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TAX & EXCHANGE CONTROL ALERT

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BEPS ACTION 1: Tax challenges of the digital economy – a brief history and forecast

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CLIFFE DEKKER HOFMEYR

BEPS ACTION 1: Tax challenges of the digital economy – a brief history and forecast

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The internet and allied technologies have blossomed from a mere communication revolution into an increasingly indispensable part of everyday life. The growing range of what we can achieve online has allowed new ways of doing commerce and creating economic value, whether through cell phone based payments in underbanked countries, reimagined global retail offerings, or “free to use” digital services which indirectly generate advertising revenue. Appropriately and fairly taxing the value earned online is the next major challenge for international tax policy.

The present context

Current models of taxation underlying bilateral Double Taxation Agreements (DTAs) allocate the right for a country to tax income based on a nexus to the country, being either the residence of the taxpayer or deemed geographic source of the income. In brief, a country will have the right to tax certain income if it was generated by a taxpayer that is resident there by virtue of it being effectively managed from that country or having a significant physical presence there. DTAs may also allocate the right to tax certain types of income based on the income being sourced in a country in which the taxpayer is not resident. However, these models do not neatly capture the nature of all commercial income-generating activity that takes place online.

For example, with free to use digital services there is no transaction between the consumer and service provider to capture the income generated by the activity of providing the service. This along

with the international mobility of the digital service provider’s intellectual property (including branding, collected data and software) allow the value generated by a country’s advertising eyes to be legally present and taxed in a different country. This means that the country which taxes the income does not necessarily have to host the digital service providers’ physical presence or the consumer of the service. Correspondingly, the countries which in fact host significant real-world economic nexuses for the advertising income do not gain a taxing right.

Once a country has a taxing right based on the nexus rules, the extent of the income to be taxed is determined through allocation rules, generally based on the arm’s length principle. Similar concerns arise for the allocation rules, as the attribution of income to countries based on a taxpayer’s activity is complicated by digital commerce’s heavy reliance on voluntarily donated user data, intellectual property and difficulties in characterising the nature of digital transactions. In the arena of value added tax, challenges again arise due to the high volume of digital transactions and difficulty in tracking the provision of digital services.

States have recognised these mismatches, leading to both unilateral and collective interventions to address the challenges presented by the digital economy.

Some countries including France and South Africa have introduced indirect taxes on the consumption of digital services. The United States (US) has adopted a different approach and introduced a notable unilateral corporate taxation mechanism

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The G20 has mandated the Organisation for Economic Cooperation and Development (OECD), under the Base Erosion and Profit Shifting (BEPS) project, to lead the multilateral efforts to address the tax challenges posed by the increasing digitalisation of the economy.

called Global Intangible Low Taxed Income (GILTI) of 10.5% of corporate income meeting certain criteria, including income that has not been repatriated to the US. The GILTI may be capable of taxing some of the income not caught by traditional taxing right allocation under DTAs.

The G20 has mandated the Organisation for Economic Cooperation and Development (OECD), under the Base Erosion and Profit Shifting (BEPS) project, to lead the multilateral efforts to address the tax challenges posed by the increasing digitalisation of the economy. This article briefly summarises the path the OECD has taken under BEPS Action 1: Address the Tax Challenges of the Digital Economy since being mandated under the BEPS Action Plan published in 2013, and concludes with the most recent proposals contained in the Reports on the Pillar One and Pillar Two Blueprints.

2015 BEPS Action 1 Report

In the 2015 Report, the OECD outlined its analysis of the business models which typify the digital economy, noted the ordinary BEPS challenges these business models exacerbate, identified unique taxation challenges presented by these digital business models and proposed future interventions.

The report proposed that broader BEPS interventions would help alleviate some of the concerns, including modifications to the definition of "Permanent Establishment" to prevent unwarranted business fragmentation. The report further provided transfer pricing guidance to make it clear that legal ownership was not the only basis for entitlement to an arm's length return, where closely related parties contribute important assets or take significant business risk.

The report identified tax challenges beyond BEPS which were unique to digital economy business models. These unique challenges included businesses with a significant digital presence, but little physical presence (scale, without mass), how to characterise non-traditional online commercial activity, and value creation based on voluntarily provided user data. Importantly, it was emphasised that these challenges could not be resolved by ring-fencing digital economic activity due to its increasing ubiquity.

While ultimately recommending further consultation and analysis, both the authoring task team and report discuss, but do not recommend the following potential solutions:

- a new taxing nexus in the form of a significant economic presence;
- a withholding tax on certain types of digital transactions; and
- an equalisation levy for groups with low or untaxed income.

2017 Updated OECD VAT/GST guidelines

BEPS Action 1 recognised the difficulties in applying place of supply rules where the supplier's enterprise is not located in the same place as the consumer, as is often the case with the supply of digital services and other intangibles.

As a consequence of this the OECD's VAT guidelines were updated to recommend that the consumer's usual place of residence be utilised as a fall-back criterion for the place of supply regarding digital transactions.

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On 9 October 2020, the OECD and Inclusive Framework published two detailed technical reports on the two pillars of the proposed interventions to address the challenges of the digital economy.

2018 BEPS Action 1 Interim Report

The 2018 Report built on the work of the 2015 Report towards the publication of a final set of recommendations to be released in 2020. It also provided a further analysis of the business models that typify the digital economy and assessed the impact which broader BEPS interventions had on curtailing the tax challenges posed by the digital economy.

The 2018 Report presented the inputs of a broader range of stakeholders consulted following the 2015 Report, under the inclusive framework on BEPS (Inclusive Framework) – of which South Africa is a part. Importantly, this broader group presented consensus that interim, piecemeal measures presented significant risks to the global economy and that the focus must instead be on a global solution.

The 2018 Report concludes by outlining the divergent positions on the need to and manner in which to reform the international tax system to address the challenges of the digital economy. The three main views identified were:

- Digital business models present particular challenges to standard international tax rules and these ought to be addressed by interventions targeted at such business models, rather than wide ranging changes;
- The digital economy and globalisation demonstrate shortcomings in international tax and these must be addressed through systemic change, largely through the modification or creation of updated value creation nexus rules; and
- The international tax system following BEPS is sufficient to meet the challenges presented by the digital economy and no changes are needed.

2020 G20 Statements & consensus on need for a multilateral instrument

In January 2020 the G20 released a statement recording the progress on BEPS Action 1. Specifically, that the Inclusive Framework had largely reached consensus on a basic architecture on a unified approach to the two pillars which have been identified as the most viable route to a multilateral solution. Further, that a multilateral instrument would be the best tool to address the tax challenges presented by the digital economy.

On 9 October 2020, the OECD and Inclusive Framework published two detailed technical reports on the two pillars of the proposed interventions to address the challenges of the digital economy.

Pillar One Blueprint

Pillar One represents a proposal to create new nexus rules for digital services and define a set arm's length return for certain contributory or ancillary aspects of providing digital services. To accompany these, a set of dispute prevention and resolution mechanisms are proposed. These interventions would be contained in a binding multilateral instrument, serving the purpose of ensuring there is not a proliferation of domestic measures.

The proposed nexus rule would coexist with existing rules and apply to all digital services providers. While there is no political agreement on the exact parameters of what kind of nexus must exist to found the new right, it is set to determine the significance of a multinational services provider's presence in a given country using proxies such as proportion of revenue attributable to such country.

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Although the political dynamics are unlikely to make the introduction of the rules smooth or speedy, there are more signs that a change to the rules of international taxation is inevitable.

Pillar One also proposes rules for allocation of certain income to related parties to the service provider. These will be standardised allocations, based on comparable company benchmarks to be applied where digital service providers purchase services or pay rent to related parties in the process of providing services.

Pillar Two Blueprint

Pillar Two is a broader set of proposed rules, dubbed Global Anti-Base Erosion (GloBE) rules, aimed at ensuring large multinational groups (turnover > €750 million p/a) pay a minimum level of tax as a group. These rules are set to apply to all multinational groups and are not limited to those engaged in the digital economy. The proposed GloBE rules include:

- An Income Inclusion Rule (IRR) which would trigger a tax payable in the jurisdiction hosting the ultimate parent of the group where the effective tax rate of either the group or any given constituent company is below a defined threshold;
- Absent an IRR in the ultimate parent jurisdiction, any intermediate holding company that is subject to an IRR could be subjected to the tax charge to bring the effective tax rate to the required level; and
- An undertaxed payment rule based in DTAs, which would trigger a taxing right where none of the holding companies in the group are based in a jurisdiction with an IRR.

It is intended that these rules will be adopted by individual states, without a multilateral agreement to provide the core of the rules. The Pillar Two blueprint emphasises that the disparities in the capacity of different countries' tax authorities requires that the GloBE rules be administratively simple to implement. Further, the blueprint notes the potential for its recommendations to be undermined by the tax policy interventions of individual states not aligned with Pillar Two.

Where to next?

The successful implementation of both Pillar One and Pillar Two hinge on the political consensus on the aims and parameters of new rules. The history of BEPS Action 1 shows that there has been a consistent push to address the low and non-taxation of income related to the digital economy. This has manifested in agreement that the fundamental principles of international tax policy need to be augmented.

Initially, it was intended that a multilateral instrument would be agreed to during 2020. However, the COVID-19 pandemic has stalled the progress and given the US cause to temporarily withdraw from the negotiations on how to appropriately tax the digital economy. At the same time, individual states continue to promulgate unilateral measures to tax aspects of the digital economy. Therefore, although the political dynamics are unlikely to make the introduction of the rules smooth or speedy, there are more signs that a change to the rules of international taxation is inevitable.

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BBBEE STATUS: LEVEL TWO CONTRIBUTOR

Our BBBEE verification is one of several components of our transformation strategy and we continue to seek ways of improving it in a meaningful manner.

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