



# Observations on OECD Interim Paper and EU Commission Digital Tax Proposals

KPMG International

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# Introduction

On 16 March the OECD released its Report "*Tax Challenges Arising from Digitalization — Interim Report 2018*" and on 21 March the EU Commission (EC) released two draft directives on the taxation of digitalized businesses. The first is an interim measure for a Digital Services Tax and the second is a long-term approach for taxing revenues from a Significant Digital Presence.

The purpose of this commentary is to try to offer a positive contribution to move the debate forward and to set out KPMG International's<sup>1</sup> initial reaction to the above proposals<sup>2</sup>.

Our intention is not to propose a particular solution or outcome but to try to clarify the issues, comment on whether or not proposals meet their stated aims and highlight potential consequences.

This note first looks at the issues caused by digitalization and the different rationale put forward for changing the taxation of highly digitalized businesses. Then it looks at the OECD's and the EC's approaches to both a long term solution and interim measures.



## Background

- October 2015: Action 1 of the OECD Base Erosion and Profit Shifting (BEPS) on the digital economy published which:
  - Notes there is digitalization of the economy not a digital economy
  - BEPS is exaggerated by digitalization
  - Proposes a destination principle for determining the place of taxation for VAT for cross-border supplies
  - Reaches no agreement on corporation tax
  - Agrees to monitor developments and report again in 2020
- 2016 onwards: Countries introduce unilateral "digital" taxes — e.g. Israel's significant economic presence tax (2016); India's equalization levy (2016); France's online audio visual content/ advertising levy (extended in 2016); Slovak Republic's expanded fixed place of business (2017); Italy's levy on digital transactions (2017), Hungary's advertisement tax;
- March 2017: The G20 mandate the OECD to produce an interim report by the IMF/World Bank Spring Meeting in April 2018
- October 2017: EU Commission launches a questionnaire on "Fair Taxation of the Digital Economy"
- November 2017: OECD starts public consultation
- 16 March 2018: OECD releases "*Tax Challenges Arising from Digitalization — Interim Report 2018*" agreed by the 113 Countries in the Inclusive Framework
- 21 March 2018: EU Commission releases proposals for two directives on a "common system of a digital services tax" and "corporate taxation of a significant digital presence"

<sup>1</sup> KPMG is a global network of professional services firms providing Audit, Tax and Advisory services. We operate in 154 countries and territories and have 200,000 people working in member firms around the world. The independent member firms of the KPMG network are affiliated with KPMG International Cooperative ("KPMG International"), a Swiss entity. Each KPMG firm is a legally distinct and separate entity and describes itself as such.

<sup>2</sup> KPMG has already responded to the consultation initiated by both the OECD and EU Commission.

# Summary

Put at its simplest, the basic issue is that digitalization makes it increasingly possible for businesses to reach markets in jurisdictions in which they may have relatively little physical presence. This means that under existing international tax rules, which allocate taxing rights on business profits on the basis of physical presence, it is possible for a company that is resident in one state (Residence State) to generate significant revenues in another state (Source State) without paying a significant amount of corporation tax in Source State. The OECD and EU appear to take related, but different views on how to approach this:

- 1) OECD: The Report focuses on taxing where value is created, and on understanding the impact that digitalization may have had on business models and value creation. Due to lack of consensus among the member countries, it does not reach any recommendations on whether or to what extent changes to international tax rules for dividing profits between source and residence countries may be required. Instead, it calls for further work to examine the existing international tax rules on nexus (e.g. should a digitalized business be deemed to have a taxable presence in a country where it does not have a traditional physical presence) and on how to allocate profit on the basis of that nexus.
- 2) EU Commission: It appears that the EC considers the issue to be more a political one over taxing rights and the balance between source and residence taxation — as witnessed by the fact that the EC talks about digital companies “paying their fair share of tax”<sup>3</sup>. The draft directives released by the EC would allocate additional taxing rights to countries in which users of digital services are located, rather than the country of residence of the enterprise providing those services. While the interim Digital Services Tax is quite focused (taxing advertising, digital platforms and sale of data) the long term Significant Digital Presence proposal would tax a broad range of digital services — such as the provision of films, music, software, or cloud computing. In such cases it is much less obvious that the non-resident company is carrying on business or creating value in the Source State above and beyond generating revenues from residents.

It is unclear at this stage if agreement can and will be reached either over how to identify precisely where value is created in highly digitalized businesses or concerning changing the traditional balance of source versus residence taxation. Both approaches however will require a political consensus to be reached on a global basis: political because both require a change to existing international taxing rights; global because without agreement there will be double taxation of profits in Source State and Residence State.

***It is therefore important:***

- that clarity is reached on the perceived problem, in particular on whether the key rationale for any new rules would be to ensure tax continues to be levied where economic activity is performed and value is created or whether a more fundamental change to the balance of source versus residence taxation is contemplated;
- to understand how value is created in different business models, including the role of data in that process, before arriving at a solution to the problem;
- that a consensus-based approach is adhered to in finding a long term solution; and
- interim measures, if deemed necessary, are approached with caution and dealt with in a coordinated fashion.

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<sup>3</sup> For example see Q & A in the Fact sheet released on 21 March 2018

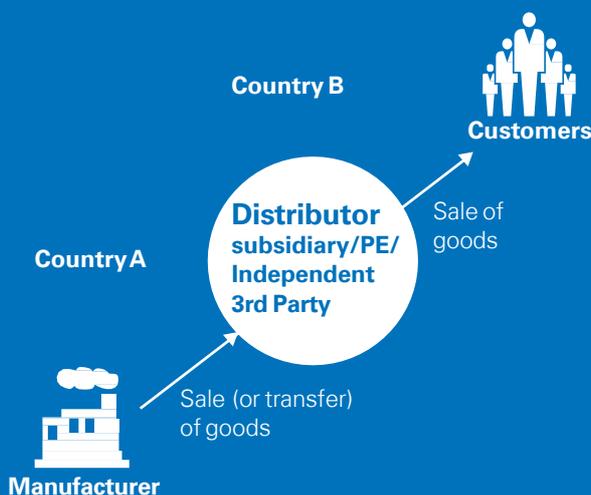
# General observations on the underlying issues in the debate about taxing the digital economy

Before digitalization the phenomenon of a company in Resident State making significant revenues from residents in Source State without the latter state being able to collect tax on part of the value chain generally did not occur. A company supplying goods or service from Residence State to Source State would have done so via a local subsidiary, a permanent establishment (PE) or an independent local entity. In each of those cases the local entity is part of the overall supply chain, is generating value locally, and would normally have been paying local corporate income tax. Technology development reduce the need for the local entity in some cases — hence the concern that Source State collects a reduced amount of tax while the company in question continues to make significant revenues from that state.

Put this way, the underlying issue is that technology has enabled a change in business models and this is driving questions over if and to what extent value is being created in the Source State and, especially, whether there should be a change in the traditional split of taxing rights between Source and Residence States. However, in the tax debate, concerns about the digital economy are often expressed in different ways. And these different concerns have led to differing proposals on how to tax digitalized companies to address them. These concerns are examined below to show that while they may be relevant in some cases, they should not be applied as a generalization; which indicates they are not a good foundation for a general change in the taxation of digitalized businesses.



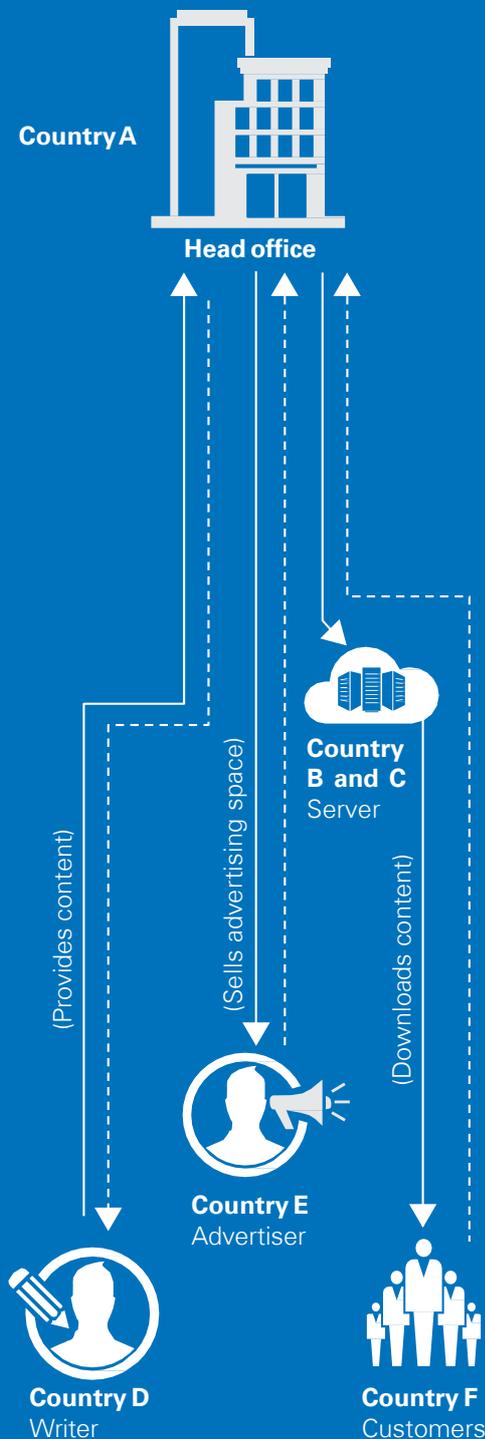
## Traditional value creation



- Manufacturer in Country A produces goods and sell them to Distributor in Country B (or transfers them if Distributor is its own PE)
- Distributor holds the stock, carries out marketing and sells to local customers in Country B
- Manufacturer generates value in Country A and is taxed there on the profit it makes
- Distributor generates value in Country B and is taxed on there on the profit it makes



## Digital publisher



- Publisher in Country A develops all the software systems and manages the entire business
- Independent writer in Country D sells an article to Publisher
- Publisher uploads all its content to a cloud based platform with servers in Countries B and C
- Publisher sells advertising space to Advertiser based in Country E which enables Advertiser to customize adverts to Publisher's subscribers in Country F
- Subscribers in Country F pay a subscription to Publisher in Country A in order to access content on their platform
- Publisher generates value in Country A from developing the platform and running the business and is taxed on all the profits it earns there
- Writer is taxed in Country D on the fee he or she earns
- Publisher generates value from using the data of Customers in Country F to sell advertising space to Advertiser in Country E. But is the value created in Country F where the data is collected, in Country E from which a tax deductible payment is made or in Country A where the software and business model are developed? Which country has the taxing rights on this portion of value creation?
- Is Publisher generating value in Country F simply by receiving the subscription fees? Does this change if Publisher is able to use the Customers' data to actively sell more digital content or if Customers actively engage in suggesting what sort of articles Publisher should produce? Which country should be able to tax (part of) the subscription fees?
- Publisher's business relies on the servers in Countries B and C but these require no local personnel of Publisher to maintain them. Is Publisher generating value in Countries B and C and can they tax the profits of Publisher?

## **BEPS/Avoidance**

The OECD's work on the digital economy was undertaken initially as part of the base erosion and profit shifting (BEPS) project, which focused on the shifting of profits from source and residence countries to low or no-tax jurisdictions in which minimal functions were performed. In particular, the OECD's 2015 report on the tax challenges of the digital economy concluded that certain features of the modern, digitalized economy could exacerbate BEPS risks. The outcomes of the BEPS project were intended to address concerns about artificially avoiding Source State nexus or shifting profits to a third country in which no significant activity was performed, including with respect to digitalized businesses.

Thus, while the BEPS concern continues to be put forward as a reason for changing the taxation of digitized businesses, it is clear that this is no longer a key driver. This is made clear by the fact that recent proposals to tax the digital economy go far wider than addressing profit shifting to low-tax jurisdictions. For example, both the EC interim proposal and the long term Significant Digital Presence proposal would allow Source State to tax an MNE irrespective of the rate of tax it paid in Residence State or of its overall effective tax rate.

## **Reduction in the tax base**

Another argument which is put forward is that digitalization is eroding some countries' tax bases — irrespective of any planning or BEPS issues. For example hotels in Source State are increasingly using internet booking enterprises and having to pay fees to the offshore provider located in Resident State; companies which want to advertise their product for sale in Source State are paying social media networks located in Resident State. There is therefore a tax deduction in Source State but it cannot tax the profits made in Resident State.

No studies seem to have been carried out to show if such erosion is occurring or its extent. Given that the local enterprises will be accessing the digital platforms for business reasons — e.g. to increase the number of bookings or obtain cheaper or more effective advertising — it may also be that their profits increase and so does the local corporation tax take. It may also be the case that the company paying to advertise product in Source State is itself based in Resident State. There is therefore no tax deduction in Source State and the erosion argument cannot be used for taxing the corresponding income.

Finally, this issue is not particular to digitalization. It is simply the result of any cross-border activity where a company finds it is more productive to source inputs from abroad.

## **Unfair competition**

The EU Commission papers talk about "A Fair and Efficient Tax System in the EU for the Digital Single Market"<sup>4</sup>. The Fact Sheet released on 21 March 2018 notes that the "effective tax rate for digital companies ... is around half that of traditional companies" and the debate is sometimes framed around unfair competition between traditional and digitally enabled businesses.

However, any difference in tax rate is due to the international nature of digitalized companies and the fact the business may be operated from a low tax country. A traditional company which manufactures goods in a low tax country for distribution worldwide would also have a similar benefit. Furthermore, a digital business which is developed in a high tax country and which provides goods and services from that country would have a high rate of tax; nevertheless its profits would be still subject to tax in any Source State under the EU proposals.

## **Fairness/fair share of tax**

A similar argument to that of unfair tax competition is the statement that digital companies must "pay their fair share of tax."<sup>5</sup> However such an argument presupposes that the MNE in question is not paying a "fair share" already. Underlying this claim is therefore the assumption that i) the MNE is engaged in profit shifting; ii) the MNE is carrying on business or generating value in the Source State but not paying (sufficient) tax there; or iii) there needs to be a shift of taxing rights away from the Residence State and to the Source State.

## **Need to tax where the value is created**

The EU Commission's Fact Sheet states that the current tax rules do not "effectively tax profits generated largely from consumer data." The OECD Report also notes that the two key issues are nexus and allocation of profits. Various ways have been put forward for overcoming the nexus issue. For example the EU Significant Digital Presence proposal would deem a PE to exist in a Source State where a threshold based on revenue, users or business contracts was met. The difficulty however is allocating profits to the deemed PE. Fundamentally this raises the issue of how to value data. It is sometimes argued that data is like a natural resource — e.g. oil — and a country whose citizens' data is being used should be able to tax it. Others however point to the fact that the real value is in the algorithms which manipulate the data and these will have been created in the Residence State.

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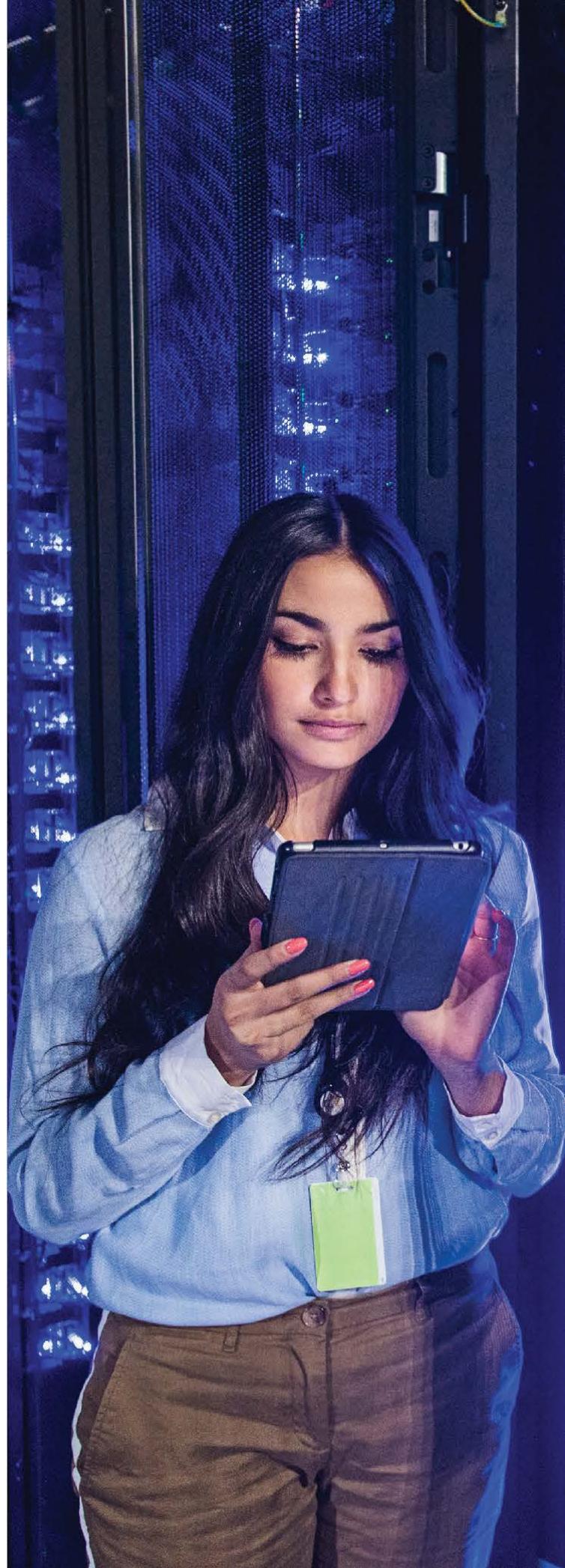
<sup>4</sup> For example see Q & A in the Fact sheet released on 21 March 2018

<sup>5</sup> Ibid

The EC proposals may seem to have overcome the issue of how to value the data to a certain extent by deeming activities related to data and users carried out through the digital interface to be economically significant activities carried out through the Significant Digital Presence relevant to the attribution of assets and risks. It is true that this analysis would then be followed by an attribution of profit to the Significant Digital Presence based on current transfer principles and so does consider value creation. But this is done by deeming functions to be carried out through the Significant Digital Presence. Furthermore, the EC proposals would tax the supply of films, music, software and access to cloud computing even where there is no need for the supplier to be using the customers' data. In these cases it is difficult to see what value is generated in the Source State — above and beyond the fact that there are customers paying for the service. The EU Significant Digital Presence proposal therefore seems to be more of an attempt to redefine the balance of source versus residence taxation than an attempt to quantify and tax value creation.

***Is there an agreed basis for changing the taxation of digitalized businesses?***

The OECD Report notes that there was no agreement on this question amongst the members of the Inclusive Forum; there was only general agreement to continue work on analyzing new business models.



# Consideration of the OECD and EU Commission proposals

## Long-term solutions

### OECD approach

The OECD Report notes three common characteristics of what are described as highly digitalized business models (see 2.5, page 51):

- cross-jurisdictional scale without mass (i.e. the ability to obtain significant revenues from a country without having a significant physical presence);
- the importance of intangible assets; and
- the importance of data, user participation and the synergies with intellectual property.

The Report also notes that some of the members of the Inclusive Framework considered that the role of user participation represents a unique and important driver of value creation in digitalized businesses. Other countries, however, view data collection as a transaction between the users and the digitalized business with the latter providing financial or non-financial. In principle such a transaction could be taxed although income tax systems rarely capture such barter transactions (para 158, page 58).

Chapter 5 of the Report identifies the challenges in adapting the international tax system to the digitalization of the economy. It recalls the challenges set out in the 2015 BEPS Action 1:

- Nexus: the reduced need for a physical presence to carry a business in a country;
- Data: how to attribute value created from the generation of data through digital products and services; and
- Characterization: the fact that the development of new digital products or means of delivering services creates uncertainties in relation to the proper characterization of payments.

The potential responses to these challenges are presented in three groups of countries (5.4.2).

The first group agrees that the characteristics of highly digitalized business models may lead to a misalignment between the location in which profits are taxed and the location in which value is created. This is the result of the unique features observed in such business models which are not captured by the existing international tax framework. Therefore the issues are confined to certain business models and may be addressed through targeted changes to existing tax rules including a reconsideration of the rules relating to profit allocation and nexus.

The second group of countries believe that the issue is wider and that ongoing digital transformation of the economy and more general trends associated with globalization present challenges to the continued effectiveness of the existing international tax framework for business profits.

The third group of countries considers that the BEPS package has largely addressed the concerns of double-non-taxation although many consider that it is too early to make a full assessment.

The Report concludes that despite the differing views there is general agreement that there should be more exploration of potential changes to the nexus and profit allocation rules (5.4.3). The next stage of work will therefore require refining the analysis of the value contribution of certain characteristics of highly digitalized business models with a view to studying its impact on any revision of the nexus and profit allocation rules. The intention is to work towards a consensus-based approach through the Inclusive Framework by 2020.



## KPMG Observation

If the concern is around BEPS there is merit in the third view — i.e. the issues should largely have been addressed by the OECD BEPS programme and it would be advisable to wait a number of years to judge its effectiveness.

However, this does not address the concern of some countries that value is being created in the Source State which is not being taxed, or that the source versus residence rules need adjusting. To this extent there seems to be some alignment between the first and second groups of countries. Both agree that changes to business models and practices have put pressure on traditional international tax rules. The question is whether this is only or mainly in the area of highly digitalized businesses or is a wider problem of globalization. Clearly, a fundamental change to

the source versus resident principle would require global agreement and could be difficult to achieve. There could therefore be merit, as an initial step, in focusing on specific issues arising from highly digitalized businesses and determining whether and how they may place pressure on existing tax principles.

The key issue will be how to identify and agree upon where value which is generated in a digitalized business — which raises the question of how to value data. Chapter 2 of the OECD Report contains a detailed analysis of business models and value creation and we support the call for further work to be done in this area.

### *The EU Commission proposals*

The EU Commission proposal is to tax the profits of a deemed PE — a Significant Digital Presence. It is aimed at taxing profits from “digital services” which means “services which are delivered over the internet or an electronic network and the nature of which renders their supply essentially automated and involving minimal human intervention, and impossible to ensure in the absence of information technology”. The definition goes on to refer to a number of services such as digitized products generally, software and upgrades; services supporting a business or personal presence on electronic network such as a website; services automatically generated from the computer; the transfer for consideration of the right to put goods or services up for sale on an internet site operating as an online market; provision of content pages, web hosting and access to online databases. Annex II to the draft directive contains a more detailed list of digital services, including for example accessing or downloading films and music. The sale of goods or services which is facilitated by using the internet is specifically excluded.

The draft directive recognizes that, where tax treaties exist between EU member states and third countries, it would be necessary to renegotiate the particular treaty before the new PE concept could be applied. Therefore the interim measure (see below) will remain in place until such change has been effected.

A Significant Digital Presence exists where digital services are provided through a digital interface and one of three conditions is met:

- the total revenue in the tax period from the supply of digital services to users located in a member state exceeds €7 million;
- the number of users of the digital services located in the member state exceeds a hundred thousand; or
- the number of business contracts for the supply of such digital services that are concluded in the tax period by users located in that member state exceeds 3,000.

Article 5 of the draft directive states that the profits attributable to the Significant Digital Presence are the profits it would have earned if it had been a separate and independent enterprise. Such profits are found by carrying out a functional analysis. In determining the economic ownership of assets and risks it is necessary to take account of the economically significant activities performed through the digital interface. Activities “related to data or users” are deemed to be “economically significant activities of the significant digital presence which attribute risks and the economic ownership of assets to such presence.” Finally the profits attributable are calculated using a profit split method unless the taxpayer proves that an alternative method based on an internationally accepted principle is more appropriate.



## KPMG Observation

The EC proposals for allocating profit to a Significant Digital Presence are built on the current OECD transfer pricing framework, and the Authorized OECD Approach (AOA) remains the underlying principle. The Commission, however, acknowledges that in order to meet the objective of attributing profit to a Significant Digital Presence, the AOA needs to be adapted. The AOA in its current form attributes economic ownership of assets and risks, and consequently profits, to a PE based on its significant people functions and so would not attribute much or any profit to the Significant Digital Presence in the absence of such functions in Source State. Hence, the EU Commission proposals deem activities undertaken by the MNE through a digital interface related to data and users to be “economically significant functions” in Source State relevant to the attribution of economic ownership of assets and risks. The proposals therefore sidestep the objection that value cannot be attributed to the deemed PE due to the fact that significant people functions are located elsewhere.

Nevertheless, the issue of how much profit to attribute to the Significant Digital Presence remains a challenge. The EC proposals attribute to the Significant Digital Presence the economic ownership of the portion of the intangible assets of the MNE used in the performance of economically significant activities in the Source State. A key open question is how to determine what that portion of the MNE’s intangible assets actually is.

Once the intangible assets attributable to Source State have been determined, the next step will be determining how this should be factored into a profit split. The proposals suggest that the development, enhancement, maintenance, protection and exploitation (DEMPE) functions associated with the intangible assets used in the performance of the economically significant activities by the digital presence could be attributed to Source State and the expenses incurred for these activities relative to other expenses attributable to the head office and/or any other significant digital presences could be used as a possible splitting factor. However, unless the MNE is able to track expenses associated with intangibles

attributed to different significant digital presences separately, which is quite unlikely, it is hard to envision this allocation key being informative. The proposals also suggest the number of users in a Source State and data collected per Source State as possible allocation keys for a profit split. However, the challenge with these allocation keys is measuring the relative contributions of users in Source State in comparison with the digital platform. Therefore, even a prescriptive use of the profit split method will require countries to agree upon the relative value generated by the different functions and digital activities.

Nevertheless, while considerable work remains to be done to determine how the EC proposals would work in practice, they do seem to be moving away from trying to value and tax the use of data as such. The proposals may create a tax charge in Source State even where there is no or relatively little use of customer data or indeed any creation of intangible assets or business activity beyond the supply of services to customers. For example they would apply to the supply of films, software, music and the like and data warehousing even when the servers are outside Source State. It may be that even the modified version of the AOA would not attribute much profit to such a PE, but by deeming a taxable Significant Digital Presence in such situations the proposals appears to move beyond focusing on taxing whether value is created to changing the balance of the source versus residence taxation.

A possible way of addressing concerns of those states identified by the OECD as believing the focus should be on taxing perceived value creation due to customer interaction and data would be to narrow the definition of digital services to exclude those where little customer data or interaction is involved. Nevertheless, the extent of perceived “user value creation” will vary depending upon the type of service and the structure of a particular business and is likely to be disputed by different parties. It may not be possible therefore to create a bright line test to delineate which services do involve such features and which do not.

## Interim measures

### OECD Report

The OECD Report notes there is no consensus on the need or the merit of introducing interim measures (para 407). A number of countries oppose any measures irrespective of their design. Concerns raised include:

- impact on investment, innovation and growth;
- impact on welfare as tax on a gross basis distorts business choices and is likely to have an adverse impact on the economy;
- potential economic incidence of taxation on consumers and businesses as the tax could be (partially) passed on to consumers in the form of higher prices;
- possibility of over taxation as an entity may be subject to corporation tax on its profits and the interim

measures, while economic double taxation could arise by the tax being applied at different levels in the value chain;

- the tax may be difficult to repeal and therefore become a permanent not an interim tax; compliance and administrative costs.

The OECD Report further notes, however, that a number of countries believed that concerns about a perceived mismatch between taxation and value creation challenge the “fairness, sustainability, and public acceptability” of the current system (para 408). They concluded, therefore, that interim measures were necessary, particularly in light of the time likely to be required for consensus on a broader approach. Those countries did, however identify a framework for the design of such measures which they believed would mitigate some of the concerns.



### KPMG Observation

The concerns raised by certain countries about interim measures are valid ones.

Given the fact that, to comply with double tax treaties, any interim tax cannot be an income type tax it is almost inevitable that it will create double taxation. The tax could impact heavily on start-up businesses both due to the compliance burden but also because it would apply even during loss-making years. If interim measures based on tax on turnover are introduced it is therefore important that the applicable rate is not excessive, taking into account the impact of other relevant taxes.

It is also welcome that the countries that did favor the introduction of interim measures agreed on a framework for the design such as the measures being very targeted, not conflicting with tax treaties and respecting other international agreements (e.g. WTO). While such countries indicated that these criteria were intended to minimize the negative effects, this will depend heavily on the details of such measures.

### EU Proposals

The draft EU directive on a Digital Services Tax applies a 3 percent charge to revenues generated from:

- the placing on a digital interface of advertising targeted at users of that interface;
- the making available to users of a multi-sided digital interface which allows users to find other users and interact with them, and which may also facilitate the provision of underlying supplies of goods or services directly between users; and

- the transmission of data collected about users and generated from users activities on digital interfaces.

The tax only applies to a taxable person which has worldwide revenue for the relevant financial year exceeding €750 million; and taxable revenue (i.e. revenue from provision of the above digital services) within the EU in the relevant financial year exceeding €50million.



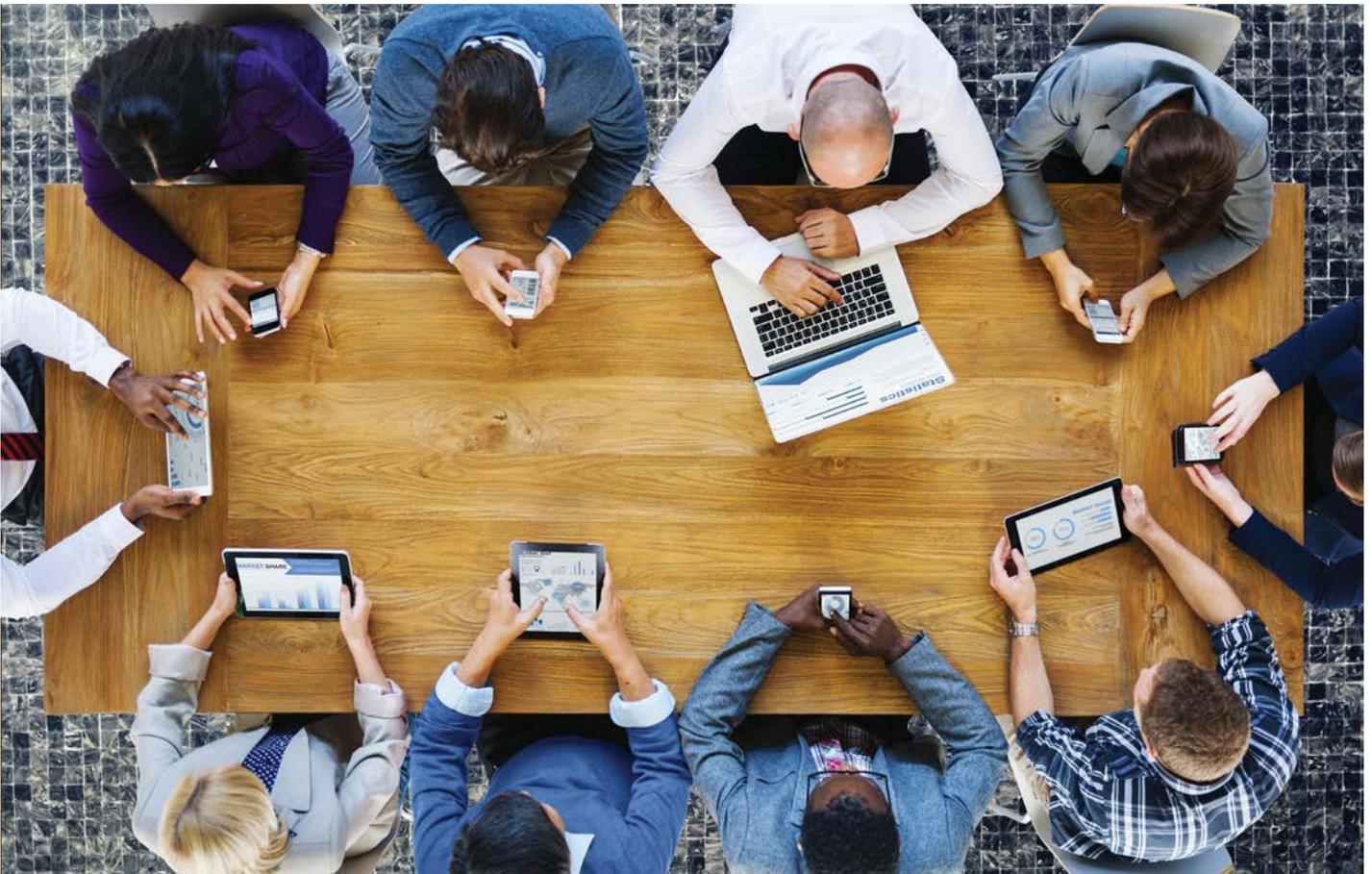
## KPMG Observation

Unlike the Significant Digital Presence proposal, the interim proposal is more narrowly focused on a subset of business models involving collection and monetization of user data or acting as an intermediary between different groups of users. For example, it taxes the sale of data collected from the Source State (presumably the assumption here is that data has value in itself rather than all the value being in the software that collects and manipulates it); it taxes the operation of a platform within the Source State and it taxes advertising revenues. (As regards the latter presumably the rationale is that the digital business is making use of the customers' data to target advertising).

The measure is therefore relatively narrowly targeted but as a tax on gross revenue does have the draw

backs listed above. Even if the charge is allowed as a deduction against the profits subject to tax in the Residence State, it will nevertheless create double taxation. Furthermore, it would create a different effective tax burden depending upon the margins a company makes. As 3 percent charge on *gross revenue* — not net profit — the Digital Services Tax does represent a considerable shift of taxing rights to Source States.

The threshold for the tax appears to have been intended to partially mitigate the disincentive to start ups and the possibility of it being chargeable when a company is in loss position. However, the fact it does not apply to all companies may raise a State Aid issue.



# Indirect Tax

The proposed Digital Services Tax shares a number of features with a VAT, by applying destination based principles to determining the tax base, and in potentially allowing taxpayers to leverage information already collected from their customers (in a VAT context) for determining their location.

The OECD's discussion of interim measures also raises the prospect of leveraging existing VAT methods for the collection of the tax from non-residents. What appears to be contemplated is the idea of a non-resident taxpayer accounting for the tax by registering and paying in each jurisdiction in which they are liable for the tax. The EU proposals similarly contemplate the use of existing VAT collection methods already in place in the EU.

The experience with these VAT collection methods highlights concerns about the number of practical issues which will arise. First, the VAT collection methods being referred to apply primarily to business to consumer ("B2C") cross-border supplies, not business to business ("B2B") cross-border supplies. However, the interim tax will most commonly be invoked for B2B supplies such as advertising services, so the perceived benefits of consistency with existing VAT collection methods may not be achieved

in reality. Second, these VAT collection methods work reasonably effectively in places like the European Union where non-residents can effectively register and account for VAT referable to all Member States in a single location, known as the Mini One Stop Shop (MOSS). However, there is no equivalent to this in many other parts of the world, which will potentially necessitate compliance obligations being imposed in multiple new jurisdictions, together with the need to appoint fiscal representatives, opening local bank accounts, managing currency controls etc. Third, the experience at present with VAT is that there is a lack of uniformity of collection methods imposed in different countries — commonly used approaches including collecting the VAT from platform operators (in respect of supplies made through them); collecting the VAT from the vendors making the supply themselves; collecting the VAT from the service recipient on a withholding basis; and even collecting through credit card providers under a split payment mechanism. This simply highlights that leveraging existing VAT collection methods may not be easy to apply in practice, especially for digital providers with global customer bases.



# Conclusion

It is clear that globalization and developments of business models and technology have put pressure on the international tax systems and theory which were developed at the start of the last century. Digitalization has exacerbated this but there is still a debate as to the extent to which it is (largely) a “digital issue” or a more general one. As yet there is no one agreed solution.

We believe that the debate needs to recognize, on the one hand, the right of governments to set their tax policy and, on the other, the need for tax systems to support economic development. The latter includes minimizing distortions on investment decisions, and avoiding double taxation, over complexity and the use of tax policy as protectionism. It also suggests that if action is going to be taken by a significant number of countries, a uniform global approach is likely to be better than an uncoordinated series of unilateral actions.

In regards to specific approaches, the options are broadly:

- 1) No additional change: The OECD Report notes that some countries consider that the previously agreed BEPS measures are sufficient to address the challenges of digitalization. Taking this approach would, however, be politically challenging, as it would require a way to address the uncoordinated unilateral measures already taken by some states.
- 2) Specific/targeted measures: While both the OECD Report and the EC papers recognize that targeted measures raise challenges, a clear and broad-based agreement on the design of such measures could at least provide some uniformity and help address the issue of a proliferation of different taxes;
- 3) Focus on where value is created from digital activities: This is a “purist” approach, trying to adapt agreed concepts of value creation to a digital environment. It has the advantage that it could potentially provide objective criteria, but the difficulty will be agreeing how to determine value. It is also likely that value creation will depend not just on the particular type of business and services or good supplied but also on the structure of a particular business. It could therefore create more complexity and disputes. It will also require changes to existing double tax treaties. It is welcome that the OECD has proposed a detailed study into value creation over the next 2 years.
- 4) Determine that there needs to be a change in the balance of source versus residence taxation. 3) above also involves a change in the existing balance to a certain extent, but it is done by focusing on value creation. This approach goes wider in that it focuses more on the fact that significant revenues are generated in the Source State which at present cannot be taxed (or are perceived to be undertaxed). It may be simpler to apply than focusing on precise value creation in each case but for the same reason is likely to be more arbitrary. It is possible to focus such a change on digitalized businesses — as the EC Significant Digital Presence proposal does — but it also raises the question of how broadly the deemed PE should be defined and whether or not it can or should lead to a more generally shift in taxing rights from Residence to Source States. Like 3) above it would also require a change to double tax treaties.

Resolving these issues will involve political, technical and practical issues. We call on all stakeholders to engage in the debate in an open and collaborative manner and we look forward to continued participation.

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