



Tax



Navigating



Digital

# Taxing the digital economy

Digital taxation risks double taxation for all businesses

Governments and tax authorities are scrambling to keep pace with the increasing digitisation of the global economy and public outcry over the levels of corporate tax being paid by large multinational enterprises (MNEs).

With countries moving in different directions, the G20 wants the OECD to forge some kind of consensus. Accordingly, the 129 members of the OECD/G20 Inclusive Framework on Base Erosion and Profit Shifting (BEPS) have adopted a Programme of Work laying out a road map for reaching a new global agreement for taxing MNEs.<sup>1</sup>

Yet, a combination of differing priorities and pressure on tax authorities to act means that a common approach is unlikely whatever the OECD/G20 agrees. With this upheaval and confusion come the heightened danger of compliance failure, tax dispute and double taxation. And it's mid-size MNEs – old economy as well as new – rather than just the tech giants or digital-only businesses that could face the biggest test.

How can you manage the risks thrown up by the overhaul of digital taxation? How will the changes impact the wider shake-up in transfer pricing and international taxation? What does this all mean for your operations, structure and value chain?

<sup>1</sup> [www.OECD.org](http://www.OECD.org) – International community agrees on a road map for resolving the tax challenges arising from digitalisation of the economy – 31 May 2019.



# Every business is affected, but nothing is clear

In our previous ‘Taxing the digital economy’ article,<sup>2</sup> we looked at how a lack of international consensus on taxing an increasingly digital global economy is creating a vacuum, which individual countries are filling with their own varied set of tax measures. The results heighten the tax management uncertainty, complexity and risk for MNEs.

Examples of this patchwork of measures include India’s equalisation levy on online advertising revenue earned by non-resident companies. In countries such as Australia, companies now need to register for goods and services tax (GST) if they sell to local customers online, even if they don’t have a physical presence in the market. Under consideration are a range of proposals, including the flat rate tax on ‘digital activities’ in the European Union (EU), although this is facing pushback from both the US and a number of EU member states.

## Political pressure

So why the big push? Governments want a bigger share of the tax take from digital transactions (advertising and data mining as well as sales). A significant proportion of this business (though not quite as much as the justification for new tax measures might suggest) is controlled by companies operating from outside a particular market. These companies may therefore collect a considerable amount of indirect taxes (sales, GST or value added tax (VAT)) on these transactions. But with no ‘bricks and mortar’ physical presence, they may not have to pay any corporate tax. The new measures seek to bring them into the corporate tax net.

Why now? While this kind of business has been going on for decades, the speed of e-commerce exchange and access to the market through smartphones have made digital transactions more visible and pervasive. But the main reason for the overhaul of digital taxation is the level of public pressure stemming from headlines about companies only paying a tiny percentage of corporate tax on their revenues and profits. Although a large proportion of revenue is generated by consumption taxes like VAT, the political sensitivities surrounding digital tax ‘fairness’ mean that governments need to be seen to be bringing in more corporate tax on digital transactions. The qualification for a taxable presence is therefore being extended from physical to virtual (eg online marketplace based in one country selling into another).

## Mid-size MNEs in the firing line

It’s mid-size MNEs that could face the biggest impact, even though they are not the companies in the sights of digital tax reform. Almost every business has some form of data analytics and e-commerce within their operations and is looking to develop a more integrated digital operating model. Digital features within products and services could also be caught in the net – even something as seemingly ‘old economy’ as a tractor now comes with on-board and remote digitally-controlled operations.

<sup>2</sup> [grantthornton.global](#) – Taxing the digital economy – 4 September 2018.

## Implications

### Physical presence is no longer the deciding factor

The tax presence is now governed by economic substance rather than physical presence. Your business will therefore need to register in a lot more jurisdictions and manage compliance demands within them.

### Tax revenues set to be more evenly spread

Political reality means that more jurisdictions will be getting at least some of the corporate tax you pay. You might say that as long as the overall liability is much the same, it doesn't matter who gets what. However, tax authorities might claim the same chunk of revenue, which opens up the risk of double taxation. In addition, the changes made to the principles underlying transfer pricing mean that the arm's length charges for intellectual property exchange within your business may now run counter to how revenues and profits are divided up for tax purposes.

### Shades of grey create double taxation risks

While few would argue with the principle of extending the taxable presence from physical to virtual, it does open up a lot of uncertainty in areas such as marketing and data-driven profiling. What new countries do you need to be registered in? What are the implications for your value chain and transfer pricing arrangements?

And these dilemmas also work the other way as tech giants and online marketplaces extend their bricks and mortar presence into areas such as supermarkets. Should their revenue be taxed like a supermarket or as a digital business?

These shades of grey heighten compliance risks, including whether or not to register and, if so, what elements of the business are covered. Uncertainty over the taxable presence and the income generated within different jurisdictions also heightens the risk of double taxation and dispute. This is compounded by the focus on revenue rather than profit, which inevitably creates headaches within corporate tax.

## Actions

### Review tax registration

Look at where you need to register for tax and maintain compliance as taxable presences expand. Many of the criteria are not just grey but also fluid as tax rules change in different jurisdictions. So, it's important to consult with tax authorities and/or your advisors.

### Review your value chain

Think about where and how you create value within an increasingly digital economy. How does this map against your transfer pricing and profit attribution and to what extent might you be at risk of challenge from the different tax authorities where you operate, virtually as well as physically? This includes how you go to market, where the income is recorded for corporate tax purposes and how intellectual property is generated and exchanged within your business.

### Minimise risks

Identify where the risk of double taxation and dispute is greatest (eg allocation of marketing intangible income or the sharing of profits between jurisdictions). Be proactive in seeking advice on potential implications and clarification from tax authorities. Begin work on mitigation plans such as securing advanced pricing agreements (APAs) in highest risk areas.

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# Search for consensus: OECD sets out possible options

With different jurisdictions moving in different directions, the G20 has mandated the OECD to come up with proposals for a ‘consensus-based long-term solution’. Following public consultations, the OECD will present its recommendations to the G20 in June. So, what’s being proposed and what are the implications?

## Option one: User participation

Focusing on the value generated by users of ‘highly digitalised businesses’ such as search engines and online marketplaces, much of which is deemed to fall outside a physical presence corporate tax net (but not VAT).

### Implications

More profit is allocated to locations where value is consumed and more taxable presences (nexuses) are opened up, with additional registration and compliance burdens as a result.

This effectively creates separate tax system for what the OECD terms as ‘highly digitalised businesses’ such as Google. As we’ve outlined, all businesses are digital to some extent and could therefore find themselves in the net even though they weren’t the main target.

The proposals talk about two systems for taxing the same profit – one for ‘routine’ income still based on the arm’s length principle (ALP) and another for ‘non-routine’ income (eg use of intellectual property) split between jurisdictions, possibly through a formula. It’s not clear quite how double taxation can be avoided when taxing the same profit in two different ways, especially as there is (as yet) no definition of routine and non-routine within this system.

### Models/backers

The UK operates a broadly comparable approach and the EU has proposed a similar model.

### Likely take-up

Seen by many governments as too narrowly focused on what are deemed to be digital businesses to be relevant, though some form of this approach could be incorporated into the final recommendations.

## Option two: Marketing intangibles

Some of the taxable profit derived from so-called marketing intangibles such as brand name and data-driven insight would be reallocated from where the value is originated to where the value is consumed. Other intangibles such as use of technology would remain within the existing nexus.

### Implications

Again, a broader definition of taxable presence and hence the need for registration and allocation of profit across more jurisdictions.

Mechanics could either follow existing ALPs or more 'mechanical approximations'. But what exactly is a marketing intangible? Grey areas include whether the algorithms are generating value from the user base and hence marketing intangibles or from the underlying technology and hence not. These grey areas heighten risk of dispute and double taxation.

Further risk of double taxation stems from splitting the 'non-routine' income from marketing intangibles between jurisdictions where the benefits from these assets are shared.

The proposals are also quite critical of the limited risk distributor (LRD) model currently used by many mid-size MNEs, old and new economy, and could therefore lead to drastic changes in the profit allocation under these models.

Moreover, the proposals run counter to the OECD's own development, enhancement, maintenance, protection and exploitation (DEMPE) lifecycle of intellectual property and other intangible assets, which many MNEs have spent a lot of time adjusting to over the past couple of years.

### Models/backers

The US is likely to favour an approach that is the least likely of the three to erode its large digital tax base.

### Likely take-up

Broad applicability makes it a contender for the eventual recommendations, though the need for consensus suggests some form of compromise with other proposals.

## Option three: Significant economic presence

Extending the taxable presence from physical to virtual (eg online marketplace based in one country selling into another).

### Implications

This is a shift from taxing companies where intangible value (eg tech innovation and advanced analytics) is created to where it's consumed. In addition to an increased compliance burden, it could put paid to LRD structures used within transfer pricing.

Without clear cut agreement on the formula for sharing taxable profits, there is a very high risk of double taxation. Even if the OECD does this (it hasn't as yet), countries could shape the formula in ways best suited to their circumstances.

### Models/backers

India and other large consumer markets would have most to gain.

### Likely take-up

As with the marketing intangibles proposals, the broad applicability makes it a contender for the eventual recommendations. Again, however, the need for consensus suggests some form of compromise with other proposals.

# Get ready for a bumpy ride

The bulk of businesses we speak to want certainty, simplicity and the avoidance of costly and protracted disputes, even if this means paying more tax in some jurisdictions or even more tax overall. The Johnson & Johnson submission to the OECD consultation exemplifies this.<sup>3</sup> The company would also be comfortable with a formulaic approach to dividing taxable income between jurisdictions if this would make arrangements more straightforward.

Are there therefore grounds for a consensus to emerge internationally? Both developed and emerging markets want to secure more tax income from the exploitation of their markets. The speed with which individual countries are coming up with their own disparate set of solutions means that the OECD is under pressure to set a clear path forward rather than a 'wait and see' approach. G20 sponsorship of the OECD initiative will in turn force leading economies to come to some view on digital taxation, rather than seeking to shoehorn it into existing tax arrangements. It's possible that any recommendations could be built into common international arrangements such as the OECD's multilateral instrument to give them some legal basis rather than being just guidance.

Whatever the OECD decides, however, these recommendations will struggle to get around the fundamental divergence in interests between different states. For example, the significant economic presence approach is likely to maximise tax take in a giant consumer market like India, while the marketing intangible option preserves tax income in jurisdictions where a significant proportion of the intellectual property is generated and risks taken such as the US. The patchwork of approaches and the complexity and uncertainty they create will therefore almost definitely remain.

Given the barriers to consensus internationally and the tight timelines the OECD team is working to, it may leave the choice of approach open. And even if it does opt for one of the three proposals or some combination, individual governments will interpret it in a way that best suits them. They may even ignore the recommendations altogether. And as the pace of reform accelerates, the unintended consequences and resulting risks could mount.

## Unintended consequences – what does the future really hold?

The focus on so-called highly digitalised businesses suggests that the OECD, along with many tax authorities, doesn't appreciate the depth of digitisation in the global economy.

Rather than being a whole new strata of economic activity, digitisation enables businesses to do what they have always done (ie make and sell products and services) only in a faster (eg online distribution) and more informed (data-driven customer insight and targeting) way.

Either way, singling out digital business for a new approach to taxation doesn't reflect the realities within the economy. It's therefore unnecessary and could create needless distortions. And almost every business will be affected.

<sup>3</sup> [OECD comments received](#) – Digital – March 2019

## Implications

### Arm's length principle under threat

The ALP has always been one of the cornerstones of transfer pricing. Yet, the emergence of tax policies that don't reflect the economic substance of transactions could put severe strain on the ALP and even undermine it altogether. The threat could be compounded by the need to find a simplified way to allocate tax between multiple new jurisdictions. Some experts disagree and it's certainly too early to write off the ALP. However, the possibility of life beyond it does need to be factored into plans.

### This is an issue for value generated inside as well as on the consumer-facing side

As the use of digital technology within your business increases and becomes embedded in your operating model, it is generating significant amounts of intangible value. This stretches from data feeds to artificial intelligence-enabled design and innovation. While governments are primarily focused on the money generated outside the business, you can't ignore the impact on the exchange of intellectual property internally and how this impinges on transfer pricing.

## Actions

### Take advantage of simplification

Moving towards a simplified formulaic approach could free up capacity and reduce compliance costs and risks.

### Lobby for real fairness

The OECD wants businesses to engage as it develops new rules. It's important to take up the opportunity. 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. A key part of this is making sure that tax reform focuses on the digitisation of the economy rather than just what are deemed to be digital businesses, as all companies will be affected in the end.

### Look at the big picture

These developments are part of the wider shake-up in tax. This includes the overlaps with the focus on substance and the imposition of minimum taxes in some jurisdictions. They also impinge on the reputational risks created by low levels of corporate tax income generation in comparison to other forms of taxation (eg personal income tax). The digital tax reforms should therefore form part of a wider review of whether your current tax management is fit for purpose. With the situation so fluid and so many moving parts to take into consideration, clear scenario planning and the ability to respond quickly and flexibly are key.

“...recommendations will struggle to get around the fundamental divergence in interests between different states.”

# Digital businesses: Keeping tax simple

While the digital tax overhaul affects all businesses, it's businesses with highly integrated digital business models such as platforms or online marketplaces that the tax authorities have most firmly in their sights. The results could be a complex and costly headache. How can your business ease the strain and steer clear of the potential pitfalls?

A key value driver is capitalising on the network effects (eg connectivity and data generation) within your value chain. A big challenge under the emerging tax rules is how to allocate the income generated by these so-called 'non-routine' intangible assets, which are likely to be jointly owned by multiple entities operating in different markets.

From a transfer pricing perspective, a formulaic profit split could ease the burden. A possible way is to divide the profits according to the relative reach of each platform or website. This would make use of the key performance indicators (KPIs) for website traffic and user activity. This would create a transparent and comprehensible data-based profit allocation that can be easily implemented with your existing systems.





# Conclusion: Keeping pace with change

Business models are being reshaped by the increasing speed and connectivity of digital technology. Tax authorities are responding in disparate ways, with the potential for unintended consequences heightened by the pace at which legislation is being enacted and the political pressures that underlies this.

Large technology companies are already on top of this. But other businesses face huge risks from believing this doesn't apply to them or from relying on a reactive compliance-focused response. Your business doesn't just need to comply with a multitude of new legislation, but also manage the impact on your value chain.

A clear understanding of what's coming and its implications is essential. It's also important to be proactive by taking advantage of opportunities to simplify compliance and putting in place safeguards such as pricing agreements.

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 here:

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