

## *Chapter 1*

### **Introduction to tax challenges of the digital economy**

*This chapter discusses the background leading to the adoption of the BEPS Action Plan, including the work to address the tax challenges of the digital economy. It then summarises the work of the Task Force on the Digital Economy leading to the production of the report. Finally, it provides an overview of the contents of the report.*

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. The BEPS Action Plan identifies 15 actions to address BEPS in a comprehensive manner, and sets deadlines to implement those actions.

As noted in the BEPS Action Plan, “the spread of the digital economy also poses challenges for international taxation. The digital economy is characterised by an unparalleled reliance on intangible assets, the massive use of data (notably personal data), the widespread adoption of multi-sided business models capturing value from externalities generated by free products, and the difficulty of determining the jurisdiction in which value creation occurs. This raises fundamental questions as to how enterprises in the digital economy add value and make their profits, and how the digital economy relates to the concepts of source and residence or the characterisation of income for tax purposes. At the same time, the fact that new ways of doing business may result in a relocation of core business functions and, consequently, a different distribution of taxing rights which may lead to low taxation is not per se an indicator of defects in the existing system. It is important to examine closely how enterprises of the digital economy add value and make their profits in order to determine whether and to what extent it may be necessary to adapt the current rules in order to take into account the specific features of that industry and to prevent BEPS.”

Against this background, the BEPS Action Plan includes the following description of the work to be undertaken in relation to the digital economy:

***Action 1 – Address the tax challenges of the digital economy***

*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 examined include, but are not limited to, the ability of a company to have a significant digital presence in the economy of another country without being liable to taxation due to the lack of nexus under current international rules, the attribution of value created from the generation of marketable location relevant data through the use of digital products and services, the characterisation of income derived from new business models, the application of related source rules, and how to ensure the effective collection of VAT/GST with respect to the cross-border*

*supply of digital goods and services. Such work will require a thorough analysis of the various business models in this sector.*

At their meeting in St. Petersburg on 5-6 September 2013, the G20 Leaders fully endorsed the BEPS Action Plan, and issued a declaration that included the following paragraph related to BEPS:

*In a context of severe fiscal consolidation and social hardship, in many countries ensuring that all taxpayers pay their fair share of taxes is more than ever a priority. Tax avoidance, harmful practices and aggressive tax planning have to be tackled. The growth of the digital economy also poses challenges for international taxation. We fully endorse the ambitious and comprehensive Action Plan – originated in the OECD – aimed at addressing base erosion and profit shifting with mechanism to enrich the Plan as appropriate. We welcome the establishment of the G20/OECD BEPS project and we encourage all interested countries to participate. Profits should be taxed where economic activities deriving the profits are performed and where value is created [...] (G20, 2013).*

The Task Force on the Digital Economy (TFDE), a subsidiary body of the Committee on Fiscal Affairs (CFA) was established in September 2013 to carry out the work, with the aim of developing a report identifying issues raised by the digital economy and possible actions to address them by September 2014.

The TFDE held its first Meeting on 29-31 October 2013 during which delegates discussed the scope of the work and heard presentations from experts on the digital economy. The Task Force also discussed the relevance of the work done in the past on this topic. In particular, the Task Force discussed the outcomes of the 1998 Ottawa Ministerial Conference on Electronic Commerce where Ministers welcomed the 1998 CFA Report “Electronic Commerce: Taxation Framework Conditions” setting out the following taxation principles that should apply to electronic commerce.

#### **Box 1.1. Ottawa Taxation Framework Conditions – Principles**

Neutrality: Taxation should seek to be neutral and equitable between forms of electronic commerce and between conventional and electronic forms of commerce. Business decisions should be motivated by economic rather than tax considerations. Taxpayers in similar situations carrying out similar transactions should be subject to similar levels of taxation.

**Box 1.1. Ottawa Taxation Framework Conditions – Principles**  
(continued)

**Efficiency:** Compliance costs for taxpayers and administrative costs for the tax authorities should be minimised as far as possible.

**Certainty and Simplicity:** The tax rules should be clear and simple to understand so that taxpayers can anticipate the tax consequences in advance of a transaction, including knowing when, where and how the tax is to be accounted.

**Effectiveness and Fairness:** Taxation should produce the right amount of tax at the right time. The potential for tax evasion and avoidance should be minimised while keeping counteracting measures proportionate to the risks involved.

**Flexibility:** The systems for taxation should be flexible and dynamic to ensure that they keep pace with technological and commercial developments.

The Task Force considers that these principles are still relevant today and, supplemented as necessary, can constitute the basis to evaluate options to address the tax challenges of the digital economy. In addition, the Task Force discussed the post-Ottawa body of work and in particular the work of the Technical Advisory Group on Business Profits (TAG BP) relating to the attribution of profits to permanent establishments (PEs), the place of effective management concept and treaty rules in the context of e-commerce. For an overview of this prior work, please refer to Annex A.

Considering the importance of stakeholders' input, the OECD issued a public request for input on 22 November 2013. Input received was discussed at the second meeting of the TFDE on 2-3 February 2014. The Task Force discussed the evolution and pervasiveness of the digital economy as well as the key features of the digital economy and tax challenges raised by them. The Task Force heard presentations from delegates outlining possible options to address the BEPS and tax challenges of the digital economy and agreed on the importance of publishing a discussion draft for public comments and input. The input received was discussed by the Task Force and contributed to the finalisation of its report.

This report provides first an overview of the fundamental principles of taxation, focusing on the difference between direct and indirect taxes and the concepts that underlie them as well as double tax treaties (Chapter 2). It then examines the evolution over time of information and communication technology (ICT), including emerging and possible future developments (Chapter 3) and discusses the spread and impact of ICT across the economy, providing examples of new business models and identifying the key features of the digital economy (Chapter 4). It then provides a detailed description

of the core elements of BEPS strategies in the digital economy (Chapter 5) and discusses how the development of the measures envisaged in the BEPS Action Plan and the OECD work on indirect taxation are expected to address them (Chapter 6). Finally, it identifies the broader tax challenges raised by the digital economy (Chapter 7) and summarises the potential options to address them that have been presented to, and initially discussed by, the Task Force (Chapter 8). The conclusions of the Task Force are included at the end of the report.

## *Bibliography*

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