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Corporate Tax 2019

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Sub Editor
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Senior Editors
Suzie Levy
Caroline Collingwood

CEO
Dror Levy

Group Consulting Editor
Alan Falach

Publisher
Rory Smith

Published by
Global Legal Group Ltd.
59 Tanner Street
London SE1 3PL, UK
Tel: +44 20 7367 0720
Fax: +44 20 7407 5255
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This publication is intended to give an indication of legal issues upon which you may need advice. Full legal advice should be taken from a qualified professional when dealing with specific situations.

EDITORIAL

Welcome to the fifteenth edition of *The International Comparative Legal Guide to: Corporate Tax*.

This guide provides corporate counsel and international practitioners with a comprehensive worldwide legal analysis of the laws and regulations of corporate tax

It is divided into two main sections:

Two general chapters, offering an insight into tax and state aid, and tax in relation to the digital economy.

Country question and answer chapters. These provide a broad overview of common issues in corporate tax laws and regulations in 34 jurisdictions.

All chapters are written by leading corporate tax lawyers and industry specialists and we are extremely grateful for their excellent contributions.

Special thanks are reserved for the contributing editor William Watson of Slaughter and May for his invaluable assistance.

Global Legal Group hopes that you find this guide practical and interesting.

The *International Comparative Legal Guide* series is also available online at www.iclg.com.

Alan Falach LL.M.
Group Consulting Editor
Global Legal Group
Alan.Falach@glgroup.co.uk

Taxing the Digital Economy

Sandy Bhogal

Panayiota Burquier

Gibson, Dunn & Crutcher LLP

Introduction

As part of the OECD/G20 BEPS project, and in the context of Action 1, the Task Force on the Digital Economy ("**TFDE**") considered the tax challenges raised by the digital economy. The 2015 Action 1 BEPS final report (the "**2015 report**") and the 2018 Action 1 BEPS interim report (the "**2018 interim report**") (together, with the 2015 report, the "**reports**") note that the digital economy is characterised by an unparalleled reliance on intangibles, the massive use of data (notably personal data) and the widespread adoption of multi-sided business models.

The reports also highlight ways in which digitalisation has exacerbated BEPS issues and note that measures proposed under the other BEPS Actions are likely to have a significant impact in this regard. The most relevant BEPS direct tax measures for highly digitalised businesses include amendments to the permanent establishment definition in Article 5 of the OECD Model Tax Convention (Action 7), revisions to the OECD Transfer Pricing Guidelines related to Article 9 of the OECD Model Tax Convention (Actions 8–10) and guidance based on best practices for jurisdictions intending to limit BEPS through CFC rules (Action 3).

These topics are explored in more detail below.

The position described in this chapter is accurate as at 31 August 2018.

Digitalisation of the Economy, not the Digital Economy

One key message from both reports is that the digital economy is becoming the economy itself. The 2015 report concluded that it is extremely difficult – if not impossible – to ring-fence the digital economy from the rest of the economy for tax purposes. What is also clear from both reports is that a robust understanding of how digitalisation is changing the way businesses operate and how they create value is fundamental to understanding the challenges of taxing the digital economy.

It is clear that the structure of businesses and the process of value creation have significantly changed and evolved, becoming technically very complex. A detailed explanation of business models shaping the digital economy can be found in the 2015 report. The 2018 report focuses on three characteristics that the TFDE identified as frequently being observed in certain highly digitalised business models. These are:

1. scale without mass;
2. heavy reliance on intangible assets; and
3. the role of data and user participation, including network effects.

See Box 1 below for details.

Box 1

Cross-jurisdictional scale without mass

Digitalisation has allowed businesses in many sectors to locate various stages of their production processes across different countries, and at the same time access a greater number of customers around the globe. Digitalisation also allows some highly digitalised companies to be heavily involved in the economic life of a jurisdiction without any, or any significant, physical presence, thus achieving operational local scale without local mass (referred to as "scale without mass").

Reliance on intangible assets, including IP

The analysis also shows that digitalised companies are characterised by the growing importance of investment in intangibles, especially IP assets which could either be owned by the business or leased from a third party. For many digitalised companies, the intense use of IP assets such as software and algorithms supporting their platforms, websites and many other crucial functions are central to their business models.

Data, user participation and their synergies with IP

Data, user participation, network effects and the provision of user-generated content are commonly observed in the business models of more highly digitalised businesses. The benefits from data analysis are also likely to increase with the amount of collected information linked to a specific user or customer. The important role that user participation can play is seen in the case of social networks, where without data, network effects and user-generated content, the businesses would not exist as we know them today. In addition, the degree of user participation can be broadly divided into two categories: active and passive user participation. However, the degree of user participation does not necessarily correlate with the degree of digitalisation. For example, cloud computing can be considered a highly digitalised business that involves only limited user participation.

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Relevant Measures of the BEPS Package

Permanent Establishments (Action 7)

The possibility to reach and interact with customers remotely through the Internet, together with the automation of some business functions, has significantly reduced the need for local infrastructure and personnel to perform sales activities in a specific jurisdiction (i.e. scale without mass). The same factors create an incentive for multinationals to remotely serve customers in multiple market jurisdictions from a single, centralised hub. In certain cases, however, the multinational group will continue to maintain a degree of presence in countries that are significant markets for its products, for instance by establishing a local subsidiary responsible for supporting and facilitating sales (so-called "trade structures"). The latter is typically remunerated for the services it provides on a cost-plus basis.

These traditional structures can present some BEPS concerns. This is the case when the functions allocated to the staff of the local subsidiary under contractual arrangements (e.g. technical support, marketing and promotion) do not correspond to the substantive functions performed. For example, the staff of the local subsidiary may carry out substantial negotiation with customers, effectively leading to the conclusion of sales. Provided the local subsidiary is not formally involved in the sales of the particular products or services of the multinational group, these trade structures generally avoid the constitution of a dependent agent permanent establishment in the market jurisdiction.

In response to these BEPS risks, Action 7 resulted in the amendment of key provisions of Article 5 of the OECD Model Tax Convention and its Commentary. The changes aim to prevent the artificial avoidance of permanent establishment status which is the main treaty threshold below which the market jurisdiction is not entitled to tax the business income of a non-resident. In addition, the 2015 report noted that these changes could help mitigate some aspects of the broader direct tax challenges regarding nexus, if widely implemented. These expectations were primarily relevant for situations where businesses have some degree of physical presence in a market (e.g. to ensure that core resources are placed as close as possible to customers) but would otherwise avoid the permanent establishment threshold.

More specifically, Action 7 provided for the amendment of the dependent agent permanent establishment definition through changes to Articles 5(5) and 5(6) of the OECD Model Tax Convention. The amendments address the artificial use of commissionaire structures and offshore rubber stamping arrangements. Some structures common to all sectors of the economy involved replacing local subsidiaries traditionally acting as distributors with commissionaire arrangements. The result was a shift of profits out of a certain jurisdiction but without a substantive change in the functions performed there. Other structures more specific to highly digitalised businesses, such as the online provision of advertising services, involved contracts substantially negotiated in a market jurisdiction through a local subsidiary, but not formally concluded in that jurisdiction. Instead, an automated system managed overseas by the parent company could be responsible for the finalisation of these contracts. Such arrangements allowed a business to avoid a dependent agent permanent establishment under Article 5(5). Where the recommendations of Action 7 are implemented, these structures and arrangements would result in a permanent establishment for the foreign parent company if the local sales force habitually plays the principal role leading to the conclusion of contracts in the name of the parent company (or for the transfer of property or provision of services by the parent company), and these contracts are routinely concluded without material modification by the parent company.

Action 7 also recommended an update of the specific activity exemptions found in Article 5(4) of the OECD Model, according to which a permanent establishment is deemed not to exist where a place of business is used solely for activities that are listed in that paragraph (e.g. the use of facilities solely for the purpose of storage, display or delivery of goods, or for collecting information). The proposed amendment prevents the automatic application of these exemptions by restricting their application to activities of a "preparatory or auxiliary" character. This change is particularly relevant for some digitalised activities, such as those involved in business-to-consumer online transactions and where certain local warehousing activities that were previously considered to be merely preparatory or auxiliary in nature may in fact be core business activities. Under the revised language of Article 5(4), these types of local warehousing activities carried out by a non-resident no longer benefit from the specific activity exemptions usually found in the permanent establishment definition if they are not preparatory and auxiliary in nature. This would be the case, for example, for a large warehouse maintained by a non-resident company in a market jurisdiction in which a significant number of employees work for the main purpose of storing and delivering goods owned and sold by the non-resident company and that a warehouse constitutes an essential part of the non-resident company's sales/distribution business.

What are jurisdictions doing about Action 7?

Italy has introduced legislation to replace the domestic definition of permanent establishment with the one provided by BEPS Action 7. Under the new permanent establishment definition, a significant and continuous economic presence in Italy set up in a way that does not result in a substantial physical presence in Italy may constitute a permanent establishment. Other examples of countries that have followed Action 7 recommendations and moved forward with the adoption of the significant economic presence test are Israel, the Slovak Republic and India. Saudi Arabia has also officially endorsed what is being called the "virtual service PE". Turkey has published legislation revealing an "electronic permanent establishment" and Japan has also said it will amend the definition of permanent establishment in its domestic legislation in line with Action 7 recommendations.

The BEPS package is designed to be implemented via changes in domestic law and practices, and via treaty provisions. To this end, the multilateral instrument ("**MLI**") is intended to facilitate the implementation of the treaty-related BEPS measures, but the adoption rate of the permanent establishment-related provisions through the MLI have been reported to be low. Some jurisdictions may have reserved their position on the permanent establishment-related provisions of the MLI until seeing the Inclusive Framework's work on "Attribution of Profits to Permanent Establishments" – published in March 2018. However, the adoption rate of the new permanent establishment definition may increase over time in any case, as governments base future treaty negotiations on the 2017 OECD Model incorporating those changes.

Unilateral UK action prompts further measures elsewhere

As part of the 2015 Finance Act, the United Kingdom introduced the Diverted Profits Tax ("**DPT**"). The DPT operates through two basic rules:

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1. First, a rule that counteracts arrangements that exploit permanent establishment rules. Very broadly, the DPT applies in cases where a person is carrying on activities in the UK in connection with the supply of goods and services by a non-UK resident company to customers in the UK. Detailed conditions must be met for this "avoided PE" measure to apply.
2. Second, a rule to prevent tax advantages obtained through the use of transactions or entities that lack economic substance. This is essentially a "sideways CFC" measure whose primary function is to counteract arrangements that exploit tax differentials and will apply where the detailed conditions, including those on an "effective tax mismatch outcome", are met.

Following the UK example, Australia introduced its own DPT in July 2017. France attempted to legislate for a DPT in 2017 but its Constitutional Council ruled that the legislation was insufficiently detailed, giving the tax authorities too much discretion. However, France is expected to resubmit the legislation to the Constitutional Council in an amended form for inclusion in its 2018 Finance Bill.

Transfer Pricing (Actions 8–10)

Business models where intangible assets are central to the firm's profitability, such as those of highly digitalised businesses, have in some cases involved the transfer of intangible assets or their associated rights to entities in low-tax jurisdictions that may have lacked the capacity to control the assets or the associated risks. To benefit from a lower effective tax rate at the group level, affiliates in low-tax jurisdictions have an incentive to undervalue the intangibles (or other hard-to-value income-producing assets) transferred to them. At the same time, they could claim to be entitled to a large share of the multinational group's income on the basis of their legal ownership of the intangibles, as well as on the basis of the risks assumed and the financing provided (i.e. cash boxes). In contrast, affiliates operating in high-tax jurisdictions could be contractually stripped of risk, and avoid claiming ownership of other valuable assets.

Actions 8–10 of the BEPS Action Plan developed guidance to minimise the instances in which BEPS would occur as a result of these structures. In particular, the guidance seeks to address the prevention of BEPS by moving intangibles among group members (Action 8), the allocation of risks or excessive capital among members of a multinational group (Action 9) and transactions which would not occur between third parties (Action 10).

The guidance developed under BEPS Actions 8–10 was incorporated into the OECD Transfer Pricing Guidelines in 2016 to ensure that transfer pricing outcomes are aligned with value creation. While the Transfer Pricing Guidelines play a major role in shaping the transfer pricing systems of OECD and many non-OECD jurisdictions, the effective implementation of these changes depends on the domestic legislation and/or published administrative practices of the relevant countries.

Overall, tax administrations may feel better equipped to address profit shifting by multinational groups through mechanisms such as:

- Identification of actual business transactions between the associated companies by supplementing, where necessary, the terms of any contract with evidence of the actual conduct of the parties.
- An analytical framework to determine which associated company assumes risk for transfer pricing purposes, with contractual allocations of risk being respected only when they are supported by actual decision-making.
- Guidance to accurately determine the actual contributions made by an associated company that solely provides capital without functionality. Specifically, if the capital provider does not exercise control over the investment risks that may give rise to premium returns, that associated company should expect no more than a risk-free return.
- Guidance on transactions that involve the use or transfer of intangibles which ensures that legal ownership of an intangible by an associated company alone does not determine entitlement to returns from the exploitation of this intangible.

Controlled Foreign Company Rules (Action 3)

The 2015 BEPS Report on Action 3 provided recommendations in the form of six building blocks, including a definition of Controlled Foreign Company ("**CFC**") income which sets out a non-exhaustive list of approaches or combination of approaches on which CFC rules could be based. Specific consideration is given to a number of measures that would target income typically earned in the digital economy, such as income from intangible property and income earned from the remote sale of digital goods and services to which the CFC has added little or no value. These approaches include categorical, substance, and excess profits analyses that could be applied on their own or in combination with each other. With these approaches to CFC rules, mobile income typically earned by highly digitalised businesses would be subject to taxes in the jurisdiction of the ultimate parent company. This would counter offshore structures that result in exemption from taxation, or indefinite deferral of taxation in the residence jurisdiction.

What are jurisdictions doing about Action 3?

The European Commission's (the "**Commission**") 2016 Anti-Tax Avoidance Directive requires all 28 EU Member States to introduce CFC rules that draw heavily on the recommendations of Action 3. Article 7 of that Directive provides two alternative methods to define the income earned by a CFC. One is based on formal classifications and covers a broad range of income categories, including "*royalties and any other income generated from Intellectual Property*" and "*income from invoicing companies that earn sales and services income from goods and services purchased from and sold to associated enterprises*". This method may in some cases cover sales income generated primarily from the use of underlying intangible property (i.e. "embedded royalties") but is limited by a substance carve-out rule available to a CFC that "*carries on a substantive economic activity supported by staff, equipment, assets and premises, as evidenced by relevant facts and circumstances*". The other method is based on a standalone substance test which captures income "*arising from non-genuine arrangements which have been put in place for the essential purpose of obtaining a tax advantage*". In accordance with the best practices outlined in the 2015 BEPS Action 3 Report, this method looks at the significant people functions within the group to determine whether the CFC is conducting non-genuine arrangements. However, this method may not always reach income from online services, where the CFC may typically be established with the necessary substance to comply with transfer pricing rules.

Other Tax Developments Around the World

Use of withholding taxes

The UK introduced changes to UK royalty withholding tax where royalty payments are deemed to have a UK source. For royalty

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payments made by a foreign company on or after June 2016, where the royalty is connected with a trade carried on through a UK permanent establishment, the royalty may be deemed to have a UK source. This is regardless of whether the royalty amount would be deductible in calculating the profits of the UK permanent establishment. A foreign company with a UK permanent establishment paying a royalty to a group company must calculate the "just and reasonable" portion of that royalty that should be sourced to the UK permanent establishment *vs* sourced to the foreign parent. The portion which has a UK source is then *prima facie* subject to the basic rate of UK income tax (20%) via a withholding mechanism.

Turnover taxes

A meaningful number of countries have taken actions to assert taxing rights over non-resident companies, such as foreign-based suppliers of digital products and services. These measures typically include sectoral turnover taxes targeted at (or including) revenue from online advertising services, such as India's Equalisation Levy, Italy's levy on digital transactions, Hungary's advertisement tax and France's tax on online and physical distribution of audio-visual content.

In March 2018, the EU Commission published its proposal for the introduction of a digital permanent establishment. Here, companies (including those in non-EU jurisdictions) that exceed certain digital activity thresholds in a tax year in a given Member State will trigger a digital permanent establishment in that Member State. The host Member State would have the taxing rights in respect of profits attributable to that permanent establishment. The digital activity thresholds set out in the EU proposal are as follows:

- revenue from digital services in a Member State that exceed EUR 7,000,000 (seven million euros);
- number of active users of the digital service in a Member State that exceeds 100,000 (one hundred thousand); and
- number of online contracts concluded that exceeds 3,000 (three thousand).

What the EU Commission (and other countries that have set out similar thresholds) does not do is provide guidance as to how "active users" will be measured. The problem is that there is little publicly available material on the process of defining and identifying active users and more detailed metrics need to be developed for the purpose of using "active users" as a factor. For example, how do countries identify a "user" or what level of engagement is required for a user to be considered "active"? Reliability and veracity of the information would also need to be ensured to address fraudulent accounts, multiple accounts and false information volunteered by users.

Turning to how contracts will be concluded. Does this mean that for every time online platforms provide free services to their users and who specify on their websites that by accessing or using the products and services of the company the user agrees to the "Terms of Service" and this results in the conclusion of a legally binding agreement and therefore, a concluded contract? How will this work when commercial activities are carried out remotely while travelling across borders? An individual can, for example, reside in one country, purchase an application while staying in a second country, and use the application from a third country. Challenges presented by the increasing mobility of users are exacerbated by the ability of many users to use virtual personal networks or proxy servers that may, whether intentionally or unintentionally, disguise the location at which the ultimate sale takes place. The fact that many interactions on the Internet remain anonymous adds to the difficulty of the identification and location of users.

Interim measures

The EU Commission also published a second legislative proposal in the form of an interim 3% tax on certain revenue from digital activities. This interim measure is only intended to apply until comprehensive international reform has been implemented and is intended to focus on scenarios where revenues are escaping the current tax framework altogether.

The 3% interim tax is characterised as a basic indirect levy on gross revenues (with no deduction of costs) where users play a major role in value creation that leads to those revenues, e.g. revenues created from:

- selling online advertising space;
- digital intermediary activities which allow users to interact with other users and which can facilitate the sale of goods and services between them; and
- the sale of data generated from user-provided information.

This will capture, for example, revenues raised from social media platforms or search engines, and services of supplying digital platforms that facilitate interaction between users, who can then exchange goods and services via the platform (such as peer-to-peer sales platforms).

Broader picture – US tax reform

The USA has made no secret of its scepticism for the digital economy project, not least because a number of the "case studies" used in this area are US-headquartered multinationals, and a number of these entities are already facing scrutiny as a result of domestic measures in EU jurisdictions or EU state aid proceedings. The Trump administration have also repeatedly warned of the potential dangers of inhibiting growth in this area and are clearly not afraid to enact unilateral measures to deal with what they perceive as deliberate targeting of US businesses.

Following the various amendments made to US federal tax laws in December 2017 under the Tax Cuts and Jobs Act, the USA also maintains that US multinationals do not erode tax unfairly because the companies in question pay tax where the "value" is created. A comprehensive summary of the changes is beyond the scope of this chapter, but the following changes should be highlighted:

- the base erosion anti-abuse tax ("**BEAT**"), which is essentially a corporate minimum tax arising from so-called "base erosion" payments;
- the global intangible low-taxed income ("**GILTI**") regime, whereby a 10% or more US corporate shareholder of a controlled foreign company must include the relevant share of net-income of that foreign company in its gross income. Such net income is an amount above a deemed fixed return to that foreign company on its tangible assets (subject to certain exceptions); and
- the foreign-derived intangible income ("**FDII**") regime, which provides for corporate tax deductions against such income which is earned directly by a US corporate. This is intended to provide an incentive against the transfer of intangibles outside the USA to low tax jurisdictions.

The UK's Position on the Digital Economy

On 13 March 2018, the UK government issued an update (the "**update**") on its position paper entitled Corporate Tax and the Digital Economy and contains the UK government's updated thinking on the digital economy.

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Very broadly, the update provides detail of how the UK government believes "user participation" creates value for certain digital business through engagement and active contribution. It sets out four channels by which it believes value is created:

- Generation of content by users that supports a business's ability to attract and retain users and generate revenue.
- Deep engagement with the platform allowing tailoring of platform and content and collection of valuable behavioural data.
- Development of networks through engagement and actions that create connections between users.
- Contribution to a business's brand through provision of content, goods or services and through moderation and the rating of content.

The update identifies a number of issues, including: how much residual profit derives from user participation; how to allocate it between different jurisdictions; which legal person should be liable for the tax; and what (minimum) threshold (such as number of active users or revenues) should be applied before the tax is imposed. The update discusses issues regarding the scope of such a tax, including how to identify the businesses and revenues within its scope, challenges in identifying the location of users, how best to minimise distortions and avoid damaging the UK digital sector (including start-ups) and whether it could be applied to revenues net of certain outflows (such as payments to conduits).

Avoiding damage to the UK digital sector is the key policy objective for the UK Government, as it strives to present itself as a global leader in the digital arena and in the services it offers to help digital businesses grow faster and more efficiently. The appointments of Jacky Wright (previously Corporate Vice President, Core Platform Engineering at Microsoft Corporation) as New Chief Digital and Information Officer in 2017 and Professor Jason Furman (former US President Barack Obama's Chief Economic Advisor) as Chair of a new government expert panel will help in this regard and aim to ensure the UK remains at the forefront of the digital revolution.

However, a balance must be struck. The UK Chancellor of the Exchequer recently raised the prospect of an "Amazon tax" for online retailers amid fears that high street shops are being put out of business. The UK has made it clear that it is not afraid of going it alone if international solutions take too long, as the introduction of the DPT demonstrates.

Closing Remarks

The 2015 report says that countries *could* introduce measures on a unilateral basis – albeit in line with international tax practices. But any uncoordinated actions (as set out earlier in this chapter) serve only to create uncertainty for taxpayers and are a sure way to make the digital economy an even more complex area.

There are considerable technical and legal hurdles to overcome in any digital economy tax mechanisms, but if governments are to create sustainable long-term models then cooperation and coordination with all those directly involved is essential.

This, of course, is all in the background of countries competing for capital, trade wars and Brexit. One of the greatest challenges facing tax authorities around the world is perhaps bridging the gap between political rhetoric and legal reality and creating enforceable frameworks which offer the clarity, certainty and coherence essential to long-term economic growth and stability. The OECD and the G20 recognise this task is highly complex when it comes to the digital economy.

The TFDE will provide an update on its work in 2019, as members work towards a consensus-based solution by 2020.

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Sandy Bhogal

Gibson, Dunn & Crutcher LLP
Telephone House 2–4
Temple Avenue
London, EC4Y 0HB
United Kingdom

Tel: *+44 20 7071 4266*
Email: *sbhogal@gibsondunn.com*
URL: *www.gibsondunn.com*

Sandy Bhogal is partner in the London office of Gibson, Dunn & Crutcher and a member of the firm's Tax Practice Group.

His experience ranges from general corporate tax advice to transactional advice on matters involving corporate finance & capital markets, structured and asset finance, insurance and real estate. He also has significant experience with corporate tax planning and transfer pricing, as well as with advising on the development of domestic and cross-border tax-efficient structures. He also assists clients with tax authority enquiries, wider tax risk management and multi-lateral tax controversies.

Prior to joining Gibson Dunn, Sandy was head of tax at Mayer Brown, and prior to that was associated with Ernst & Young LLP and with a leading international legal practice.

Panayiota Burquier

Gibson, Dunn & Crutcher LLP
Telephone House 2–4
Temple Avenue
London, EC4Y 0HB
United Kingdom

Tel: *+44 20 7071 4259*
Email: *pburquier@gibsondunn.com*
URL: *www.gibsondunn.com*

Panayiota Burquier is an English qualified associate in the London office of Gibson, Dunn & Crutcher and a member of the firm's Tax Practice Group.

Ms. Burquier qualified as a solicitor in 2009 and has a range of transactional and advisory experience. Her practice focuses on advising clients on tax aspects of a wide variety of financing and corporate transactions, including mergers and acquisitions, corporate restructurings, accessing capital markets and bank finance. Ms. Burquier also advises on real estate and investment fund transactions.

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glg global legal group

59 Tanner Street, London SE1 3PL, United Kingdom
Tel: +44 20 7367 0720 / Fax: +44 20 7407 5255
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