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IN FOCUS

SPECIAL EDITION: TAXING THE DIGITAL ECONOMY

Could the US Supreme Court's *Wayfair* Decision Open Pandora's Box Across the Globe?

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Welcome

David Gibbs
Chair of International Tax Services Group
(david.gibbs@alliotts.com)

The international tax world is changing at an unprecedented pace; the "global tax project" is well under way. Much change is being driven by the growth of the 'digital economy', the special focus for this edition of Tax Express International.

The digital economy and the economy are one and the same, yet governments have been slow to adapt to the implications of changing business models, specifically how the profit and income of digital businesses should be taxed. The need for clarity is put into perspective by the fact that nine of the world's Top 20 most valuable companies are now digital companies. A decade ago, only one of the Top 20 was a digital business.

Government responses at the local, national and supranational levels to taxing profits made from the digital economy are all explored in this newsletter. Certainly, proposals from the OECD and EU seem to be focused on ensuring that taxation is natural and fair and that compliance does not become a burden that stifles the digital economy's investment and growth.

Saying that, the ruling in the recent Wayfair case in the US poses the question of whether governments have got the balance wrong and are too focused on looking for additional sources of tax revenue at the cost of creating a compliance nightmare and setting a precedent that could become problematical not just in the US, but also worldwide.

Traditional rules relating to VAT and Permanent Establishment and where value is created are also having to evolve in line with the digital economy and are explored in this newsletter. We have also made them the focus of our tax training in Milan on 19th October – if you are not signed up already, please do soon as places are limited.

The launch of two new tax groups under the International Tax umbrella *(VAT/Indirect Tax and Transfer Pricing)* reflects the growing demand for services in these areas and our focus on meeting them.

Finally, we welcome US CPA Daryl Petrick to the International Tax Services leadership team. Daryl steps up to become our US Chair and will be our eyes and ears in the United States which is undergoing the biggest changes to its tax laws in a generation. Interesting times indeed!

David Gibbs

www.alliottgroup.net/internationaltax

Could the US Supreme Court's ***Wayfair*** Decision Open Pandora's Box Across the Globe?

In the case of South Dakota vs. *Wayfair*, the United States Supreme Court may have opened a Pandora's Box of tax compliance problems around the world as states seek to collect taxes they believe are due to them.

South Dakota *(a lightly populated US state)* sought to force the online seller *Wayfair* to collect its 4.5% sales taxes on behalf of the state. Bricks-and-mortar merchants have long complained about the ability for customers to effectively obtain a discount by purchasing the items over the internet from companies that do not have a physical presence in South Dakota as bricks-and-mortar stores are mandated to collect sales taxes from customers for in-store purchases, and internet retailers are not.

Although individual internet purchasers are required to self-report taxable items they buy from out-of-state retailers, this self-reporting is virtually non-existent. *Wayfair* argued that it did not have an obligation to collect South Dakota sales tax because it did not have any property or employees in the state. The Supreme Court ruled in favor of South Dakota in *Wayfair*, meaning that company and others similarly situated now have the obligation to collect and remit South Dakota taxes, no matter where they are located—domestically or abroad.

Other state legislatures have seized upon this ruling as a way to help balance state tax budgets. As internet-based shopping has taken hold, states have sensed that their taxable base has eroded in favor of remote online retailers. This ruling thus gives a boost to states that view sales tax underreporting as a major issue and provides a quick source of revenue. My state of California has indicated that they plan to copy South Dakota's law almost immediately.

The fallout from the *Wayfair* decision puts the burden onto sellers into a particular jurisdiction to be aware of their obligation to collect sales tax from their customers. The good news is that not all states currently have a sales tax—shoppers in the relatively unpopulated states of Oregon, Montana, New Hampshire, Delaware and Alaska are currently free of sales taxes. The bad news is that unique local district taxes in all of the other states have more than made up for the lack of taxes in these five states. In fact, although only 31 states currently tax internet sales, it is estimated that there are nearly 10,000 separate sales tax jurisdictions located in the United States, with Texas having over 1,500 all by itself.

What's a company to do when faced with the potential of having to manage 10,000 separate tax systems? Business interests are attempting to influence Congress to intervene to regulate this potential compliance nightmare. Although we might see Federal legislation to try to control this situation, a polarized Congress will struggle to find common ground especially under the non-regulatory framework that has been a hallmark of the Trump administration. The Court's ruling specifically noted that South Dakota's tax was relatively easy to compute and remit using specialized software. It is thus likely that companies will soon be required to obtain software that monitors unique tax requirements for each customer.

Foreign retailers are especially cautioned that US tax treaties do not prevent states from taxing sellers from out of the country, nor do the permanent establishment rules prevent sales tax collection.

On the horizon is yet another *Wayfair*-related issue—the ability for states to collect income taxes based solely upon sales rather than the physical presence that has been required to date. We have an eye on this issue as well as states may respond with aggressive income tax collection based upon sales.

For advice on state sales and income tax

For assistance with state sales or income tax questions regarding any US jurisdiction, or if you need help with compliance and tax planning, reach out to US Tax Chair Daryl Petrick *(DPetrick@cpabowman.com), a partner* at Bowman & Company.

Intercompany Transactions: Applying the Cost Plus Method

The pure cost plus method is a method used to determine the sales price of a product or service between associated parties. As such, its aim is to determine a gross profit mark-up. However, in some circumstances *(e.g. when it is difficult to find a comparable gross profit margin, but easier to identify a comparable net profit margin and for some functions such as tolling)*, the aim of the cost plus method is to determine the company's net profit. In such a scenario, the correct name of the method is the transactional net profit margin method *('TNMM')* with a cost plus as a profit indicator. Marie-Lise Swinne, Corporate Tax Partner at Tax Consult in Belgium and Head of Alliott Group's recently launched Transfer Pricing Services Group *(see page 10)*, explains how this complex international tax concept applies in practical terms.

In both cases, despite the level of mark-up applied, attention should be given to how the cost base is determined. While this is very familiar to some companies applying a true or pure cost plus method, it is often ignored by others.

Fully loaded costs *(including direct and indirect costs)* are often used when applying a cost based transactional net margin method. In practice, multinationals and group companies tend to include all operational costs linked to the provision of their services and simply apply a mark-up on those costs when what they should be doing is excluding shareholder costs and / or pass-through costs. During a tax audit, this could quite clearly, trigger questions from the tax authorities!

The question can thus arise whether it is acceptable, and to what extent, to treat a significant portion of the taxpayer's costs at arm's length as pass-through costs to which no profit element is attributed *(i.e. as costs which are potentially excludable from the denominator of the net profit indicator)* or as shareholder costs.

The quantitative and qualitative content of a 'cost pool' will typically give cause for concern- all appropriate costs should be within the pool and all inappropriate costs excluded i.e. disbursement / pass-through costs and shareholder costs.

Pass-through costs are expenses that are initially paid by the service provider but which are generally passed on separately to the recipient, for example third party services such as the purchase of advertising space on behalf of group members. Although these external expenses relate to the functions performed by the provider, they do not warrant any additional remuneration as there is no question of any added value being generated by the service provider *(neither performs any significant functions nor assumes any risks)*.

These costs are related to the functions carried out by the service provider, but apart from passing these costs on, they do not justify remuneration. Whether costs are involved in such cases generally hinges on whether an independent entity would not charge a profit margin on passing on

such costs. The response should not be based on the classification of these costs as 'internal' or 'external' costs.

Shareholder costs are the costs incurred for the provision of shareholder activity. The OECD Guidelines *(July 2017, paragraph 7.10)* define shareholder activity as *"an intra-group activity that may be performed relating to group members even though those group members do not need the activity (and would not be willing to pay for it were they independent enterprises). Such an activity would be one that a group member (usually the parent company or a regional holding company) performs solely because of its ownership interest in one or more other group members, i.e. in its capacity as shareholder. This type of activity would not be considered to be an intra-group service, and thus would not justify a charge to other group members. Instead, the costs associated with this type of activity should be borne and allocated at the level of the shareholder. This type of activity may be referred to as a 'shareholder activity'."*

Shareholder costs include, for example, those costs related to:

- shareholder meetings
- Reporting requirements *(consolidation of reports)*
- Preparation of the consolidated financial statements.

The aforementioned costs should be excluded from the cost base. However, one can see that their identification is subject to discussion / interpretation. As with many issues, nothing is ever black and white!

Correct analysis of the cost base will minimise the provider's profit – from the group's perspective, this will be attractive as it will allow the impact of a high mark-up to be reduced when required and will reduce the risk for the paying company in the event of a tax audit.

For these reasons, we strongly recommend a regular review of your cost plus method with your tax advisers. This is essential in the post-BEPS environment!

For more information

Contact Marie-Lise Swinne *(mls@taxconsult.be)*, Corporate Tax Partner at Tax Consult in Brussels.

Taxing the **Digital Economy** Fairly

The EU and OECD agree that traditional tax rules and systems need to be updated with a new future-proof solution that will not stifle the digital economy.

In this article, David Gibbs, corporate tax partner at London accounting firm Alliotts and Chair of the International Tax Services Group, explains that the OECD and the European Commission *(EC)* have issued publications with their latest analysis and proposals to tackle the issue of taxing profits and income earned from the digital economy. So where are we now in terms of concrete proposals?

David Gibbs
Partner, Alliotts
(david.gibbs@alliotts.com)

The OECD issued an interim report arising from Action 1 of the Base Erosion and Profit Shifting proposals which were delivered to G20 Leaders in November 2015. The report is an analysis of the issues, with a 'do nothing now' approach and a commitment to a two year project for delivery in 2020. The EC takes a more proactive view and appears keen to support interim measures while a full global solution is found.

What is the digital dilemma?

The recent case of Facebook giving access to its data to Cambridge Analytica encapsulates one of the core areas of the digital economy that governments want to seek to tax. Previously, most people were simply enjoying social networks for free and, other than a bit of advertising, didn't perceive that they or their data was creating value. The phrase which emerged was "if you're not paying for the service, you are the service". Essentially, individuals' personal data has become a valuable IP asset digital companies can use to generate revenues. The users of the digital media themselves are creating value for the digital companies. This is categorised into three areas by the report:

1. **User engagement**– this can be bookmarking pages, giving 'Likes', commenting in on-line debates etc

2. **User data**– core demographic, social background, education etc, to purchasing profiles, web browsing history and social networks

3. **User generated content**– e.g. uploading videos to YouTube, contributions to articles and forms.

The huge growth in digital media and content is reflected in the world's most valuable companies where nine of the top 20 are digital companies compared with 1 in 20 ten years ago.

What is the tax issue?

So, with all these digital interactions translating into wealth for large global companies, governments want to trace where the value is being created and seek to tax it.

In the 'traditional economy' we have the concept of Permanent Establishment and profit nexus to identify if a company is generating profit in a territory and, if so, seek to tax it. The definition of what creates a Permanent Establishment is fairly multilateral and the treaty network provides for the avoidance of double tax. However, in the digital economy, companies are not creating PEs in the countries in which their users are based and all profits are often being collected and taxed in low tax jurisdictions.

The OECD report notes and accepts that the digital economy is a global growth accelerator and there are risks of stifling investment and growth if it is over taxed or encumbered with excessive reporting and filing requirements.

What is the solution?

Neither report sets out to provide a long term solution. The OECD is very reserved with the mood of the report, keen to deter governments from implementing unilateral solutions which could damage the global tax project.

The EC published two formal Draft Directives within its tax package. The first proposes changes to the status of PE where digital services are provided.

This is measured by revenues generated from users in a state, the number of actual users in a state and the number of online contracts for supplying digital services to users.

The proposal suggests a profit split method be used to attribute profits from the overarching group to the state in question.

The Second Directive proposes a Digital Services Tax of 3% on revenues from advertising, making available multi-sided platforms for users and from the sale of data. This measure is targeted at large groups with revenues of over €750 million.

What's next?

The EC has taken a more proactive stance however. Within the EU, unanimous agreement is needed to implement any proposals. The OECD only needs consensus to bring about change.

There is risk of leaping from no taxation to over taxation if unilateral measures are implemented. For example it is easy to see two countries tax the same revenues if they are using different measures of value creation. Additionally, the current treaty framework does not provide for double tax relief where such new taxes are levied. This is evidenced by the Diverted Profits Tax introduced in the UK which is not corporation tax and hence has no basis for double tax offset.

All parties are keen to stress that the digital economy is the economy and the idea is not to create separate rules to tax profits from digital businesses but to update the tax framework so that such profits are naturally and fairly taxed. We now await the OECD interim report in 2019.

E-Commerce and the Special Scheme for **Distance Selling**

According to a study conducted by the CRR *(Centre for Retail Research)*, e-commerce generated net sales of €232.6 billion in Europe and Poland in 2016 and €265.7 billion in 2017. In 2018, this market should exceed €300 billion. Although it proves a fantastic opportunity for online sellers, e-commerce can also be the source of significant tax risks, particularly VAT. Mickael Tatayas, Head of Alliott Group's VAT/Indirect Services Group, explains the state of play in Europe and provides scenario examples.

E-commerce and existing VAT treatment of sales to private individuals

According to VAT legislation, online sales for customers are subject to VAT. In principle, the VAT applicable is that of the state where the seller has its establishment. However, a specific regime can apply to cross border sales.

i. 'Local' sales: customer and seller are in the same member state

When seller and customer are in the same member state, i.e. when the sale is local, the VAT applicable to sales is that of the member state where seller and customer are located.

A Belgian company selling goods to a Belgian customer will apply the Belgian VAT (6%, 12% or 21%).

ii. 'Cross border' sales: customer and seller are in different member states

In principle, when seller and customer are in two different member states, the VAT applicable to the sales is that of the seller's member state.

A Belgian company selling goods to a French customer will apply Belgian VAT (6%, 12%, or 21%).

This regulation favours member states with lower VAT rates, such as Luxembourg where the VAT rate is 17%. A Belgian customer would therefore be advised to purchase goods from a Luxembourg seller rather than from a Belgian seller.

To curb competition between member states, the European legislation has put in place a regime called the 'special scheme for distance selling'. According to this regime, above a determined threshold of sales in another and the same member state, the VAT applicable is that of the state where the customer is located.

In France, the threshold allowed per calendar year for distance sales is set at €35,000. A Belgian company selling goods to French customers will have to apply the French VAT rate when its total sales in France exceed €35,000.

The thresholds by member state are :

Austria	€35,000
Belgium	€35,000
Bulgaria	BGN 70,000 *(+/- €35,800)*
Croatia	HRK 270,000 *(+/- €36,250)*
Cyprus	€35,000
Czech Republic	CZK 1,140,000 *(+/- €42.000)*
Denmark	DKK 280,000 *(+/- €37,700)*
Estonia	€35,000
Finland	€35,000
France	€35,000
Germany	€100,000
Greece	€35,000
Hungary	€35,000
Ireland	€35,000
Italy	€35,000
Latvia	€35,000
Lithuania	€35,000
Luxembourg	€100,000
Malta	€35,000
The Netherlands	€100,000
Poland	PLN 160 000 *(+/- €37,150)*
Portugal	€3, 000
Romania	RON 118,000 *(+/- €26,150)*
Slovakia	€35 000
Slovenia	€35,000
Spain	€35,000
Sweden	SEK 320,000 *(+/- €33,800)*
United Kingdom	GBP 70,000 *(+/- €82,500)*

Exceeding the threshold and enforcing the special scheme for distance selling is not without consequences for sellers. The latter must obtain a VAT number in the member state where the threshold has been exceeded, apply the VAT rate of that member state to their invoices and submit VAT returns in that member state. If these requirements are not fulfilled, sellers run the risk of being forced to pay:

- VAT on sales for the current year and, as the case may be, for several years back
- Fines on the due VAT for the absence of a VAT number and for failure to submit VAT returns.

Special scheme for distance selling on the 2021 horizon

In December 2017, new regulations enforceable from 2021 were presented to help online sellers:

- The creation of a digital portal in every member state to allow the seller to fulfil in its member state of establishment all VAT obligations in other member states
- The introduction of a €10,000 threshold under which cross border sales are considered equivalent to local sales.

Conclusion

In view of the risks, online sellers should pay very careful attention to the obligations resulting from the application of the special scheme for distance selling. The adjustment of these rules should therefore make the current formalities which hinder the activity of the sector's professionals much easier.

For more information

Mickael Tatayas
(MT@taxconsult.be),
VAT Director
at Tax Consult in Belgium.

Vision

Turning a Challenge into an Opportunity: Belgian Tax Adviser Launches Transfer Pricing Services Group

If you haven't already noticed, the Base Erosion & Profit Shifting project *(BEPS)* is in full flow – the OECD/G20 led project is the biggest change to the basis of corporate taxation in a generation. With actions 8 and 11 of the BEPS Action Plan focused specifically on the use of transfer pricing, many multinationals and their advisers are on the back foot. However, in the opinion of Marie-Lise Swinne, a Corporate Tax Partner at Tax Consult in Brussels, the transfer pricing challenges should be seen by professional advisers as a huge opportunity. Therefore, Marie-Lise has initiated Alliott Group's Transfer Pricing Services Group to position the alliance as the natural partner to mid-market international companies needing multi-jurisdictional support.

In recent months, Alliott Group's umbrella International Tax Services Group has evolved to include a VAT/Indirect Tax Services Group and now a Transfer Pricing Services Group.

Key players across the international alliance will be working together under Marie-Lise's leadership to develop a global transfer pricing offering. Marie-Lise comments:
"BEPS has created increasing demand from international mid-market companies for transfer pricing advice and documentation support. Many international groups' use of transfer pricing can be unsophisticated - that creates risk. As a international alliance of accountants and tax advisers with big firm experience, we have a real opportunity to win work from companies positioned below the very large international corporations. Many buyers of tax services want to procure advice from outside the Big Four, but they are afraid of the risks. Our combined portfolio of international clients shows that we have the expertise to help these companies – we must now build the Alliott Group name to make sure we are seen as a real alternative."

There is a strong nucleus of transfer pricing expertise *(e.g. benchmarking studies, transfer pricing documentation and Country by Country Reporting)* within the global membership- the creation of the Transfer Pricing Services Group ensures that this knowledge can now be shared more effectively so that member firms can extend the services available to their clients.

For more information
Contact Marie-Lise Swinne *(mls@taxconsult.be)* at Tax Consult.

VAT & Indirect Tax Group Launched at EMEA Regional Conference

A new special interest group has been formed to focus on VAT and indirect taxes and will be nested within the International Tax Services Group.

VAT & Indirect Tax, a new specialist international tax group, was launched at the International Tax Services Group meeting in Prague in May. The energy and inspiration for the group comes from Mickael Tatayas, VAT Director at Tax Consult in Belgium *(pictured above left with Zaheer Anis of Alliott Management Consulting UAE in Abu Dhabi)*.

The group has been set up as a sub-group of the International Tax Services Group headed up by David Gibbs, and will initially be led by an international team of specialist members, most notably Mickael Tatayas.

Unveiling his plans for the group at the 2018 EMEA Regional Conference, Tatayas expressed his ambitions to establish a close network of international VAT/indirect tax experts who can advise each other's clients when doing business in a different jurisdiction. VAT, explained Tatayas, has become an issue for clients involved in remote selling, and it is important that we... *"increase the collaboration between Alliott Group members on VAT/indirect tax matters in EU member countries but also in non EU-member countries."*

Among Tatayas' other plans are initiatives to share and publish country-specific information, develop marketing communications and generate new business opportunities within and outside the EU.

More information will follow soon, but if you are a specialist in VAT or indirect tax, in the first instance, please get in contact with Giles Brake *(giles@alliottgroup.net)* at the Executive Office so that we can involve you in the group as it develops.

International Tax Training on VAT and Permanent Establishment Rules Scheduled for Milan

We are pleased to announce details of the next International Tax Training programme which will be held in Milan on 19th October 2018 and led by international tax training experts from the IBFD.

We will be splitting the day into two sessions to ensure sufficient variety and keep people awake! The morning session will cover the latest developments in VAT, in the afternoon training will be provided on Permanent Establishment issues.

This will be an excellent opportunity to stay current on the latest tax developments and to network in a highly targeted way with other Alliott Group colleagues facing similar challenges with their clients. Could this also present a good opportunity to visit member firms in Italy and surrounding European countries as part of a wider business development trip?

When & Where

When: 09:00-17:00, Friday 19th October *(preceded by optional networking dinner at 19:30 on Thursday 18th)*

Where: Milan, Italy *(at the offices of local member BES Associati)*.

Cost: Approximately UK£550 + cost of accommodation/dinner *(see website for more details)*. Delegates are to find their own hotel accommodation - recommendations are available on our website.

Visit the Events/BAP section of our website to register for this training event or please email Giles Brake *(giles@alliottgroup.net)* or Jenny Ringrose *(jenny@alliottgroup.net)*.

Alliott Group's International Tax Services Group facilitates access to expert tax advisors in many of the world's commercial centres across some 63 countries. Visit our website *(www.alliottgroup.net)* to find an international tax professional or in the first instance, contact Giles Brake *(giles@alliottgroup.net)* at Alliott Group's Executive Office.