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Committee on Fiscal Affairs
The Organisation for Economic Co-operation and Development

International Tax Committee
Japan Machinery Center for Trade and Investment

Comments on BEPS Action 1 Public Discussion Draft on 'ADDRESS THE TAX CHALLENGES OF THE DIGITAL ECONOMY'

Japan Machinery Center for Trade and Investment ("JMC") is a non-profit organisation established in 1952 to promote the sound development of international trade in machinery by Japanese multi-national entities. Its members include major machinery manufacturers, trading companies and engineering companies. Its International Tax Committee was established at the beginning of 1990 in order to enhance the international competitiveness of machinery industry in Japan and has been active in studying, and contributing to, the development of domestic and foreign international taxation systems.

URL：http://www.jmcti.org/jmchomepage/english/index.htm

JMC is submitting its opinion on Action 1 of the Action Plan on BEPS because it potentially has a significant impact on the members of JMC that are engaged in the export of, and investment in, wide-ranging machinery.

The comments of JMC

<General comments>

JMC recognises that the digital economy has widely and deeply permeated the economic activities surrounding 'hardware' machinery and requests that the outcome of possible solutions presented in Public Discussion Draft on BEPS ACTION 1 : ADDRESS THE TAX CHALLENGES OF THE DIGITAL ECONOMY will contribute to keeping compliance costs under control. JMC hopes that it will help resolving the unfairness in competition between resident and non-resident businesses due to the different tax treatment of VAT/GST. Furthermore, JMC believes that solutions to BEPS issues should not only lead to more taxation by every tax authorities but also to the realisation of fair taxation on businesses and the resolution of double taxation.

JMC would like to thank the OECD for assembling the background the context on information and communication technologies and the digital economy related to Action 1 as the development of the digital economy could have an important implication to international taxation.

The development of the digital economy makes economic activities more efficient and, even if there are issues that should be addressed by the BEPS project, they should be regarded as the side effects of the digital economy. There should be recognition that the development of the digital economy is desirable. Then, it will be very important that any possible tax measures should avoid imposing excessive compliance costs that could hamper the development of the digital economy. If a country imposes, for example, periodical reporting and withholding tax obligations excessively, businesses could move to a country where there are no such unnecessary regulatory obligations.

JMC observes that some of the proposed measures in the draft, such as the expansion of the concept of PE and the creation of withholding tax on electronic transactions, do not seem to be useful from a practical point of view, or could impose excessive administrative burden on businesses for compliance, and that they could have an impact on the treatment of other transactions or have an distorting effect that could result in new double taxation.

<Specific comments>

(1) <u>Whether it is possible to ring-fence the digital economy from the rest of the economy, and if not, whether specific types of digital transactions could be identified and addressed through specific rules</u>

It is impossible to ring-fence the digital economy in an appropriate manner because the digital economy has permeated widely and deeply to the economic activities of the traditional and hardware sector as machinery.

In reality, some business models are hard to be classified in or outside the digital economy. For example, the most valuable part of an internet shopping site could be secure settlement or the development and maintenance of a logistics network. In that business model, a traditional sales and service model is mixed with the digital economy. Thus, arbitrary ring-fencing of the digital economy could result in distortion in taxation.

Let us take cloud computing services as another example. As a variety of intangible assets are employed in a complex manner, it is inevitable that some intangible assets are employed both in the digital economy and in the rest of the economy. Any taxation on the consideration for such use of intangible assets should, therefore, be consistent and fair between the digital economy and the rest of the economy.

In addition, from the point of view of *flexibility*, one of the five principles endorsed in the 1998 Ottawa Ministerial Conference, *'the systems for taxation should be flexible and dynamic to ensure that they keep pace with technological and commercial developments'*, a harm could be done by separating the two economies because the digital economy and the rest of the economy are being increasingly integrated as technology develops.

As the paragraph 120 of the draft states, the nature of the strategies used to achieve BEPS in digital businesses is similar to the nature of strategies used to achieve BEPS in more traditional businesses. It should be, therefore, unnecessary to take measures specifically targeting the digital economy.

It is necessary, however, to set a certain rule in order to address the existing competitive unfairness resulting from the different VAT treatment when digital contents are downloaded from the internet website of a resident business or a non-resident business.

Furthermore, the treatment of transactions in services that do not depend on the internet, that are commissioned by a resident business to a non-resident business and that are executed outside the country should be maintained as services provided outside the country.

(2) <u>The key features of the digital economy identified by the Task Force and whether there are other key features that should be taken into account</u>

JMC does not have specific comments.

(3) <u>The examples of new business models in the digital economy and whether (and if so which) other business models should be considered</u>

JMC does not have specific comments.

(4) <u>The ability of the measures developed in the course of the BEPS Project and the current work on VAT/GST to address BEPS concerns in the digital economy</u>

Although some of the measures developed in the course of the BEPS Project and the current work on VAT/GST may be applicable to BEPS concerns in the digital economy, JMC believes that the highest priority should be given to setting a certain new rule in order to address the existing competitive unfairness resulting from different VAT treatment when digital contents are downloaded from the internet website of a resident business or a non-resident business.

(5) <u>Whether other measures should be developed during the course of the work on other aspects of the BEPS Action Plan to address BEPS concerns in the digital economy and if so which ones</u>

Other measures in the BEPS Action Plan can be applied to address BEPS concerns in the digital economy. It is understood that the digital economy has been raised in Action 1 in order to present typical issues in the current BEPS concerns as a whole. If the work in Action 1 is carried out as stand-alone, it could lead to inconsistency in a larger picture. The approach to the digital economy, therefore, should be a synthesis of individual issues such as the definition of PE, intangible assets and CFC rules.

For example, it appears that Action 2 (Neutralise the effects of hybrid mismatch arrangements), Action 3 (Strengthen CFC rules), Action 7 (Prevent the artificial avoidance of PE status), Action 8 (Assure that transfer pricing outcomes are in line with value creation: intangibles) and Action 12 (Require taxpayers to disclose their aggressive tax planning arrangements) are applicable to the digital economy. Concerning transfer pricing taxation, particularly the issue of intangibles that is discussed in other Action and the concept of a distinction between intangibles and service provisions that is part of the former, should be discussed in common.

Except for transactions concerning the downloading of digital contents from an internet website, measures specific to the digital economy should not be hastily adopted. Although the deadline of the output of Action 1 is September 2014, instead of giving a definitive conclusion of Action 1 by then, it will be more appropriate to seek an output that is consistent with work done in other Actions.

(6) The broader tax challenges raised by the digital economy which have been identified by the Task Force and how these challenges should be addressed, taking into account both direct and indirect taxation (Section VI)

Concerning direct taxation, an expansion of the concept of PE status or the creation of a withholding tax on digital transactions should not be lightly introduced. Because it is impossible to ring-fence the digital economy from the rest of the economy, measures to prevent BEPS applicable to the traditional economy should also be applicable to the digital economy.

Concerning indirect taxation, it is necessary to set a certain new rule in order to address the existing competitive unfairness resulting from different VAT treatment when digital contents are downloaded from the internet website of a resident business or a non-resident business. In addition, it will be necessary to create a mechanism to prevent double taxation because there is no treaty relief for indirect taxation and the amount of double taxation could be large due to gross taxation.

(7) The options to address these broader tax challenges discussed by the Task Force and summarised in the discussion draft (Section VII)

JMC believes that the options to expand the concept of PE that are discussed in 3.1 Modifications to the Exemptions from Permanent Establishment Status, in 3.2 A New Nexus based on Significant Digital Presence and in 3.3 Virtual Permanent Establishment are not viable options. The Business Profit TAG worked on the concept of PE in the digital economy meticulously since 1998, which resulted in the changes to the Commentary on Article 5 of the OECD Model Tax Convention. In addition, work on PE status will also be done in Action 7 of the BEPS Action Plan as explained in the paragraph 150 onwards. By taking the above context into consideration, it is dangerous to try to reach a conclusion on the Article 5 of the OECD Model Tax Convention or a new concept of PE by Action 1 that is related only to the digital economy. Action 1 should not go beyond analysing these issues and summing up main points.

JMC is against the creation of a withholding tax on digital transactions (option 3.4) because it is fundamentally difficult to make a distinction between digital transactions and the other transactions and thus it will not be feasible. If it were created, it would risk creating new economic distortions and double taxation.

Concerning 3.5 Consumption Tax Options, it is necessary to introduce a rule to require the non-resident supplier to register and account for the VAT on cross-border B2C service supplies in the jurisdiction of the consumer.

(8) The potential cost of compliance arising from the options proposed to address the tax challenges of the digital economy and suggestions for more cost efficient alternatives (Section VII)

Concerning the options 3.1 Modifications to the Exemptions from Permanent Establishment Status, 3.2 A New Nexus based on Significant Digital Presence, 3.3 Virtual Permanent Establishment, and 3.4 Creation of a Withholding Tax on Digital Transactions, because the recognition and valuation of attributable profits is complex and difficult, it will be extremely difficult and burdensome for many businesses to recognise such PEs and grasp attributable profits to them regularly and continuously.

(9) Whether the Ottawa taxation framework principles identified above are an appropriate framework for analysing options to address the tax challenges, and whether and how they should be supplemented

They are an appropriate framework. As the framework for analysing options to address the tax challenges, the tax principles in the Ottawa framework conditions centred on neutrality would be appropriate. Action 1 is more general and comprehensive than other Actions and contains various elements. Action 1 should, therefore, position itself as the general remarks on the entire BEPS project and focus on summing up issues. It may be mostly the case that concrete policy options could be delegated to other Actions of the BEPS Action Plan.

JMC submits the above comments to the OECD Public Consultation because the theme is of significant importance for many Japanese companies exporting machinery and investing. JMC appreciates the opportunity that has enabled JMC to provide these comments.

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