

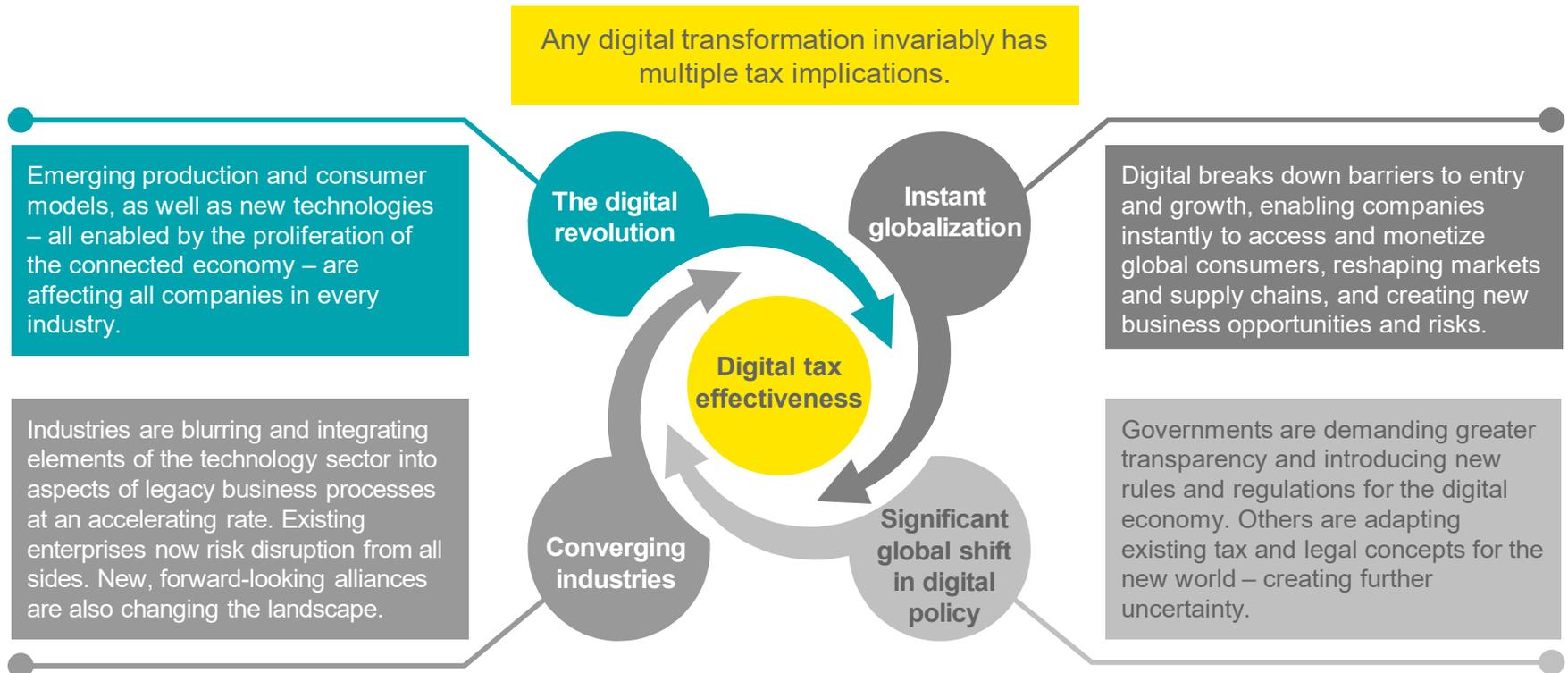
# **Tax Challenges in Digital Economy**

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# Digital tax

## Managing interconnected themes



# Typical business models in Technology Sector



# Traditional business models in Technology Sector

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- ▶ Captive software development services
  - ▶ Contract R&D for software?
- ▶ Reseller of software products
  - ▶ Dealers of Microsoft Windows/ Office Packages
  - ▶ Dealers of Adobe Products
- ▶ Entrepreneurial software development services
- ▶ IP owner of software products

# Highly digitized business models

## Unconventional / newer models

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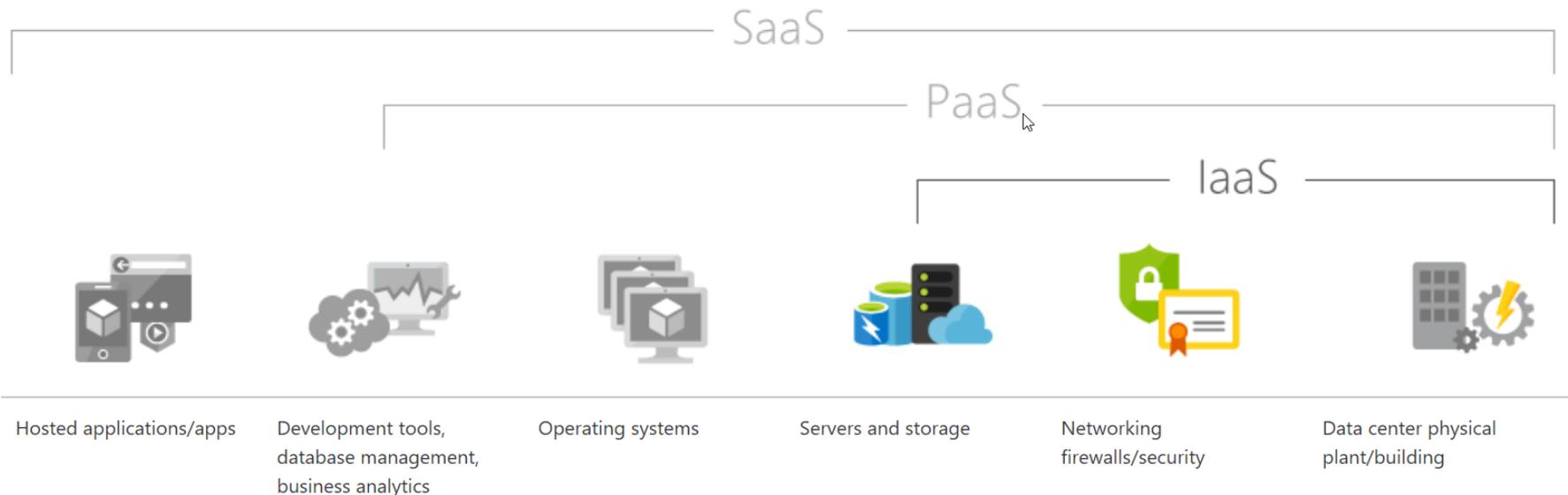
- ▶ Marketing support or resale of technology platform driven services/ products (with or without presence in India)
  - ▶ Apple Music
  - ▶ Google Ads
  - ▶ Netflix
  
- ▶ Multi-sided platforms
  - ▶ Uber
  - ▶ Amazon
  - ▶ Facebook
  - ▶ Twitter
  - ▶ YouTube
  - ▶ Google
  - ▶ Whatsapp
  
- ▶ Vertically integrated firms
  - ▶ Amazon e-commerce (warehousing and logistics)
  - ▶ Netflix (film production)

# Highly digitized business models

## Unconventional / newer models

### ► Cloud computing services

- Infrastructure as a service – Eg: Microsoft Azure, Amazon Web Services (AWS)
- Platform as a service – Eg: Deploying site/ tools on Azure or AWS
- Software as a service – Eg: Office 365 e-mail service



# Upcoming evolutions

## 3D Printing

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### Direct Manufacturing of end products

**Airbus** A350 XWB airplane flies with more than 1,000 3D printed parts and achieves 25% fuel savings compared to competitors.

**UPS** set-up 3D printing facilities at its Worldhub in Louisville and over 60 other locations around the world. Customers can place print orders for urgently needed objects and UPS ships them within 24 hours to any location in the world

**Hoet** sells glasses that are aligned to the individual facial shapes of the customer as well as frames with new designs.

**GE** produces a jet engine fuel nozzle with 3DP – integrated 20 parts into 1, 5x longer product lifetime and 15% fuel savings

**Siemens** refurbishes the burner tips of their gas turbines by cutting off the burner tip and 3D printing the replacement part on top.

**Adidas** offers customers high-end running shoes with 3D printed midsoles within their Futurecraft 3D initiative. In a store customers get their feet scanned while running. The resulting 3D model of the ideal midsole is manufactured with 3DP in order to be inserted in a pre-fabricated green body of the pair of shoes

**Daimler Trucks** 3D-prints spare parts on demand and saves logistics and manufacturing costs.

# Upcoming evolutions

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## ▶ Blockchain and Cryptocurrency

- ▶ Block chain cloud or distributed cloud
- ▶ Crypto currency

## ▶ Industrial Mash-ups

- ▶ **Apple Inc.–International Business Machines Corporation** alliance to bring IBM's big data analytics capabilities to iPhone and iPad platforms for enterprise customers.
- ▶ **Johnson & Johnson** plans to bring to market a mobile app that would be a virtual coach for patients in a variety of circumstances. The app would leverage Johnson & Johnson's clinical know-how and **Apple**'s user experience design and link to **IBM**'s Watson for back-end cognitive computing and big data analytics intelligence.

## ▶ Internet-of-things (IoT)

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# Types of value creation

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## ▶ Value Chain

- ▶ Software products (standard package), apps, SaaS
- ▶ Reseller of tangible or intangible products

## ▶ Value Network

- ▶ Facebook, Twitter
- ▶ Amazon
- ▶ Google, YouTube
- ▶ Paytm (for transactions within the same service provider)

## ▶ Value Shop

- ▶ Cloud platform (except for standardised SaaS)
  - ▶ Software development services
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# Some questions on taxation of highly digitised business models

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## Multi-sided platforms/ Vertically integrated firms:

- ▶ Who gets to tax the platform operator – country where the platform is developed or conceptualised or where users are located?
- ▶ How should the profits be allocated amongst the group entities?

## Cloud Computing:

- ▶ What will be the right characterisation of the income from cloud computing – IaaS, PaaS, SaaS?
- ▶ Will use of server capacity in different countries trigger PE for the customer contracting entity in country where server is physically located?
- ▶ Will data localisation laws impact value chains and taxes?

## 3D Printing:

- ▶ Who owns a product's IP - Is it the designer, the programmer who translates the design into a printable file, the business or consumer printing out a product — or all of the above?
- ▶ What will be the right characterisation of the income from 3D printing?
- ▶ How would 3D printing change the global footprint of your functions, assets and risks?
- ▶ What are the taxable events in 3D supply chain (for example, there is no cross-border movement of goods if they are printed near to customer's location, thereby skipping customs control)

# Some questions on taxation of highly digitised business models

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## Blockchain:

- ▶ How will provision of distributed cloud change the characterisation of entities providing their spare or un-utilised computing capacity?
- ▶ Will use of server capacity in different countries trigger PE for the in country where server is physically located?

## Industrial Mash-ups:

- ▶ How does an industrial mash-up impact the function, asset and risk profile of the alliance partners?
- ▶ How will the profit commercially shared amongst them be split between the group entities of each alliance partners, when only a part of the overall value chain is involved in the alliance?

# Digital indirect tax trends

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- ▶ Lack of clarity and agreement between countries or states about how tax should apply to e-commerce sales and who is responsible for charging and remitting it may lead to double taxation or no taxation. Even if the nonresident supplier is deemed to be responsible, compliance levels may be low.
  - ▶ “International VAT/GST Guidelines” published with a heavy focus on the place of supply of cross-border supplies of services and intangibles and the application of the principles of destination and neutrality. Trend toward digital supplies becoming taxable in the country of consumption
- ▶ Challenges exist when different import values flow through similar distribution channels. Traditional product flows of products purchased through B2C (e.g., in a brick and mortar store) may have different prices than products purchased over the internet.
- ▶ The widespread use of 3D printing at the customer’s premises is likely to increase the trend towards shifting the value chain to services.
- ▶ Digital provision and consumption of services could make it difficult to enforce VAT/GST, especially on barter transactions on multi sided platforms

# Digital indirect tax trends

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- ▶ The use of cloud computing could create challenges around determining the place of consumption of services, as export of services may be inter-posed between domestic consumption of such services.
- ▶ Digital marketplaces now facilitate trade between private individuals - peer-to-peer (P2P) platforms – such as online sale of used goods platforms. Therefore, there could be challenges around collection of VAT/GST on C2C transactions.
- ▶ Who will collect tax and from whom?
  - ▶ Collect the VAT from the non-resident supplier?
  - ▶ Collect the VAT from the end consumer?
  - ▶ Collect the VAT from an online marketplace?
  - ▶ Collect the VAT from the debit or credit card issuer used in the transaction?
  - ▶ Collect the VAT through a so-called ‘split payment method’, in which the purchaser pays the VAT into a separate bank account which is diverted for the tax authority’s benefit?
  - ▶ Collect the VAT by deeming a permanent establishment to exist in the country if goods or services are supplied to customers in that country either through a local domain name address, or through local payment processing?

# Key characteristics of highly digitalised business models



# Key characteristics of digitalized business

And its perceived impacts on international tax rules



## “Scale without mass”

## Reliance on IP

## Data value, user participation

### Description

Ability to have a significant economic presence in a country without a major physical presence.

Particularly heavy reliance on intangible assets, including intellectual property.

Many newer business models include elements of data, user participation, user-generated content and network effects

### Government concerns

Impacting the distribution of taxing rights over time by reducing the number of jurisdictions where a taxing right can be asserted over the business profits of an MNE

Notwithstanding BEPS work:  
Often difficult to determine how to allocate income from intangibles among different parts of an MNE group

If considered a source of value creation, could pose challenges, as such a concept of value creation is currently not captured by the existing tax framework

# Reactions of tax administrations



# The OECD's interim report

Issued on 16 March 2018

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1

Provides analysis of the main features frequently observed in certain highly digitalized business models and value creation in the digitalized age.

3

Outlines framework of design considerations regarding interim measures

5

Members will work towards a consensus-based solution, noting that divergent views exist.

2

Describes the complexities of the issues involved, and the positions that different countries have in regard to these features.

4

*[BEPS IF] Members agreed to undertake a coherent and concurrent review of the “nexus” and “profit allocation” rules.*

6

Will produce a final report in 2020, with an update to the G20 in 2019.



Notes that “*There is **no consensus** on the need for, or merits of, interim measures, **with a number of countries opposed to such measures** on the basis that they will give rise to **risks and adverse consequences.**”*”

# Five categories of national action

What we are seeing around the world

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Alternative PE thresholds (India, Israel, Italy)



Specific anti-abuse regimes (Australia, UK, US)



Equalization Levies/Turnover taxes  
(Hungary, Greece, India, Italy)



Withholding taxes



Application of VAT/GST  
(Argentina, Australia, New Zealand, Singapore, Turkey - in all around 50+ countries)

# Proposed profit allocation and nexus rules

## OECD Public consultation document

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### ▶ User participation

- ▶ Focuses on the value created by certain highly digitalised businesses (such as social media platforms, search engines and online marketplaces) through developing an active and engaged user base, and soliciting data and content contributions from them.
- ▶ Existing international tax framework focuses on the physical activities of a business in determining where profits should be allocated and the extent of the taxing rights of user jurisdictions.
- ▶ The proposal would modify current profit allocation rules to require that, for certain businesses, an amount of profit be allocated to jurisdictions in which those businesses' active and participatory user bases are located, irrespective of whether those businesses have a local physical presence.
- ▶ This would be implemented with the help of Residual Profit Split Method (RPSM) wherein the routine profits are first assigned to each entity in the value chain based on their functional profile and then the residual non-routine profits would be allocated to various entities that have business users, using some agreed allocation metric (such as revenue)

# Proposed profit allocation and nexus rules

## OECD Public consultation document

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### ▶ Marketing intangible

- ▶ The report sees an intrinsic functional link between marketing intangibles and the market jurisdiction. This intrinsic functional link is seen as manifested in two different ways.
  - ▶ First, some marketing intangibles, such as brand and trade name, are reflected in the minds of customers and so can be seen to have been created in the market jurisdiction.
  - ▶ Second, other marketing intangibles, such as customer data, customer relationships and customer lists are derived from activities targeted at customers and users in the market jurisdiction, supporting the treatment of such intangibles as being created in the market jurisdiction.
- ▶ The more data on consumers that can be collected, analysed and exploited remotely through the use of digital technology, the easier it is to avoid exercising any of the DEMPE and related risk management functions in the market jurisdiction that under today's rules govern the allocation of income from marketing intangibles.
- ▶ Therefore, this proposal contemplates that the market jurisdiction would be entitled to tax some or all of the non-routine income properly associated with such intangibles and their attendant risks, while all other income would be allocated among members of the group based on existing transfer pricing principles (again akin to RPSM).

# Proposed profit allocation and nexus rules

## OECD Public consultation document

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- ▶ Significant economic presence
  - ▶ Digitalisation of the economy and other technological advances have enabled business enterprises to be heavily involved in the economic life of a jurisdiction without a significant physical presence.
  - ▶ Under this proposal, a taxable presence in a jurisdiction would arise when a non-resident enterprise has a significant economic presence on the basis of factors (as explained below) that evidence a purposeful and sustained interaction with the jurisdiction via digital technology and other automated means. The factors that would trigger SEP are:
    - ▶ Revenue generated on a sustained basis from that jurisdiction, along with any of the below:
      - (1) the existence of a user base and the associated data input;
      - (2) the volume of digital content derived from the jurisdiction;
      - (3) billing and collection in local currency or with a local form of payment;
      - (4) the maintenance of a website in a local language;
      - (5) responsibility for the final delivery of goods to customers or the provision by the enterprise of other support services such as after-sales service or repairs and maintenance; or
      - (6) sustained marketing and sales promotion activities, either online or otherwise, to attract customers.
  - ▶ The proposal contemplates that the allocation of profit to a significant economic presence could be based on a fractional apportionment method

# Concluding thoughts



# Concluding thoughts

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- ▶ Technology and business models are constantly evolving and tax regulators are trying to catch-up
- ▶ Value creation needs to be viewed from a broader perspective
- ▶ No consensus yet amongst all countries
- ▶ No clear recommendations as yet, but trends suggest:
  - ▶ Focus on re-defining nexus rules to enable taxation of digital businesses
  - ▶ Emphasis on “demand” side factors?
  - ▶ Profit split method preferred over other methods
  - ▶ But gradually formulary or fractional apportionment seems to be gaining ground over arm’s length principle?
  - ▶ Larger compliance burden on various parties to meet revised VAT/GST guidelines

**Thank you**