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Taxation of the Digital Economy

This paper considers the recent consultation on the taxation of the Digital Economy, insofar as relevant to banks. It provides comments on the structure of banking businesses, key risks to the banking sector and cautions against applying some of the digital tax solutions to banking activities.

1. Summary

- In the Digital Economy, a main concern and potential source of disagreement between countries is the question of where value is created. While countries agree that a multinational's profits should be taxed in the jurisdictions in which it creates value, some countries argue that the value for companies in the Digital Economy derives from factors such as user participation or user location.
- No clear consensus has been reached, with the OECD calling for further consultation and a consensus approach.
- The European Commission and the UK Government are seeking to implement specific tax measures.
- The international tax framework needs to be responsive and flexible to the changing nature of the Digital Economy. Whilst banks are experiencing changes to the way that they operate as a result of the Digital Economy, they should be differentiated from "pure" digital companies.
- Measures taken to address the tax challenges identified must be internationally coordinated in order to avoid the danger of double or multiple-taxation. In that respect, the Digital Services Tax proposed by the Commission would result in double taxation.

Jurisdiction-specific comments are provided in the Appendix to this paper.

2. Background

The Digital Economy is experiencing dramatic growth and is altering the way that multinational organisations interface with their customers. Many jurisdictions are concerned that their taxation systems do not cater well enough to the Digital Economy, and accordingly revenues could be diluted.

Following on from a 2015 report "*Addressing the Tax Challenges of the Digital Economy"* as part of the OECD/G20 Base Erosion and Profit Shifting (BEPS) package, the Task Force on the Digital Economy (TFDE), sought input from the public on a number of key issues including:

- Digitalisation, Business Models and Value Creation;
- Challenges and Opportunities for Tax Systems;
- Implementation of the BEPS package; and
- Options to address the broader direct tax policy challenges.

The 2015 report acknowledged that it would be difficult to 'ring-fence' the Digital Economy from the rest of the economy for tax purposes, and other BEPS measures would need to be considered. Following on from this, a new interim report on the implications for taxation of digitalisation was delivered to G20 Finance Ministers in March 2018.

OECD interim report

On 16 March 2018, the OECD published its interim report[1] following on from the abovementioned consultation. It sets out the agreed direction of work on digitalisation and the international tax rules through to 2020.

The OECD members agree that there needs to be a "coherent and concurrent review of the 'nexus' and 'profit allocation' rules" which are fundamental concepts relating to the allocation of taxing rights between jurisdictions. A consensus-based approach is preferred given differing views, and the goal will be to produce a final report in 2020, with an update to the G20 in 2019.

The report also sets out the framework of design considerations for countries in favour of introducing interim measures.

[1] http://www.oecd.org/ctp/tax-challenges-arising-from-digitalisation-interim-report-9789264293083-en.htm

European Commission response

On 21 March 2018 the European Commission proposed the introduction of a Digital Services Tax imposable on revenues resulting from the provision of certain digital activities, as well as the introduction of a new regime relating to the corporate taxation of companies “with a significant digital presence”, aimed at addressing the tax challenges of the Digital Economy in the European Union.[2] These legislative proposals are to be submitted to the Council for adoption and to the European Parliament for consultation. It is understood that the parliaments of 4 EU Member States have submitted formal objections to the European Commission's proposals to tax the Digital Economy. The national parliaments that are formally opposed to the proposals are understood to include those of Denmark, Ireland, and Malta, and the House of Representatives of the Dutch Parliament.

The European Commission has said the current tax rules were not designed for the recent boom in global digital business that has little or no physical presence. As a result, there is, according to the European Commission, a disconnect / mismatch - between where value is created and where taxes are paid.

The European Commission has put forward an approach involving two distinct legislative proposals:

- A reform to corporate tax rules (long-term solution) - so that profits are taxed where businesses have significant interaction with users through digital channels, even if a company does not have physical presence in the jurisdiction in question.
- A Digital Services Tax (interim solution) - covers the digital activities that escape tax altogether in the EU. The tax will apply to revenues created from activities where users play a major role in value creation and which are the hardest to capture with current tax rules. These include revenues (which are not immediately obvious as banking services):
  - created from selling online advertising space;
  - created from digital intermediary activities which allow users to interact with other users and which can facilitate the sale of goods and services between them; and
  - created from the sale of data generated from user-provided information.

In its interim report, the OECD did not directly address Digital Economy concerns from the perspective of the banking industry. However, the importance of customer data is a key focus by both the OECD and European Commission (albeit it is acknowledged that data itself does

[2] https://ec.europa.eu/taxation_customs/business/company-tax/fair-taxation-digital-economy_en
http://europa.eu/rapid/press-release_MEMO-18-2141_en.htm

not drive value creation). Rather, it is reflected in the profit generated by specific client transactions that may utilise available data.

It is therefore important to consider how banks differ from other organisations utilising and providing services within the Digital Economy and to what extent tax reform may be required for the Digital Economy from the perspective of banks.

3. Structure of banking business and identification of value drivers

Banking vs other digital business

- Banks are similar to non-bank organisations in that they provide services and products to their customers. However, there are also fundamental differences. Banks are generally regulated with scrutiny in jurisdictions in which they operate, and exercise their activities under a licence and applicable banking laws. Banks must meet ongoing and increasing regulatory capital requirements, they are subject to information disclosure requirements and transparency laws, and must deal with increasing threats to data security. In turn, the highly regulated industry allows access to capital markets and a low cost of funds.
- Non-banking digital organisations, on the other hand, are generally not subject to such onerous legal and regulatory barriers, such as those applied to banks. Some jurisdictions have introduced rules to specifically encourage non-banks to challenge the established banking industry.

Agile structure of banks

- To respond to competition from outside the industry, banks are adopting more customer-centric strategies to engage with digitally-aware customers (e.g. in the retail banking space, digital apps and platforms now offer a broad range of solutions). The ways that customers bank have changed vastly in the last 5-10 years, and will continue to do so. Banks are also improving productivity and reducing cost by closing physical branches, reducing the number of ATMs / cashpoints and ushering customers onto digital service points, on phones, wearables, tablets and online. Automated systems deal with telephone banking as staff numbers are reduced. With a reduction in ‘bricks and mortar’ banking, customers may ‘consume’ financial services at their place of choosing. This could be in any jurisdiction, i.e. bank customers could be located anywhere at the point of consumption. However, it would be unusual for a bank’s retail customer base to not be mainly located in jurisdictions where the bank is licenced to operate.
- Additionally, banks are making substantial technology investments to explore the next series of value networks and systems, e.g. with the use of Blockchain technology or Artificial Intelligence.

Location of banking services

- As noted above, banks are regulated in the jurisdictions in which they operate. This does not always mean that banks, particularly in a retail banking context will be providing their services cross-border. Many banks operate in a purely domestic market, whilst others provide ‘global’ services. Accordingly, this is one structural difference between many banks and other digital businesses that seek to service their customers across many jurisdictions.

Adoption of technology

- Banks are adopting technology at different speeds. Some banks are embracing collaboration and co-innovation, actively investing in FinTechs, start-ups and making other strategic investments. Accordingly, there is an interrelationship between the two, where banks look to FinTechs for speed and agility to develop products and target customers, and FinTechs can leverage off a bank’s infrastructure, scale and client base.
- The use of platforms is key to driving banking value in the digital economy. Platforms bring together products and services for consumption. Banks are in a good position to build partnerships within the industry and outside of the industry.
- More generally, there is a movement toward an ‘open’ banking landscape whereby products, services and data (including customer data) can be shared with third parties. Regulators and lawmakers have already implemented frameworks for requirements, for example in the EU around third party sharing of customer data and payments information.

Use of data

- Typically for digital business, users can form strong relationships with online platforms with which they engage and participate. This interaction between customers and service providers, which characterises the Digital Economy, allows businesses to generate data on users’ behaviours, interests and consumption habits through direct information that users provide and the monitoring of their engagement with a platform. Value is often then created using a combination of algorithms, user data, sales functions and market knowledge.
- Whilst value may be derived from data, the collection of the data itself does not result in the users participating in a value creation activity. The UK government agrees with this view, stating that “sourcing of data from the UK, through what could be considered

passive or transactional relationships with UK customers" should not "entitle the UK to a taxing right on business profit."[3]

- In a banking context, data may allow banks to derive value from its use to produce useful information on how best to tailor/complement the banking experience for customers, and ability to cross-sell products. Banks are increasingly investing in analytics to best drive value from the data they hold.
- Digital companies often choose to offer a 'free' service, and collect data associated with this service with the objective or tailoring their service/monetising. Banks generally charge a fee for banking products either directly or via margins. Banking activities are different to those types of services that can be considered targeted by a Digital Services Tax (as noted above) such as the selling of advertising and intermediary activities.

Non-retail activities

Notwithstanding the change to how banks interact with customers, they continue to carry on other traditional banking activities, particularly in their wholesale and treasury businesses. Bank funding is sourced locally and globally, and is dependent on market conditions and availability of credit. The tax rules that apply to banks, including the residence / source principles, as well as attribution rules around profits to permanent establishments should continue to apply to these transactions.

4. Key risks to the banking sector

Banks face risks of revenue loss from non-bank entities competing for share of customers and the provision of traditional banking and other financial services. Examples of competitive threats include:

- Fintech start-ups and disruptors;
- Large technology companies offering traditional banking products;
- Digital payment platforms;
- Social media companies;
- Financial service aggregators; and
- Peer to peer lending.

- With customers having access to comparison sites and independent 'aggregators', a bank's brand loyalty and competitive opportunities can be diminished. This is particularly so in respect to their lending business, where customers may access the cheapest pricing through digital means. At the same time, banks face regulatory pressure on sales

[3] https://www.gov.uk/government/consultations/corporate-tax-and-the-digital-economy-position-paper

and pricing models, reflected by recent scrutiny in many countries on incentive-based branch sales, cross-subsidies, and mis-selling of services such as insurance and financial advisory products.

- Within the industry, those banks that are agile enough meet customer requirements by enhancing systems and platforms, and may be able to successfully partner with smaller FinTechs to achieve greater efficiencies and success.

Tax law reform

- Banks recognise the need for a fair and flexible tax system which appropriately allocates taxing rights based on where value is created. Tax reform to the Digital Economy has the potential to impact different banks by differing scales (e.g. local vs global banks, and retail vs wholesale banking).
- An approach that is not global, poorly considered and perceived as revenue-raising could bring jurisdictions out of line with each other. Particularly where the majority of jurisdictions are still applying established residence and source taxation principles.
- Banks have traditionally safeguarded important private customer data and continue to do so. To the extent that this information is required to be shared in an 'open' banking ecosystem with third parties, the protection of data is paramount.
- Challenges remain with global transfer pricing rules, however these are not limited to the Digital Economy.
- The successful implementation of BEPS initiatives globally needs time to properly have impact. Any inconsistency in global tax rules could discourage investment and growth due to uncertainty. A greater risk of uncertainty arises from interim solutions that are not applied consistently for global banks.

5. Recommendations / observations

- Banks are inherently different from other businesses, including 'pure' digital corporates and generally have a regulated / licenced presence in the jurisdictions in which they operate. Retail banking customers are typically located in these same jurisdictions in which they operate. It is therefore important to differentiate between banks and other participants in the digital economy with regard to any changes to the taxation laws.
- The Digital Economy has developed dramatically in a short number of years however and there is a significant further way to go. There are potentially unknown and new ways in which the Digital Economy may develop. Accordingly, well thought out measures are important and there is a need for flexibility as the landscape changes.
- Measures taken to address the tax challenges identified must be internationally coordinated in order to avoid the danger of double or multiple taxation. The OECD BEPS

project with its inclusive framework has a very broad base and is well placed to facilitate international coordination. The BEPS measures can already be seen to have meaningful impact with multinational corporates ensuring their structures are in alignment with BEPS principles. Short-term solutions could have an adverse impact as conflicting rules apply between countries and cut across existing established principles

- Banks play a large role with respect to data management but their business models remain essentially the same. Any rules seeking to tax the use of data must be closely aligned with the actual value creation model for banks, which does not include data monetisation.
- Banks use data to better provide products and services to their customers and not by directly monetising that data. Therefore, banks should continue to be taxed on the profits arising from those products and services.
- The impact of the digital changes will likely initially be more visible for retail banking activities. This is because customers now consume banking services from various locations and jurisdictions. However, as banks will typically only provide services where they are licensed to do so (and have a presence), there continues to be an important role to play for existing tax rules around residence / source and the attribution of profits to permanent establishments.
- Technology advancement by itself has not fundamentally changed how businesses generate revenues. Rather technology and automation may increase operational efficiencies or replace certain business functions that are becoming more mobile. The speed of uptake of technologies will differ between types of banks and financial services providers.
- Any interim solution (e.g. a Digital Services Tax) should proceed with careful consideration of its potential scope, nexus, rate, collection mechanism and detailed design. It should not result in additional taxes for banks as all banking activities are already fully taxed according to the rules set by the OECD. It should also be ensured that such measures do not create, by over-charging banks, distortion of competition between traditional banks and certain players entering banking markets and resulting from the Digital Economy. Furthermore, the risk of double taxation with regard to existing corporate income taxation and Value Added Tax/Goods and Services Tax (VAT/GST) should be carefully considered.
- The OECD “2010 Report on the Attribution of Profits to Permanent Establishments” focused on the Key Entrepreneurial Risk-Taking functions (KERTS) and provides a robust and appropriate basis on which to attribute profits to bank branches. If the concept of a digital permanent establishment is developed and accepted, it must take into account and respect the 2010 report to ensure a consistent and coherent basis of taxation for banks.

APPENDIX

Specific actions by jurisdictions

UK

The UK Treasury[4] have set out their views which align closely with the European Commission position, i.e.:

- the participation and engagement of users is an important aspect of value creation for certain digital business models; and
- the preferred and most sustainable solution to this challenge is reform of the international corporate tax framework to reflect the value of user participation.

The UK is seeking a multilateral solution from the OECD / G20 that will confirm this approach. However, it will impose a unilateral revenue based tax in the interim – which will apply to digital businesses (wherever located) deriving significant value from UK user participation. The scope is to be determined.

The UK draws a distinction between the position of active user participation creating value for certain digital businesses, and product / service supply profit under traditional value chain models.

US

The US enacted significant tax reform measures in late 2017. These measures are drafted broadly and are far reaching in their scope of taxation, including the base erosion and anti-abuse tax (BEAT) provisions. It is not yet clear what additional position they may adopt with regard to taxation of the digital economy.

The US Supreme Court handed down its decision on 21 June 2018 for *South Dakota v Wayfair, Inc.* that US States may force online retailers to collect sales taxes, despite having no physical presence in a state. The decisions could also affect non-US businesses that make sales to the United States but do not have a physical presence there. Given the Court's conclusion that *"physical presence is not necessary to create substantial nexus",* this decision may impact other US state taxes, such as corporate income taxes, which could apply to the income of an entity conducting significant business activities in a state without having a physical presence there.

[4] https://www.gov.uk/government/consultations/corporate-tax-and-the-digital-economy-position-paper

Australia

The Australian Government held an initial public consultation in late 2017 ahead of the proposed Digital Economy Strategy which is to be released in 2018.

The Australian Government has separately announced that a consultation will be under ken into the taxation of the Digital Economy.[5]

The Netherlands

The Dutch House of Representatives endorses the importance of taxing the Digital Economy and of reforming the tax system in order to achieve this and takes the view that only a global approach would be an appropriate solution.

For that reason, and especially since Member States are already working on a joint approach in the OECD context, the Dutch House of Representatives drew a "yellow card" on 15 May 2018 against the plans of the European Commission to introduce a tax for international companies providing digital services in the EU.

The House of Representatives believes that taxation and policy are primarily a matter for the Member States themselves, and that Member States can implement this reform even without European harmonisation or interference.

South Africa

South Africa has, since 1 June 2014, implemented VAT on the supply of electronic services by any supplier from a place in an export country (any country other than South Africa) where at least two of the following factors are present:

- the recipient is a South African resident,
- payment for such electronic services originates from a registered South African bank; and/or
- the recipient of the supply has a business, residential or postal address in South Africa.

Foreign suppliers of such electronic services are required to register for VAT where supplies made exceed R50 000.

The Minister of Finance announced in the Budget Speech 2018 that the VAT base for the supply of electronic services by foreign businesses to South African consumers would be

[5] As announced in the Federal Budget on 8 May 2018

broadened. The Draft Regulations state that "electronic services" will be defined as: *"…any services to be supplied by means of an electronic agent, electronic communication or the internet for any consideration…"* subject to certain exclusions for educational services provided by a person regulated by an educational authority in the export country and telecommunication services. This now includes anti-virus software, online advertising, broadcasting, online gaming, cloud computing, online consulting, online software supplies and training services. With this new regulation, every possible supply of services by means of electronic agent, electronic communication or the internet including financial services and the banking sector except for telecommunications and educational services would fall within the ambit of electronic services.

The proposed effective date of the regulation is 1 October 2018.

Furthermore, in March 2018, the Davis Tax Committee made the following recommendations to the Minister of Finance in relation to VAT and electronic commerce transactions. These include that:

- supplies qualifying as electronically supplied services should be categorised and explained in a guide or interpretation note;
- a distinction should be made between supplies made between businesses, business-to-business (B2B) and business-to-consumer supplies (B2C), with only the latter being subject to the e commerce rules;
- the invoice basis of accounting for VAT be the default position; and
- the VAT registration threshold for foreign electronic suppliers (as defined) be made the same as the compulsory VAT registration threshold i.e. a taxable turnover of R1 million in any 12 month period.