Irish Tax Institute

Response to OECD Request for Input Regarding the Tax Challenges of the Digitalised Economy

13 October 2017

About the Irish Tax Institute

The Irish Tax Institute is the leading representative and educational body for Ireland's Chartered Tax Advisers (CTA) and is the only professional body exclusively dedicated to tax.

The Chartered Tax Adviser (CTA) qualification is the gold standard in tax and the international mark of excellence in tax advice. With over 5,000 members in Ireland, along with the Chartered Institute of Taxation UK and The Tax Institute of Australia, we are part of the 28,000-strong international CTA network and a member of the Confédération Fiscale Européenne, (CFE) the European umbrella body for tax professionals.

Our members provide tax education and expertise to thousands of businesses, multinationals, and individuals in Ireland and internationally. In addition, many hold senior roles within professional service firms, global companies, Government, Revenue, state bodies and the European Commission.

After 50 years, the Institute remains deeply committed to the role it can play in education, tax administration and tax policy in Ireland and in building an efficient and innovative tax system that contributes to a successful economy and society. We are also committed to the future of the tax profession, our members and our role in serving Ireland's taxpayers and best interests in a new international world order. Our *Irish Tax Series* publications and online database *TaxFind* are respected and recognised as Ireland's most extensive tax information sources.

Irish Tax Institute - Leading through tax education.

The Irish Tax Institute welcomes the opportunity to contribute to this consultation on the tax challenges of the digitalised economy.

The importance of the "Digital Economy" to global economic growth

Businesses make enormous capital and human investment every year in digitising their operations. Such advances in technology and developments in the digitalisation of the overall economy provide tremendous opportunities for development and growth for OECD countries.

Business to business and business to consumer e-commerce, has opened up a global market place that did not exist twenty years ago. Consumers now have access to a vast array of products and services sold online that they could never have previously enjoyed, ranging from goods such as books and computer equipment to the increasing range of digitised services in the form of entertainment, financial services and education, to name but a few. Consumers in OECD countries across the world now have a much wider breadth of choice at lower cost than they would have paid in the digital economy because digitisation has enabled businesses to sell across greater geographical distances and has removed many of the barriers to cross border trade.

The contribution that the digital economy is making to global growth has been recognised widely by the OECD, World Economic Forum, the EU and many others.

OECD, Ministerial Declaration on the Digital Economy: Innovation, Growth and Social Prosperity (Cancun Declaration), 22-23 June 2016

"Recognise that the digital economy is a powerful catalyst for innovation, growth and social prosperity."[1]

OECD, *Key Issues for Digital Transformation in the G20* - Report prepared for a joint G20 German Presidency/ OECD conference, Berlin, Germany, 12 January 2017

"The ongoing digitalisation of the economy and society holds many promises to spur innovation, generate efficiencies, and improve services throughout the economy. Moreover, the successful transition to a digital economy is a necessary condition for boosting more inclusive and sustainable growth and enhancing overall well-being."[2]

World Economic Forum - Shaping the Future of Digital Economy and Society

"The exponential growth in digitization and internet connectivity is the backbone of the Fourth Industrial Revolution. It has the potential to propel societies forward, enable innovative business models and help governments address legitimate policy concerns. Digitization is transforming business models, the policy landscape and social norms."[3]

[1] OECD, Ministerial Declaration on the Digital Economy: Innovation, Growth and Social Prosperity (Cancun Declaration), 22-23 June 2016 https://www.oecd.org/internet/Digital-Economy-Ministerial-Declaration-2016.pdf

[2] OECD, *Key Issues for Digital Transformation in the G20* - Report prepared for a joint G20 German Presidency/ OECD conference, Berlin, Germany, 12 January 2017 http://www.oecd.org/g20/key-issues-for-digital-transformation-in-the-g20.pdf

[3] World Economic Forum - Shaping the Future of Digital Economy and Society https://www.weforum.org/system-initiatives/shaping-the-future-of-digital-economy-and-society

European Commission Mid-term Review on the implementation of the Digital Market Strategy, May 2017

"It is essential that EU businesses grasp the opportunities of digital technology to remain competitive at global level, that EU start-ups are able to scale up quickly, with full use of cloud computing, big data solutions, robotics and high speed broadband, thereby creating new jobs, increased productivity, resource efficiency and sustainability."[4]

European Commission President Jean-Claude Juncker, Political Guidelines, 15 July 2014

"I believe that we must make much better use of the great opportunities offered by digital technologies, which know no borders."[5]

European Commission Expert Group on the Digital Economy Report, 28 May 2014

"First: there should not be a special tax regime for digital companies. Rather the general rules should be applied or adapted so that "digital" companies are treated in the same way as others."[6]

The importance of the Digital Economy for Ireland

Like many small economies in the OECD, Ireland has to trade openly with other countries in order to generate sustainable tax revenues and meet the needs of its citizens.

Ireland has a population of less than five million people but digitisation provides our small and medium sized businesses with the opportunity to participate in the global marketplace. This global access is critical to the development of Ireland's tax base as we currently have narrow product and market diversification in our indigenous sector:

- 20% of Irish small firms export just one product and close to half, export fewer than five.[7]
- 23% of all exported products by Irish companies in 2015 were "Meat of bovine animals, fresh or chilled."[8]
- 27% of Irish firms export to just one market.[9]

[4] European Commission, Mid-term review on the implementation of the Digital Single Market Strategy – A Connected Digital Single Market for All, 10 May 2017 http://eur-lex.europa.eu/legal-content/EN/TXT/?qid=1496330315823&uri=CELEX:52017DC0228

[5] Political Guidelines for the next European Commission – A New Start for Europe: My Agenda for Jobs, Growth, Fairness and Democratic Change, 15 July 2014 https://ec.europa.eu/commission/sites/beta-political/files/juncker-political-guidelines-speech_en.pdf

[6] European Commission Expert Group on the Digital Economy Report, 28 May 2014 https://ec.europa.eu/taxation_customs/sites/taxation/files/resources/documents/taxation/gen_info/good_governance_matters/digital/report_digital_economy.pdf

[7] ESRI, Expanding and Diversifying the Manufactured Exports of Irish-owned Enterprises (April 2017 https://www.esri.ie/pubs/BKMNEXT335.pdf

[8] ESRI, Expanding and Diversifying the Manufactured Exports of Irish-owned Enterprises (April 2017 https://www.esri.ie/pubs/BKMNEXT335.pdf

[9] ESRI, Expanding and Diversifying the Manufactured Exports of Irish-owned Enterprises (April 2017 https://www.esri.ie/pubs/BKMNEXT335.pdf

- 11% of Irish owned firms account for close to 50% of total export value.[10]

Supporting more Irish businesses to to scale up is essential if we are to achieve the necessary diversification in our tax base that will help to insulate it against future economic shocks.

IMF comments on Ireland

The IMF has been instructive in terms of what Ireland must set out to do. It "must create a resilient, dynamic, innovative economy that is broader based in its structure and less vulnerable."[11]

Digitisation is a key enabler to achieving this growth and diversification in the domestic sector because it offers our businesses the opportunity to trade beyond Irish and UK shores.

Digitizing Europe, May 2016

Digitizing Europe[12] has named Ireland as one of nine European frontrunner countries that could see the largest benefits from a more digitised European economy.

The report says that: "*Europe is at a digital crossroads, with a unique chance to either capture an immense opportunity, or see the region fall behind other nations. And the frontrunner countries are even more sensitive than the EU as a whole to a lost digital opportunity, since a larger share of their economies is digitized, and the majority of their future growth is digitally enabled.*"

"A European digital single market (DSM) would encompass more than 500 million consumers and is expected to add €415 billion in annual GDP to EU."

The digital economy is part of the broader global economy

In October 2015, the OECD Task Force on the Digital Economy concluded that it is "neither appropriate nor feasible" to ring fence the digital economy, recognising that the overall global economy is becoming increasingly digitised.

The digital economy has penetrated the overall economy and one cannot be ringfenced from the other. For this reason, care should be taken to avoid creating a separate set of tax rules for so called "digital" businesses. To do so would require policy makers, tax administrations and taxpayers to make arbitrary distinctions every day about which businesses are "digital" businesses and which are not. And the complexity of such characterisations will inevitably deepen over time when you consider that this generation of children is likely to carry out work in the digital economy that has not even been imagined today.

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[10] ESRI, Expanding and Diversifying the Manufactured Exports of Irish-owned Enterprises (April 2017 https://www.esri.ie/pubs/BKMNEXT335.pdf

[11] IMF, "Staff Concluding Statement of the 2017 Article IV Consultation" (May 2017), http://www.imf.org/en/News/Articles/2017/05/12/ ms051217-ireland-staff-concluding-statement-of-the-2017-article-iv-consultation

[12] Digitizing Europe, May 2016 http://image-src.bcg.com/BCG_COM/BCG-Digitizing-Europe-May-2016_tcm22-36552.pdf

For all the opportunity that the digital economy offers, it remains part of the overall global economy and whatever rules are developed to deal with the tax challenges it brings must apply equally to all businesses operating in the global economy.

An overview of the tax challenges

The rapid expansion of the digital economy has undoubtedly created challenges for the global tax regime. However, many of these challenges are in the process of being addressed through the OECD's Base Erosion and Profit Shifting (BEPS) project. The OECD's report on Action 1[13] acknowledges that the digital economy does not generate unique BEPS issues, rather some of its key features exacerbate other BEPS risks. The mobility of customers, business functions and intangibles that characterise the digital economy are recognised across the 15 BEPS Actions and the overall approach of more closely aligning profits with value will resolve much of the misalignment between the business models and the tax rules. Furthermore, countries such as Ireland which are in the European Union are also in the process of implementing the EU Anti-Tax Avoidance Directives, ATAD[14] and ATAD 2.[15]

Most OECD countries are still only part way through the implementation of these BEPS and ATAD actions.In addition to this, guidance on hard to value intangibles and profit splits is still evolving and the impact of choices by policymakers and tax authorities in the application of emerging guidance has yet to be fully understood.

Until the details of the overall BEPS package have been agreed and BEPS and ATAD have been implemented, it is very difficult to assess the impact that these far reaching changes will have on the digital economy.

Indirect taxes also have an important role to play in the taxation of the digital economy and cannot be dealt with in isolation to corporation tax. Just as the global corporation tax rules have not kept pace with the modern digital economy, VAT systems globally have struggled to define the place of supply of a digital service. The EU has played a leading role in attempting to reform their VAT regime but despite the fact they have been working on this project since 1993 and have invested significant resources that work is still ongoing.

Federation of German Industries Submission to BEPS Action 1, 14 April 2014

"We acknowledge that consumption taxes might be the better option to tackle the issue that market jurisdictions do not obtain their desired share of revenue from digital providers. For instance, the new rules concerning the supply of electronic services entering into force in 2015 in the EU will extend the destination based principle to telecommunications, broadcasting and electronically provided services. This will ensure a fair and reliable procedure within the EU and will be combined with a Mini One Stop Shop (MOSS) to facilitate administration for businesses."[16]

In addition, many countries and regions face VAT compliance challenges and are experiencing very significant VAT gaps. In its EU VAT Gap Report published recently, it was

[13]OECD (2015), Addressing the Tax Challenges of the Digital economy, Action 1- 2015 Final Report, OECD/G20 Base erosion and Profit Shifting Project, OECD Publishing, Paris. http://dx.doi.org/10.1787/9789264241046-en
[14] Council Directive (EU) 2016/1164 laying down rules against tax avoidance practices that directly affect the functioning of the internal market
[15] Council Directive amending Directive (EU) 2016/1164 as regards hybrid mismatches with third countries
[16] Federation of German Industries Submission to OECD BEPS Action 1, 14 April 2014

estimated that EU countries lost a total of €152 billion in Value-Added Tax (VAT) revenues in 2015. This represents a loss of 12% of the total expected VAT revenue.[17]

Steps to advance the VAT rules for the digital economy and improve VAT administration and collection could result in significantly increased revenues for many countries, as work progresses on the corporation tax agenda.

The alternative OECD approaches

This consultation outlines three options to address the broader direct tax policy challenges of the digital economy:

a) Tax nexus concept of "significant economic presence"
b) Withholding tax on certain types of digital transactions
c) Digital equalisation levy

Each approach brings challenges and any decisions on whether and how to act on these options should be guided by the Ottawa taxation framework principles[18] of:

- Neutrality.
- Efficiency.
- Certainty and simplicity.
- Effectiveness and fairness; and
- Flexibility.

Tax nexus concept of "significant economic presence"

The concept of "significant economic presence" creates a new form of nexus for certain businesses in the digital economy that may not be regarded as having a permanent establishment by virtue of their physical presence under the existing Article 7 of the OECD Model Convention.[19]

At present, OECD countries are dealing with proposed amendments to this Article under BEPS Action 7 and the Multilateral Instrument (MLI). A number of countries have concerns about reducing the threshold for permanent establishment (PE) until such time as further clarity is available on the attribution of profits to such PEs. Even before considering any new nexus test for digital businesses, it is proving difficult to achieve certainty and consensus on the matter.

Particular challenges arise in trying to attribute a PE to a business that has no presence in a country other than perhaps gathering raw data there. Is this sufficient to create a nexus in that country and even if it is, what value can be attributed to that raw data, when all the people functions in extracting the value from it are located elsewhere?

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[17] VAT Gap Report, 28 September 2017 https://ec.europa.eu/taxation_customs/sites/taxation/files/vat_gap_factsheet_2017.pdf

[18] Electronic Commerce: Taxation Framework Conditions - A Report by the Committee on Fiscal Affairs, 8 October 1998 https://www.oecd.org/ctp/consumption/1923256.pdf

[19] OECD Model Tax Convention on Income and on Capital 2014

Valid concerns also arise about the level of uncertainty that would result from undoubtedly very different interpretations of such a nexus by tax authorities even in the event that global consensus could be reached on the definition of a “significant economic presence.”

Businesses are already experiencing the predicted rise in tax disputes in a post BEPS era and it is likely that a widely drawn nexus test with related profit attribution rules could open digital businesses to a never-ending plethora of international tax disputes.

Withholding tax on certain types of digital transactions

Withholding taxes that operate at present in the international tax regime, generally apply to passive income from capital investment such as dividends, interest and royalties. They apply to gross payments, often at a low rate. In these cases, the gross payment is generally a reasonable approximation to the profit arising from the asset, as the costs that are directly involved in generating that income would be low.

However, applying a withholding tax to gross payments for goods and services is an entirely different matter as the expenses involved in generating this type of income will be much higher. In fact, a lot of digital businesses operate on very low profit margins or indeed are actually in a loss-making position. This is particularly true in the case of start-up and small businesses, investing in their ambition to operate as global firms and trying to break into new markets.

Imposing a withholding tax on digital businesses would be a very “blunt instrument” to collect tax from them and could push many new entrants and small businesses into a loss-making situation. Although the context is different, Appendix 1 highlights the impact of a turnover tax (betting tax) on a business’ profitability, for illustrative purposes.

Ironically, larger digital companies may have the scale to trade through the imposition of such taxes - it is the smaller companies that could be impacted most by them.

The principle of neutrality is also important in the context of withholding taxes.

Federation of German Industries Submission to BEPS Action 1, 14 April 2014

“There are various aspects which do not support imposing WHT. First of all, it would raise neutrality issues when treating transactions in digital services different from other transactions, e.g. is music or software a digital product if downloaded but not if provided on physical instrument like a CD. Most importantly, however, levying WHT could lead to a double taxation of the digital activities as the withholding tax will easily exceed the tax due on the net profits.”[20]

A withholding tax which is based on gross payments alone is more akin to a consumption tax and it is the role of VAT to ensure that adequate taxes on consumption are collected in the relevant countries.

[20]Federation of German Industries Submission to OECD BEPS Action 1, 14 April 2014

Finally, the administration difficulties of a withholding tax must be considered. Individuals in business to consumer transactions will not collect and pay over a withholding tax to the tax authorities. This then raises the question of efficiency - who will collect the tax and how will it be administered? Will some type of collection agent be required to act as a withholding agent for the taxpayer and what costs will this add for them, in terms of complexity and uncertainty?

Digital equalisation levy

Similarly, a digital equalisation levy represents a payment based on gross revenue. The concerns raised above will equally apply in terms of proportionality, ability to pay and the potential for widescale disruption and cost for businesses small and large.

A digital equalisation levy based purely on customer numbers in the market country is completely at variance with the principle of taxing profits where value is created. It would result in a different tax model for so called "digital businesses" as compared with businesses in the traditional sector, which would be neither neutral nor fair. It would also create huge uncertainty as to who fell within the definition of a digital business for the purposes of the levy.

It is very unlikely that a levy such as this would be creditable under existing OECD double tax agreements and would thus lead to multiple taxation of business profits globally.

It would also act in an arbitrary manner to favour economies purely on the basis of large populations, without cognisance of the fact that the value created in supplying these customers is likely to have been generated elsewhere.

Conclusions

The Irish Tax Institute agrees with the OECD approach that any further measures taken to address the specific tax challenges of the digital economy should only be determined after;

1. Full consideration of the wide-ranging business models and value chains involved,
2. An in-depth understanding of the specific tax challenges posed by particular features of the digital economy; and
3. A cost benefit analysis of introducing further changes for these businesses.

Many companies that operate globally have designed their business models precisely to take advantage of the economies and efficiencies available from digitisation. It is these economies that enable them to offer their goods and services to businesses and consumers at reduced cost.

If careful thought is not given to the imposition of new tax rules on these businesses, they could be forced to fundamentally reform their business models, forcing them to set up establishments in countries worldwide that are completely unnecessary from a business point of view, purely to satisfy tax rules. This would clearly be a retrograde step in the development of the digital economy and would run contrary to the stated digital strategy of numerous national and international bodies. It would inevitably result in additional cost for individuals, businesses and investors (including pension funds) globally.

Whatever solutions are chosen have to work effectively for the digital economy and the wider global economy. They have to be fair and effective, not giving rise to multiple tax charges, and they should be reached by international consensus as was the case with the broader

BEPS actions. While this framework for agreement may require an investment of time, we believe it offers the best likelihood of sustainable progress in a very complex and ever evolving area of international taxation.

Appendix 1

Example of how punitive a turnover tax can be – in the context of betting tax

Extract from the Irish Independent Betting Offices Association submission to the Department of Finance's Betting Tax Review 2017[21]

"Because of its nature a turnover tax will have a disproportionate effect on those businesses with a lower net margin. The figures in Appendix II highlights the problem, as a flat 1% turnover tax equates to a crippling 100% of net profit for a smaller shop compared to 59% for the average Paddy Power shop. There can be no doubt that this unfair proportion of taxation to net profit borne by the smaller operator has been a major factor in the demise of many of our members."

Appendix II

Retail Sector – Betting Tax as a % of Profit

	IIBOA Average LBO	**Paddy Power Average LBO**
Turnover	€1,600,000	€4,688,000
Betting Tax	**€16,000**	**€46,880**
Operating Profit	*€16,000	€78,750
Betting Tax as a proportion of profitability	**100%**	**59.53%**

* Based on a net margin of 1%.

[21] http://www.finance.gov.ie/wp-content/uploads/2017/07/IIBOA-Submission-2017.pdf