure)
- New tax – imposed separately from the corporation and income taxes
- Effective from April 1, 2015
- Tax = 25% x taxable diverted profits
- Applies when there is a tax mismatch (i.e. base erosion)
  - Avoided UK PE – focus on this limb of the DPT
  - Insufficient economic substance

UK DPT - Avoiding a UK PE

- Foreign company making supplies of goods or services to customers in the UK other than through a PE
- Related person in UK providing services in relation to those supplies
- Reasonable to assume that the trading structure is intended to ensure that the foreign company does not have a UK PE
- Reasonable to assume that the trading structure is intended to achieve a tax mismatch
- Directly aimed at the common digital business model

UK DPT - Tax Mismatch

- Transaction results in a reduction in UK tax and the amount of any corresponding taxation (UK or foreign) in relation to the transaction is less than 80% of the tax reduction
- Reduction in UK tax may be through expenditure deductions or lower income
- Example - Supply of online advertising services by a company resident in Ireland to a corporate customer in the UK for a fee of £100
  - UK customer can deduct the cost of the services as a normal business expense
    - Tax value of the deduction is £20 (£100 x 20%)
  - Supplier has no PE in UK so no UK tax so £20 is the tax reduction in the UK
  - Taxed in Ireland at 12.5% so tax is £12.50, which is less than 80% of the tax reduction in the UK

UK DPT - Taxable Diverted Profits

- The amount of UK chargeable profit that the foreign company would have made if it had supplied the goods or services through a UK PE computed by reference to OECD profit attribution principles
- Not a self-assessed liability
  - Taxpayer required to notify HMRC within 3 months after the end of the tax year if potentially within the scope of the tax
    - Taxpayer initiates the administrative process
  - Process for determining whether the taxpayer is liable for DPT and the amount of the liability

UK DPT and Tax Treaties

- DPT imposed as a separate tax (not part of the UK corporate and income tax)
- UK has argued that, as a new tax, the DPT is not a tax covered by its DTAs
- Further, DPT designed to avoid being characterised as identical or substantially similar to the corporate and income taxes (i.e. avoid the operation of Article 2(4))

Australia – Multinational Anti-avoidance Law ("MAAL")

- Australia has also implemented a measure aimed at arrangements intended to avoid PE status
- Fundamental principle is the same as UK DPT but important differences in design
- Applies only to a globally significant entity
  - Annual MNE group turnover of AUD$1billion or more (this equates to €750,000 – BEPS Action 13 CbC reporting threshold)

Application of MAAL

- Circumstances of operation broadly similar to UK DPT but with three important differences
  - Activities in Australia may be undertaken by a related party (as in the UK) or an unrelated party that is “commercially dependent” on the foreign service provider
  - Applies if the foreign service provider has obtained a tax benefit under the arrangement
  - Not imposed as a separate tax but part of the general anti-avoidance rule

MAAL – Tax Benefit

- A person must have entered into the arrangement with “a” principal purpose of obtaining a tax benefit
- Tax benefit occurs when an amount has not been included in the assessable income of the foreign entity for a tax year that would, or might reasonably be expected to have been, included absent the arrangement
- Postulate a reasonable alternative arrangement
- Likely that ATO will argue that, absent the arrangement, the foreign entity would have established a PE in Australia to provide the support services

MAAL – Cancelling Tax Benefit

- Avoided income is subject to tax under the normal corporate tax
- PE attribution of profit rules apply to determine the taxable amount
- How is tax collected given that the foreign entity has no actual business operations or agent in Australia?
  - Australia does not have a non-resident service fee withholding tax
  - Deem the Australian entity providing related services as an agent?
    - But does not receive any monies of the foreign entity
  - Expectation that major suppliers of digital services/products will comply otherwise risk being accused of tax avoidance

MAAL and Tax Treaties

- MAAL is part of the general anti-avoidance rule
- Treaties and domestic law have equal status
- Domestic law priority rule in favour of tax treaty in case of conflict
- However, priority rule does not apply when the general anti-avoidance rule applies
  - Thus MAAL operates as a treaty override rule

VAT

- Impact of on-line business on imports of goods
- B2C imports of services and intangibles
- Foreign supplier VAT registration

Low Value Imports of Goods

- Rise of electronic commerce has seen an increase in the number of low value imports of goods
- International Convention on the Simplification and Harmonisation of Customs Procedure requires there to be a low value import duty exception
- Two arguments against the low value import VAT exception
  - Distortion in favour of foreign suppliers as equivalent purchases from local suppliers are subject VAT
    - Impact of exchange rates on purchase levels
  - Increase in low value imports has a revenue cost to Government if imports are not taxed

Low Value Imports of Goods

- Any lowering of the low value imports of goods exception will need to come within streamlined collection procedures to be cost efficient
  - Ask customers to self-assess liability in advance of import
    - Likely to be low compliance
  - Apply the offshore supplier registration model for services/intangibles to suppliers of goods purchased online

Import of Services and Intangibles

- Import of services/intangibles treated as a supply
- Many VAT systems distinguish B2B and B2C imports of services
  - B2B is an import made to a registered person
    - Reserve charge applies
  - B2C is an import made to an unregistered person (generally final consumer)
    - Normal taxable supply rules apply if foreign supplier exceeds the registration threshold
    - However, difficult to tax if the foreign supplier has no place of business in the jurisdiction
    - If B2C supplies of imported services are not taxed, then potentially no VAT in both the country of export (zero rating applies) and country of import

B2C Supplies of Imported Services

- Not feasible to apply a reverse charge rule
  - Cannot expect consumers to self-charge and report VAT
- Normal operation of VAT applies
- VAT charged if a taxable supply made by a registered person
- One of the conditions for a supply to be a taxable supply is that it is made in the jurisdiction
  - Place of supply rules locate a supply in the jurisdiction
- Foreign service provider required to register if the level of taxable supplies exceeds the registration threshold
  - This applies even if the service provider has no place of business in the jurisdiction

Place of Supply Rules

- Basic place of supply rule for services is that services are located at the place of business from which the services have been supplied
  - This effectively locates remote supplies of services at the place of export rather than place of consumption
- An exception applies for services based on either: (i) the physical location of the recipient; or (ii) residence of the recipient
- Absence of a uniform rule for remote supplies of services has led to double taxation and double non-taxation

OECD Guidelines

- Adopt residence of the recipient as the place of supply
- However, distinction made between: (i) on the spot supplies; and (ii) remote supplies
- On the spot supply is supply where the supplier and recipient are in the same location when the services are provided
  - Common examples: hairdressing, massage, beauty therapy, physiotherapy, accommodation, restaurant and catering services, entry to cinema, theatre performances, trade fairs, museums, exhibitions, and parks, and attendance at sports competitions
  - Basic place of supply rule applies
- Remote supplies – residence of recipient applies

Design Issues with Place of Residence Rule

- Should the rule apply to both B2B and B2C supplies of imported services, or to just B2C?
- Should the same registration threshold apply to foreign service providers or should a lower threshold apply?
- How do foreign service providers determine residence of customers?
- What is the treatment of supplies made through an electronic marketplace (such as an APP store)?

Simplified VAT Procedures

- Maximise electronic communication with tax administration
  - Online VAT registration
    - Registration form in main languages
    - Pay-only registration – no input tax credits
  - VAT returns filed electronically
  - Payment of VAT electronically
- Globally, there is a small number of large suppliers of digital services
  - Negotiate arrangements for registration, and reporting and paying VAT, with large foreign suppliers