Chapter 5

Identifying opportunities for BEPS in the digital economy

This chapter provides a general discussion of the common features of tax planning structures that raise base erosion and profit shifting (BEPS) concerns. It then provides a detailed description of the core elements of BEPS strategies with respect to both direct and indirect taxation.

5.1 Common features of tax planning structures raising BEPS concerns

As noted in the BEPS Action Plan (OECD, 2013a), BEPS concerns are raised by situations in which taxable income can be artificially segregated from the activities that generate it, or in the case of value added tax (VAT), situations in which no or an inappropriately low amount of tax is collected on remote digital supplies to exempt businesses or multi-location enterprises (MLEs) that are engaged in exempt activities. These situations undermine the integrity of the tax system and potentially increase the difficulty of reaching revenue goals. In addition, when certain taxpayers are able to shift taxable income away from the jurisdiction in which income producing activities are conducted, other taxpayers may ultimately bear a greater share of the burden. BEPS activities also distort competition, as corporations operating only in domestic markets or refraining from BEPS activities may face a competitive disadvantage relative to multinational enterprises (MNEs) that are able to avoid or reduce tax by shifting their profits across borders.[1]

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 are outlined in Annex B and show existing opportunities to achieve BEPS. In many cases, the nature of the strategies used to achieve BEPS in digital businesses is similar to the nature of strategies used to achieve BEPS in more traditional businesses. Some of the key characteristics of the digital economy may, however, exacerbate risks of BEPS in some circumstances, in the context of both direct and indirect taxation. Therefore, it is necessary to examine closely not only how business models may have evolved in the digital economy, but also how overall business models can be implemented in an integrated manner on an international scale from a legal and tax structuring perspective.

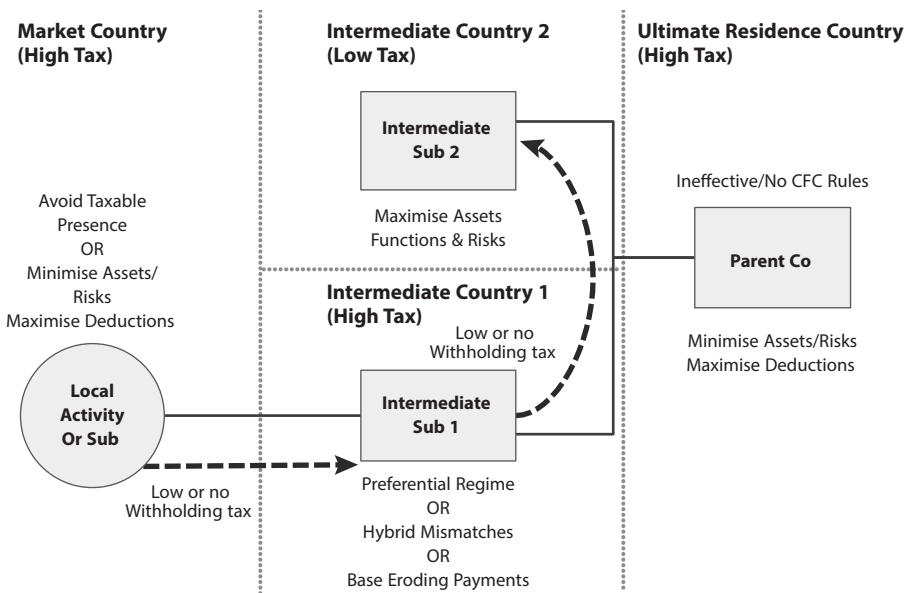
The following paragraphs consider in more detail how BEPS strategies manifest in the digital economy. The discussion below is intended to help identify the key elements of BEPS strategies in the context of direct taxation, and how those strategies take advantage of the key features of the digital economy. In addition, in the context of VAT, while there is considerable diversity in the structure of VAT systems and in how they operate in practice, the discussion below broadly illustrates ways in which the digital economy places pressure on VAT systems.

5.2 BEPS in the context of direct taxation

The February 2013 Report *Addressing Base Erosion and Profit Shifting* (OECD, 2013b) identifies a number of co-ordinated strategies associated with BEPS in the context of direct taxation, which can often be broken down into four elements:

- Minimisation of taxation in the market country by avoiding a taxable presence, or in the case of a taxable presence, either by shifting gross profits via trading structures or by reducing net profit by maximising deductions at the level of the payer.
- Low or no withholding tax at source.
- Low or no taxation at the level of the recipient (which can be achieved via low-tax jurisdictions, preferential regimes, or hybrid mismatch arrangements) with entitlement to substantial non-routine profits often built-up via intra-group arrangements.
- No current taxation of the low-tax profits at the level of the ultimate parent.

Figure 5.1. **BEPS planning in the context of income tax**



5.2.1 Eliminating or reducing tax in the market country

5.2.1.1 Avoiding a taxable presence

In many digital economy business models, a non-resident company may interact with customers in a country remotely through a website or other digital means (e.g. an application on a mobile device) without maintaining a physical presence in the country. Increasing reliance on automated processes may further decrease reliance on local physical presence. The domestic laws of most countries require some degree of physical presence before business profits are subject to taxation. In addition, under Articles 5 and 7 of the OECD Model Tax Convention, a company is subject to tax on its business profits in a country of which it is a non-resident only if it has a permanent establishment (PE) in that country. Accordingly, such non-resident company may not be subject to tax in the country in which it has customers.

Companies in many industries have customers in a country without a PE in that country, communicating with those customers via phone, mail, and fax and through independent agents. That ability to maintain some level of business connection within a country without being subject to tax on business profits earned from sources within that country is the result of particular policy choices reflected in domestic laws and relevant double tax treaties, and is not in and of itself a BEPS issue. However, while the ability of a company to earn revenue from customers in a country without having a PE in that country is not unique to digital businesses, it is available at a greater scale in the digital economy than was previously the case. Where this ability, coupled with strategies that eliminate taxation in the State of residence, results in such revenue not being taxed anywhere, BEPS concerns are raised. In addition, under some circumstances, tax in a market jurisdiction can be artificially avoided by fragmenting operations among multiple group entities in order to qualify for the exceptions to PE status for preparatory and auxiliary activities, or by otherwise ensuring that each location through which business is conducted falls below the PE threshold. Structures of this type raise BEPS concerns.

5.2.1.2 Minimising the income allocable to functions, assets and risks in market jurisdictions

In many cases, an MNE group does maintain a degree of presence in countries that represent significant markets for its products. In the context of the digital economy, an enterprise may establish a local subsidiary or a PE, with the local activities structured in a way that generates little taxable profit. Where these structures accurately reflect the functions performed in each jurisdiction, the mere fact that business functions needed to conduct business in a particular country may be more limited in one type of business

than in another does not raise BEPS issues in and of itself. This is true even if tax rates are among the factors taken into account when deciding to centralise business operations in a particular location. The ability to allocate functions, assets and risks in a way that minimises taxation does, however, create incentives to, for example, contractually allocate them in a way that does not fully reflect the actual conduct of the parties, and that would not be chosen in the absence of tax considerations. For example, assets, in particular intangibles, and risks related to the activities carried out at the local level may be allocated via contractual arrangements to other group members operating in a low-tax environment in a way that minimises the overall tax burden of the MNE group.

Under these structures, there is an incentive for the affiliate in the low-tax environment to undervalue (typically at the time of the transfer) the transferred intangibles or other hard-to-value income-producing assets, while claiming that it is entitled to have large portions of the MNE group's income allocated to it on the basis of its legal ownership of the undervalued intangibles, as well as on the basis of the risks assumed and the financing it provides. Operations in higher tax jurisdictions can be contractually stripped of risk, and can avoid claiming ownership of intangibles or other valuable assets or holding the capital that funds the core profit making activities of the group. Economic returns are thus reduced and income is shifted into low-tax environments.

Examples of digital economy structures that can be used to minimise the tax burden in market jurisdictions through contractual allocation of assets and risks include using a subsidiary or PE to perform marketing or technical support, or to maintain a mirrored server to enable faster customer access to the digital products sold by the group, with a principal company contractually bearing the risks and claiming ownership of intangibles generated by these activities. A company may, for example, limit risk at the local company level by limiting capitalisation of that entity so that it is financially unable to bear risk. In the case of businesses selling tangible products online, a local subsidiary or PE may maintain a warehouse and assist in the fulfilment of orders. These subsidiaries or PEs will be taxable in their jurisdiction on the profits attributable to services they provide, but the amount they earn may be limited. Alternatively, functions allocated to local staff under contractual arrangements may not correspond with the substantive functions performed by the staff. For example, staff may not have formal authority to conclude contracts on behalf of a non-resident enterprise, but may perform functions that indicate effective authority to conclude those contracts. If the allocations of functions, assets, and risks do not correspond to actual allocations, or if less-than-arm's length compensation is provided for intangible property of a principal company, these structures may present BEPS concerns.

5.2.1.3 Maximising deductions in market jurisdictions

Once a taxable presence in the market country has been established, another common technique to reduce taxable income is to maximise the use of deductions for payments made to other group companies in the form of interest, royalties, service fees, etc. In many cases, MNEs engaging in BEPS practices attempt to reduce taxable income in a source country by maximising the amount of deductible payments made to affiliates in other jurisdictions. For example, an affiliate in a low-tax jurisdiction may, due to a favourable credit rating, be able to borrow money at a low rate. It may then lend money to its subsidiaries in high-tax jurisdictions at a higher rate, thereby reducing the income of those subsidiaries by the amount of the deductible interest payments. Alternatively, an affiliate may use hybrid instruments to create deductible payments for a subsidiary in a source country that result in no inclusion in the country of residence of the affiliate. Payments (including underpayments) for the use of intangibles held by low-tax group companies or for services rendered by other group companies can also be used to reduce taxable income in the market country. These techniques can be used to reduce the taxable income from the local operations to extremely low amounts.

5.2.2 Avoiding withholding tax

A company may be subject to withholding tax in a country in which it is not a resident if it receives certain payments, including interest or royalties, from payers in that country. If allowed under a treaty between the jurisdictions of the payer and recipient, however, a company in the digital economy may be entitled to reduced withholding or exemption from withholding on payments of profits to a lower-tax jurisdiction in the form of royalties or interest. Structures that involve treaty shopping by interposing shell companies located in countries with favourable treaty networks that contain insufficient protections against treaty abuse raise BEPS concerns.

5.2.3 Eliminating or reducing tax in the intermediate country

Eliminating or reducing tax in an intermediate country can be accomplished through the application of preferential domestic tax regimes, the use of hybrid mismatch arrangements, or through excessive deductible payments made to related entities in low or no-tax jurisdictions.

Companies may locate functions, assets, or risks in low-tax jurisdictions or countries with preferential regimes, and thereby allocate income to those locations. While functions are often located in a particular jurisdiction for non-tax reasons such as access to skilled labour or necessary resources, as business functions grow increasingly mobile, taxpayers may increasingly be able to locate functions in a way that takes advantage of favourable tax regimes.

In the context of the digital economy, for example, the rights to intangibles and their related returns can be assigned and transferred among associated enterprises, and may be transferred, sometimes for a less-than-arm's length price,[2] to an affiliate in a jurisdiction where income subsequently earned from those intangibles is subject to unduly low or no-tax due to the application of a preferential regime. This creates tax planning opportunities for MNEs and presents substantial risks of base erosion. Heavy reliance in the digital economy on intangibles as a source of value may exacerbate the ability to concentrate value-producing intangibles in this way.

Companies may also reduce tax in an intermediate country by generating excessive deductible payments to related entities that are themselves located in low or no-tax jurisdictions or otherwise entitled to a low rate of taxation on the income from those payments. For example, an operating company located in an intermediate jurisdiction may use intangibles held by another affiliate in a low-tax jurisdiction. The royalties for the use of these intangibles may be used to effectively eliminate taxable profits in the intermediate jurisdiction. Alternatively, an entity in an intermediate jurisdiction may make substantial payments to a holding company located in a low or no-tax jurisdiction for management fees or head office expenses. Companies may also avoid taxes in an intermediate country by using hybrid mismatch arrangements to generate deductible payments with no corresponding inclusion in the country of the payee. Companies may also use arbitrage between the residence rules of the intermediate country and the ultimate residence country to create stateless income. In addition, companies may assert that the functions performed, assets used, and risks assumed in the intermediate country are limited.

5.2.4 Eliminating or reducing tax in the country of residence of the ultimate parent

Broadly speaking, the same techniques that are used to reduce taxation in the market country can also be used to reduce taxation in the country of the ultimate parent company of the group or where the headquarters are located. This can involve contractually allocating risk and legal ownership of mobile assets like intangibles to group entities in low-tax jurisdictions, while group members in the jurisdiction of the headquarters are undercompensated for the important functions relating to these risks and intangibles that continue to be performed in the jurisdiction of the headquarters. In this situation it can be claimed that a marginal remuneration for the important functions is arm's length and that all the remaining profits should be attributed to the legal owner of movable assets or to the party that is contractually bearing the risk.

In addition, companies may avoid tax in the residence country of their ultimate parent if that country has an exemption or deferral system for foreign-source income and either does not have a controlled foreign company (CFC)

regime that applies to income earned by controlled foreign corporations of the parent, or has a regime with inadequate coverage of certain categories of passive or highly mobile income, including in particular certain income with respect to intangibles. For example, the parent company may transfer hard-to-value intangibles to a subsidiary in a low or no-tax jurisdiction, thereby causing income earned with respect to those intangibles to be allocated to that jurisdiction without appropriate compensation to the parent company. In some cases, a CFC regime might permit the residence jurisdiction to tax income from these intangibles. Many jurisdictions, however, either do not have a CFC regime, have a regime that fails to apply to certain categories of income that are highly mobile, or have a regime that can be easily avoided using hybrid mismatch arrangements.

5.3 Opportunities for BEPS with respect to VAT

To the extent that Guidelines 2 and 4 of the OECD's "Guidelines on place of taxation for B2B supplies of services and intangibles" (see Chapter 6 below) are not implemented, under certain conditions opportunities for tax planning by businesses and corresponding BEPS concerns for governments in relation to VAT may arise with respect to *(i)* remote digital supplies to exempt businesses and *(ii)* remote digital supplies acquired by enterprises that have establishments (branches) in more than one jurisdiction (MLE) that are engaged in exempt activities.

5.3.1 Remote digital supplies to exempt businesses

VAT is generally not designed to be a tax on businesses as businesses are generally able to recover any tax they pay on their inputs. Many VAT jurisdictions using the destination principle for business-to-business (B2B) digital supplies will generally require a business customer in their jurisdiction to self-assess VAT on acquisitions of remotely delivered services and intangibles and then allow the business to claim a credit for this self-assessed VAT. The vast number of cross-border supplies made between businesses (other than businesses engaged in exempt activities) do not therefore, generally create BEPS concerns. BEPS concerns in a VAT context could arise however, with respect to offshore digital supplies made to exempt businesses (e.g. the financial services industry). Where a business is engaged in VAT-exempt activities, no VAT is levied on the exempt supplies made by the business, while VAT incurred by the business on the associated inputs is not deductible.

For example, a business acquiring a data processing service from a non-resident supplier would be required to self-assess VAT according to the rules of the jurisdiction in which it is located and could claim an off-setting credit for this self-assessed VAT (some jurisdictions may not require the business

to self-assess tax as it is entitled to an offsetting credit). If the business customer is an exempt business, it is still required to self-assess VAT in these jurisdictions but would not be able to claim a credit for the self-assessed tax. The exempt business is then "input taxed" in its residence jurisdiction, where it is assumed to use the service for making exempt supplies.

However, some jurisdictions currently do not require the exempt business to self-assess VAT on the services and intangibles acquired from abroad. In such case, no VAT is levied on the transaction. BEPS concerns also arise if the data processing services would be subject to VAT in the jurisdiction where the supplier is resident (established, located). The VAT would then accrue to the jurisdiction in which the supplier is situated and not the jurisdiction of the exempt business. This is likely to raise concerns particularly where this jurisdiction has no VAT or a VAT rate lower than the rate in the jurisdiction of the exempt business customer. In these cases, the exempt business customer would pay no VAT or an inappropriately low amount of VAT. The above cases illustrate how an exempt business could pay no or an inappropriately low amount of VAT when acquiring digital supplies from suppliers abroad. They also illustrate how domestic suppliers of competing services could face potential competitive pressures from non-resident suppliers. Domestic suppliers are required to collect and remit VAT on their supplies of services to domestic businesses while non-resident suppliers could structure their affairs so that they collect no or an inappropriately low amount of VAT.

5.3.2 Remote digital supplies to a multi-location enterprise

BEPS concerns could also arise in cases where a digital supply is acquired by an MLE. It is common practice for multinational businesses to arrange for a wide scope of services to be acquired centrally to realise economies of scale. Typically, the cost of acquiring such a service or intangible is initially borne by the establishment that has acquired it and, in line with normal business practice, is subsequently recharged to the establishments using the service or intangible. The establishments are charged for their share of the service or intangible on the basis of the internal recharge arrangements, in accordance with corporate tax, accounting and other regulatory requirements. However, many VAT jurisdictions do not currently apply VAT to transactions that occur between establishments of one single legal entity.

This means that where an establishment of an MLE acquires a service, for instance data processing services, for use by other establishments in other jurisdictions, no additional VAT would apply on any internal cost allocations or recharges made within the MLE for the use of these services by other establishments. On the other hand, the establishment that acquired the service will be generally entitled to recover any input VAT on the acquisition of these services if it is a taxable business. In other words, the other establishments

using the data processing services are able to acquire their portion of these services without incurring any VAT. This is generally not a great concern from a VAT perspective if all of the establishments of the MLE using the service are taxable businesses. This is because in this case they have a right to recover any input VAT. However, where the establishments using the data processing services are exempt businesses, they are not normally entitled to recover VAT paid on their inputs.

Take for example processing of data relating to banking transactions: if an establishment of a multinational bank would acquire such services directly from a local supplier, it would generally incur input VAT on these services; it would not be able to deduct this input VAT as it relates to VAT-exempt activities. Alternatively, this establishment of a multinational bank could acquire these processing services though another establishment of the same bank in another country and then reimburse this other establishment for the cost of acquiring these services on its behalf. This would allow the establishment of this bank to acquire the processing services without incurring any VAT in the jurisdiction where it is located, as no VAT is levied on the dealings between establishments of the same legal entity. If the acquiring establishment would be located in a country without a VAT, the multinational bank could acquire these services for all its establishments around the world without incurring any input VAT at all by channelling its acquisitions through its establishment in a no VAT jurisdiction. VAT-exempt businesses can make substantial VAT savings by using such channelling structures.

Notes

1. Such competitive disadvantages may also arise when competing enterprises are subject to different levels of taxation in their home jurisdictions, although that is beyond the concerns raised by BEPS.

2. Even when the country from which the Internet Protocol (IP) is transferred requires that transfers be made at arm's length, taxpayers may take aggressive positions that in fact result in less than an arm's length amount being recorded for tax purposes with respect to the transfer.

Bibliography

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