# Taxation in the digital economy – How much will things change?

# By Seun Adu



One of the most important questions the OECD had to answer was how best to tax the digital economy. The question was whether to tweak the existing rules (a patch) or to create a new set of rules (a rebirth).

"The world's largest taxi firm, Uber, owns no cars. The world's most popular media company, Facebook, creates no content. The world's most valuable retailer, Alibaba, carries no stock. And the world's largest accommodation provider, Airbnb, owns no property. Something big is going on." - Tom Goodwin

Something big is indeed going on and it has been for a while. For more than 2 decades, Information and Communications Technology (ICT) has been changing the way business is done and the way money is made. It is hard to think of any serious minded organisation that has never considered the impact of changing business models on its bottom line. So it is no surprise that tax authorities from many parts of the world eventually got together to work out how these changes were affecting their tax collections; after all tax collection is serious business.

Enter, Action 1 of the OECD's Base Erosion and Profit Shifting (BEPS) Action plan. Action 1 was an attempt (by the OECD) to identify the challenges faced by governments in getting taxes from companies who operate in the digital economy and to work out what changes were required to the existing international tax rules to overcome these challenges.

# What is the digital economy and why does it worry tax authorities?

Think of any company you've had to give your money to or do business with where you don't have to go to their office (and probably have no idea if they actually have one in your country) and perhaps never met their sales people or representative. If you can think up a few examples, you probably have a good idea of what type of businesses makes up the digital economy. It is e-commerce, app stores, online advertising, online payment services, cloud computing, participative networked platforms and the likes.

Unlike businesses in the traditional economy, companies that are part of the digital economy are able to generate significant revenues in foreign countries without the need to put up big offices or have many employees there. This is one of the major reasons tax authorities worry about the digital economy.

The existing international tax rules assume that you need a certain level of physical presence (an office, a factory, a workshop etc.) in a foreign country before you can make any significant or stable revenues. Once you have this physical presence (otherwise known as a Permanent Establishment or PE for short), you are required to pay tax in the foreign country.

In the digital economy, companies can make money without a significant physical presence, and; no significant physical presence usually means no, or very little, tax for the governments.

In reality, it is not only companies in the digital economy that can operate in this way. It's just that the nature of the digital economy can make it relatively easy to do; on a large scale; and without breaking any laws.

# To patch or to upgrade?

When software programmers decide to make changes to existing software they can create a patch or develop an upgrade. You need a patch when you want to fix an error. A patch is for blocking loopholes, fixing security vulnerabilities and the likes. You're not making any major changes just tightening things up. An upgrade on the other hand is something you do when you need to introduce completely new features that the existing software does not have.

This was one of the important questions the OECD had to answer with Action 1. To deal with BEPS and the wider tax issues of the digital economy; was the solution to tweak the existing rules so they became fit for the digital economy (a patch)? Or was there a need to create a new set of rules? A brand new feature; an upgrade? Both alternatives were analysed. Only one of them was considered appropriate.

#### The search for a new set of rules

Three new and interrelated ideas were considered in some detail. The first was to establish new bases for determining when a digital company was liable to tax in a foreign country. Some of the bases considered were revenues, number of active users and extent of digital presence. For example with a revenue basis, rather than look for a physical office or employees, the tax administrator would determine the amount of revenues being made by the foreign digital company from local customers. Once this crossed a certain threshold, the company would be required to pay tax.

The second idea was to subject digital businesses to a withholding tax (WHT) the same way you would apply WHT to dividends and interest earned by a foreign company. Slightly related to this was the third idea of applying an equalisation levy on digital transactions.

#### The case for building on the existing set of rules

This built on the idea that it was better to identify the weaknesses of the current international tax rules and then make specific changes that addressed these weaknesses rather than create a new set of rules which could have unintended consequences.

This view considered that the BEPS work and changes being proposed under the remaining 14 action plans could be made robust enough to address the specific BEPS challenges of the digital economy.

The action plans that were considered most important for addressing the challenges of the digital economy were: Action 3 (Strengthen Controlled Foreign Company – CFC - rules); Action 7 (Preventing the artificial avoidance of Permanent Establishment status); and actions 8-10 (assuring that transfer pricing outcomes are in line with value creation).

#### The verdict

The OECD concluded that the work on the other BEPS action plans would be sufficient to address BEPS issues in the digital economy. In other words, the job to be done did not require the introduction of a specific set of rules or new bases for taxing the digital economy.

While the OECD did not recommend any of the more radical changes, it did mention that countries were free to test out some of the new proposals in their domestic laws (and bilateral tax treaties) so far as they respected the provisions of other double tax treaties which were modelled after the OECD's recommendations.

## A quick word on Value Added Tax (VAT)

Action 1 includes an extensive analysis of the VAT challenges of the digital economy. Chief amongst them were issues connected with remote supplies to exempt businesses, remote digital supplies to businesses operating in multiple locations, importation of low value goods and business to consumer supplies of cross border goods and services. The recommendations are instructive and we will come back to them another time.

## Implementation and next steps

The plan is to have the BEPS recommendations implemented on a global scale. Double tax treaties will be amended to reflect some of the recommendations e.g. those from Action 7 on PEs. This will be done through the use of a multilateral instrument that will automatically amend the existing treaties (of countries that sign up for it) and save everyone the trouble of renegotiating their treaties one by one. Then there are other changes (e.g. CFC rules and also PE definitions) that are to be effected through domestic legislation.

Although the final recommendations from Action 1 are not as drastic as were first imagined, the OECD expects that they will have a significant impact on the taxation of the digital economy going forward.

It will be unwise to assume that this will be the last we will hear of the international efforts to address the tax challenges of the digital economy. The digital economy is extremely agile and will continue to evolve. The OECD will continue to monitor the evolution of business models in the digital economy as well as the effectiveness and impact of the BEPS measures.

Nigeria was an active participant in this project. It will be interesting to see what direction the country will swing on the options analysed in the Action 1 report. It will also be interesting to see how quickly any changes will happen considering the fact that agility and speed are not words that one would usually associate with our tax legislation and legislative processes.

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