E-Commerce: The Cloud and BEPS

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On May 23, 2014 at the IFA International Tax Conference, Andrew Solomon,[2] Scott Wilkie,[3] Nick Pantaleo[4] and Stuart Chessman[5] presented a topic on E-commerce which discussed the practical tax consequences for companies that engage in cross-border commerce through the internet with a focus on the recent Organization for Economic Co-operation and Development ("**OECD**") developments and base erosion and profit shifting ("**BEPS**") initiatives.

Background

In July 2013, the OECD published an action plan on BEPS to address the concerns of multinational corporations to artificially reduce taxable income or shift profits to low tax jurisdictions. Action 1 of the action plan was to address the tax challenges of the digital economy and four challenges were identified, including i) unparalleled reliance on intangible assets because intangibles assets are very difficult to locate and price; ii) massive use of data particularly personal data (e.g., the French and Italian thought the exploitation of personal data by their citizens should give rise to taxation in France or Italy); iii) widespread adoption of multi-sided business models capturing value from externalities presented by free products; and iv) difficulty of determining the jurisdiction in which value creation occurs.

On March 24, 2014, a public discussion draft (the "**Discussion Draft**") was released with preliminary findings on issues that the digital economy poses. One of the critical issues was the ability of a company to have a significant presence in the digital economy of another country without being liable to taxation due to the lack of nexus under current international tax rules.

There have always been tensions between the source or the market countries (generally the "advanced" economies) and the producing countries (which increasingly, possibly as an outgrowth of "globalization", include less advanced economies) relating to nexus. In the present "digital" world, it may be difficult to deal with this nexus issue satisfactorily using long-standing traditional connotations, yet institutional and political considerations bearing on global economic activity.

The Discussion Draft Overview

The Discussion Draft has seven sections. Sections 1 to 3 describe key features and new business models of the digital economy. The main concerns regarding the digital economy are the increased role of intellectual property, in particular, its mobility, the mobility of its people and business functions and its increased reliance on data that is perceived to be creating significant value for companies. This creates significant challenges for countries in determining what level of tax should be imposed. The Discussion

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[3] Scott is a partner at Blakes, Cassels & Graydon LLP in Toronto. His practice involves providing advice on a wide range of tax matters including tax controversies, and he is primarily focused on international taxation including international corporate tax planning, transfer pricing and tax treaty advice.

[4] Nick is the Senior Vice President in Finance at Rogers Communications Inc. in Toronto. He current heads the Rogers Tax Department and Enterprise Risk Management.

[5] Stuart is a Director in International Taxes at Vivendi in the United States. Unfortunately, he was not present at the conference due to weather related flight cancellations, but made significant contributions to the slide deck.

Draft argued that trying to isolate the digital economy as a separate sector would inevitably require arbitrary lines to be drawn between what is and what is not digital. The report concluded that the tax challenges and BEPS concerns raised by the digital economy are better identified by analysing existing structures adopted by multinational corporations together with new business models than to develop rules focused on digital businesses apart from non-digital businesses.

Section 4 identified opportunities for BEPS in the digital economy including common tax planning structures. In particular, it asserts that as the digital economy grows bigger, so will the tax leakage since taxable income can be "artificially segregated" from activities that generate it, but the nature of strategies used to achieve BEPS is still similar to traditional businesses. This tax leakage could also extend to value-added tax, goods and services tax and sales tax.

The Discussion Draft identified some typical strategies employed to minimize a company's tax in market jurisdictions. In some respects, these and the issues presented are no different than those in a more traditional setting. The strategies include i) avoiding taxable presence, which appears to be easier in the digital world because of the ability to interact with customers remotely without establishing a physical presence in the country where customers reside; ii) minimizing functions, assets and risks in market jurisdictions; iii) maximizing deductions in the market jurisdiction (e.g., in the form of interest, royalties, service fees or use of hybrid structures); and iv) avoiding withholding taxes on royalties, interest or transfer profits to low tax jurisdictions through treaty shopping. The Discussion Draft also discussed strategies to reduce tax in the intermediate country and in the country of residence of the ultimate parent through the use of preferential domestic tax regimes, hybrid arrangements, excessive deductible payments, and under compensation of services performed in headquarter jurisdiction by allocating risk and legal ownership of mobile assets to low tax jurisdictions.

Sections 5 and 6 discussed the BEPS initiatives and how it would help resolve the issues posed by the digital economy. Section 7 included several potential options to address the broader tax challenges raised by the digital economy. The proposals focused on several areas, including modifications of the permanent establishment threshold, the potential imposition of a withholding tax on certain types of digital transactions and the imposition of an indirect tax on digital transactions.

Significant Digital Presence

With the digital presence growing in many business sectors, it is a challenge to differentiate between the wholly digital economies from the insufficiently digital economies to warrant the application of these new rules. It would be arbitrary to tax one group of businesses differently than another group depending on the degrees of digital economy. For example, a goods manufacturer could still have digital presence but of a lesser degree compared to a business that has as its core function the transmission, manipulation and "sale" data as such.

Consider when a goods retailer would send out catalogues to customers where some products might not be available locally from local suppliers. When an order was placed, someone in the United States could accept the order and the goods could possibly be distributed from Canadian warehouses. Presumably, such suppliers have taken the view that they are not carrying their business in Canada, and they don't have a Canadian permanent establishment. As compared to the current environment, where instead of having hard copies of catalogues, customers view the products online. All the mechanics of the transaction are the same. Is this the same or different than a catalogue sale? Has the consumer ceased to be a passive recipient of the communications and become essentially actively involved as an exponent of the supplier's business because without it, the supplier cannot carry on the business? Should the interactive arrangement change our tax jurisdictions' notions from being essentially supply-based to demand-based?

Taxation and Location of Specific Data

Cloud computing is the delivery of computer based electronic facilities of various kinds as a service or user arrangement rather than a product purchased as such by a customer, where shared resources, software and information are provided to computers and similar devices over a network. There is no one server anywhere that is handling the transactions or if there is, you would not know which one after the data and software are replicated in multiple servers throughout the market including cross-borders servers. It is increasingly difficult to analyze these transactions in order to find a location to tax the servers. With the technological advancements, it has allowed companies to gather and use data to a different degree, causing the determination of taxation rights of relevant market country or data source to be very difficult. This has created issues relating to the attribution of value created from the generation of data through digital products and services, and how to characterize for tax purposes an entity's supply of data in a transaction.

The Taxation of Data Issues

The Discussion Draft raised the complexities of taxation of income from a market intangible but no proposal was made. Consider another example where a manufacturer in Norway is providing data to a multi-jurisdictional operation and it is getting access to the database in return. The database could contain information about the consumers' buying habits or preferences on the products which would help the manufacturer. This effectively has the main features of a barter transaction. The way we tax barter transaction seemingly would not be to tax the recipient of the "free data", which in this context, is in the nature of an acquired input to other business activities for the recipient of that data in the formation of a saleable output. Rather, the provider of the data conceivably would be taxed on a "gain" arising from an exchange of the data, used as currency, to acquire services that appear to be "free" from the perspective of the notions and biases of transaction exchange associated with prevailing jurisdictions notions.

Strengthen the Controlled Foreign Corporation Rules

The general discussion of the proposal in the Discussion Draft is to strengthen the controlled foreign corporation ("**CFC**") rules and to consider making the digital transaction subject to the treatment of passive mobile income because of the opportunity for sellers to locate intangibles and marketing activities (rather than selling activities) in specific jurisdictions. As we currently tax interest income on a CFC basis as passive income because it is mobile (e.g., the holder of the bond can move or be moved), digital income would be taxed similarly because you can move the holder of the intangibles that create the value. The CFC rules only work to the extent that the jurisdiction of the parent company imposes a relatively high rate of tax and captures the underlying income in the taxable tax base on a more or less current basis. If the parent company is moved to a low tax or no tax jurisdiction, from a source country's perspective, it may not make a difference even if all the income is caught by the CFC rules. If that income results from deductible charges recognized by a source country, there is still a migration of the source country tax base.

From a Canadian tax perspective, the CFC rules try to ensure that the outbound system of taxation does not result in an inappropriate erosion of the domestic tax base. This gives rise to long-standing tension between ensuring a country's outbound tax system is "competitive", at the same time, ensuring that it does not encourage or result in an unacceptable erosion of the domestic tax base. The BEPS's direction seems to expose a latent dimension of CFC rules to facilitate the erosion of foreign domestic tax bases with the result that income is not, at least for a time which may be a very long time, actually taxable anywhere. The tension arises between the "competitiveness" fostered by one country's CFC rules may collide with the protection of the tax base of another country. This imposes some interesting challenges to any taxation system including Canada's, as a key feature in a CFC system is the relative international competitiveness of a country's taxpayers and consequently effects of the CFC and other rules impinging on that.