

Digital tax policy disruption

Europe looks increasingly ready to go it alone



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An update: Europe looks increasingly ready to go it alone



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Brace for action: in our last report in late January 2018 outlining the ongoing consideration of digital tax policy,¹ we finished by saying that “one thing is for sure – for an issue that had largely floated into the background since 2015, the debate on digital taxation is moving at a disruptive pace.”

Fast-forward a few weeks, and just how disruptive things may get – and just how quickly – has become far more clear.

Our earlier article outlined that two multilateral organizations – the European Commission (the Commission) and the Organisation for Economic Co-operation and Development (the OECD) – were simultaneously studying options and recommendations for potential future tax regimes that would address the challenges of taxing digitalized businesses.

Things may still be expected to change between now and the final release of any proposals.

This is a fast-moving issue that tax directors must address, as the impact, while initially focused, may well expand.

1. *Digital tax policy disruption*, EY, January 2018, [ey.com/Publication/vwLUAssets/EY-digital-tax-policy-disruption/\\$FILE/EY-digital-tax-policy-disruption.pdf](https://www.ey.com/Publication/vwLUAssets/EY-digital-tax-policy-disruption/$FILE/EY-digital-tax-policy-disruption.pdf)

For the Commission, our article explained, potential policy choices were being driven by a growing sentiment – to which not all EU Member States subscribe – that the consensus position developed within BEPS Action 1 that there is “no such a thing as a separate digital economy, but that companies are now participating in the digitalized economy” was not sustainable.

Additionally, we described, a more fundamental discussion on the division of taxing rights was being demanded by many EU Member States, causing the issue of digital tax to not only be revisited, but reignited with a pace and vigor that surprised many. That pace and vigor have now increased, with arguably both US tax reform and the ongoing, heated global trade debate contributing to the shift.

Eight short weeks after the Commission said that it would move forward with assessing the impacts of a range of potential proposals, a paper – which admittedly contains many caveats and gaps – detailing the current thinking and proposed policy recommendations of the Commission has been leaked.²

We believe the proposals referred to in the paper are due to be published on 21 March 2018 (along with the impact assessment), ahead of the release of an interim report on the taxation of digitalized business by the OECD, at the G20 Finance Ministers’ and Central Bank Governors’ meeting in Washington, DC.

The leaked Commission paper, while containing many omissions and open questions, does contain a lot of what is clearly quite advanced thinking on the topic. That said, things may still be expected to change between now and the final release of any proposals. This is a fast-moving issue that tax directors must address, as the impact, while initially focused, may well expand.

The EU's justification for overturning agreed allocation of taxing rights

At the heart of this issue, both the Commission and a number of EU Member States believe that there is a mismatch between where taxation of profit currently takes place and where (and how) value is created by certain digital activities. The Commission, the paper says, believes that the mismatch is the result of a combination of several factors:³

- ▶ *Businesses can supply digital services where they are not physically established – “scale without mass”;*
- ▶ *The development of specific software such as social platforms which allow user interaction – “reliance on Intellectual Property assets (IP)”;* and
- ▶ *The value from the business perspective comes from the participation of the users in the digital activities that they offer – “user value creation.”*

The paper points out that such factors in themselves do not create a problem, and are not specific to the digital economy, but the factors being used together can lead to the mismatch. In particular, the paper says, *“the problem is that the input ‘user value creation’ is located in a tax jurisdiction (market jurisdiction) where the company carrying out a digital activity is not physically established and where its activities thus cannot be taxed. This is so because the users’ contribution to the value of a digital business is not sufficiently reflected in the current corporate tax framework.”*

This position would seem to be contrary to that of the United States who argue that a separate, special tax regime does not need to be created to address the digitalized companies.⁴ This is on the basis that the largest multinational enterprises have shifted (or are in the process of shifting) to structures that use local low-risk distributors to report income on locally filed tax returns (and then relying on transfer pricing principles to determine how much profit to report). The leaked Commission paper, meanwhile, says that *“the solution is to redefine the corporate tax framework to take into account the “value creation input” in the attribution of taxing rights/profit allocation for a jurisdiction.”*

Therein lies the key challenge faced by the OECD: developing any kind of consensus on such a thorny, complex and politically charged issue may be unfeasible – particularly as the Task Force on the Digital Economy (TFDE) (the subsidiary body of the OECD addressing the issue) is co-chaired by two nations, France and the United States, who seem diametrically opposed.

2. *Brussels’ digital tax move raises transatlantic stakes*, Politico, 28 February 2018. www.politico.eu/article/technology-brussels-digital-tax-move-raises-transatlantic-stakes/

3. Text in italics throughout this report is reproduced directly from the leaked paper.

4. *MNE Tax: US disputes need for special digital economy tax rules, seeks consensus on profit allocation issues*. 20 February 2018. mnetax.com/us-disputes-need-digital-economy-tax-rules-seeks-consensus-profit-allocation-issues-official-says-26182

The leaked paper focuses on a two-phased approach: a short-term, interim solution, plus a more comprehensive, long-term solution. The first would deliver a short-term, transitional gross revenues tax, while the second focuses on a new concept of a digital permanent establishment (PE) along with revised profit attribution rules. Both pose significant challenges to policymakers and business alike.

The Commission's current thinking: the "long-term, comprehensive solution"

The details of the long-term, comprehensive approach set out in the paper are more closely aligned to the Commission's briefings in the final quarter of 2017. It focuses on a new definition of what might constitute digital PE along with revised profit allocation rules. This, the paper says, could be delivered via a standalone EU Directive, and focuses on the definition of a digital PE and associated profit allocation rules.

These, the paper says, should be included in the Common Consolidated Corporate Tax Base (CCCTB) negotiations; but it appears that such a Directive could be introduced separately in the meantime.

Addressing third countries

Deployment of this new tax regime would depend on the existing intergovernment commitments, i.e., those in double tax treaties. Where these treaties apply, the paper accepts that domestic or EU rules should not override these agreements and it therefore recommends that the treaties are changed over time. This might of course be accelerated through the use of a tool such as the OECD Multilateral Instrument, but that will remain a contentious issue. Within the EU and indeed with countries with a limiting double tax treaty, changes could be implemented quickly.

Subject to tax

One or more of three criteria would need to be met in order for a company to be subject to tax, says the paper, but leaves the exact thresholds around those criteria unfinalized at present:⁵

- ▶ *Revenues from digital services in a tax year would need to exceed EUR [10,000,000] in a tax year*
- ▶ *The number of active users of the digital service in a Member State in a tax year would need to exceed [X]; or*
- ▶ *The number of online contracts concluded exceeds [N].*

Profit allocation

In terms of profit allocation, the paper states that the Commission's view is that adherence to the current rules for profit allocation (as set out in the OECD Model Tax Convention), which are based on the risks managed, functions performed and assets held by the PE, is unlikely to offer an effective solution for digital PEs. The paper therefore proposes setting out some additional criteria, specifically and exclusively targeted at attributing profit to a digital PE. These criteria are listed in the paper as:

- ▶ *The users' engagement and contributions to the development of a platform;*
- ▶ *The data collected from users in a Member State through a digital platform;*
- ▶ *Numbers of users;*
- ▶ *User-generated content.*

Rate of tax

Member States will apply their national corporate income tax rules with respect to the profits attributable to a digital PE in their jurisdiction, and the rate of tax to be applied to the digital activities would be determined by each Member State. It appears that this could be a different rate to the general corporate rate, but of course concerns regarding State Aid (positive or negative) would need to be addressed. The tax charge would be annual and the payment would be to the Member State where the digital PE is located.

Furthermore, the paper says, the Directive should include anti-fragmentation rules, to avoid excluding digital services that are considered as preparatory or auxiliary, when in fact they are core business activities – which they describe as activities such as the gathering and processing of data.

5. Currently unfinalized amounts are noted in square brackets, as per the leaked paper.

The paper notes that *“to facilitate this renegotiation of double tax treaties, the Commission should issue a Recommendation setting out the proposed changes to the double taxation treaties of Member States in relation to Article 5 Permanent Establishment and Article 7 Business Profits of the OECD Model Tax Convention”* while also noting that *“we could also promote the idea of updating the OECD Model Tax Convention itself in order to align international tax principles with the new EU rules through a Chapeau Communication. We could also promote the idea of revising and expanding the profit split method to focus more on the user-based criteria proposed for the profit allocation rules in the Directive.”*

In terms of implementation, the paper does not address how such extensive updates to double tax treaties would be achieved; presumably the Commission would find it attractive to try and leverage the OECD's Multilateral Instrument in that regard – but that will require a strong relationship and collaboration between the two bodies.

The “short-term” solution

The paper notes that potential global reform of the corporate tax rules will take time, while there is *“also high political pressure for Member States to adopt short-term measures with a more targeted scope which could somehow address the problem outlined.”*

That will be addressed with a tax on the gross revenues of a company delivering digital services into a Member State, says the paper.

Such a tax would be delivered via a *Directive on a common system of a tax on certain digital activities*, the legal base for which would be Article 113 of the Treaty for the Functioning of the European Union (other forms of indirect taxation). This is a key distinction, as this is an area where the Commission drives policy.

Scope of revenues subject to tax

The gross revenues tax would only target scenarios where there is deemed to be a high mismatch between the level of taxation of profits and where and how value creation for such a business occurs (i.e., digital activities that typically have high user contributions to value).

Revenues included in the scope of this tax would be those derived from digital activities generating value from user data, the sale of advertising space and also digital platforms where such users supply goods and/or services directly between themselves.

This is further described in the paper: *“The tax would be levied on services supplied for consideration consisting in the valorisation of user data, by means of making available advertisement space ... or the sale of such user data. For instance, in the case of online advertising, the added value of such advertising services is that they are specifically targeted at their optimal audience, based on user preferences obtained through user participation in social networks. It would also be levies upon revenues generated from the making available of digital platforms/marketplaces to users (i.e., ‘intermediation services’), and where such users supply goods and/or services directly between themselves ... The business model of such marketplaces heavily relies on the participation of end-users in the platform (actual suppliers and recipients of the underlying services).”*

The paper explicitly notes that the making available of digital content/solutions to users would not be in scope of the tax.

The leaked paper sets out that there will be a single rate of tax across the EU, in the region of 1% to 5%. The Financial Times, meanwhile, on 15 March 2018 reported that according to a leaked draft of next weeks' expected proposals, the rate will be set at 3% - and will also apply to subscribers services such as music or video streaming.

Thresholds

The paper sets out two key thresholds, both of which must be met for the tax to apply; again, the thresholds are set out in parenthesis, indicating that they are still under consideration by the Commission:

- ▶ *Annual worldwide total revenue above EUR [750] million, at the level of the multinational group to which the business belong*
- ▶ *Annual revenue from the provision of digital services in the EU somewhere in the range EUR 10 to [20] million*

The paper does note that the short term, targeted tax would also apply in purely domestic scenarios in order to respect the freedom to provide services and freedom of establishment according to the EU Treaties, as well as the World Trade Organisation legal framework.

Finally, only after a Member State has renegotiated its double taxation treaties with a third country should the new tax cease to apply to businesses from such third country, says the paper.

Will the tax be either creditable or deductible?

The question of creditability of this tax against the corporate tax liability in the current taxing Member State is a key concern. At first glance, a gross revenues tax would appear to have no link to underlying profit, as can be seen for loss-making companies in particular. However, this could be considered to be a tax on the imputed profit of the business undertaken in the Member State. The intricacies of such a dispute may require the courts to decide, but early indications are that most commentators (and indeed the Commission paper) are assuming that there will be no credit, leading to double taxation.

In regard to deductibility, the paper explicitly notes on two occasions (sections 3.1 and 3.7) that the gross revenues tax will be levied with no deduction of costs. It seems to assume that the tax is unlikely to be creditable, too, but notes that *"the new tax paid by a business in any Member State could be deducted as a cost from the CIT base in their territory in order to alleviate potential cases of double taxation."*

Strong levels of support from key countries

The commitment of a number of Member States to push forward with the short term solution was illustrated in a 1 March 2018 letter from five major EU Member State finance ministers (France, Germany, Italy, Spain and the UK), co-signed by both the President and Vice-President of the European Commission, to the current chair of the G20 (Argentina).

The letter states that "OECD momentum should be maintained and that ongoing work on long term [digital tax] solutions must be pursued" but also that "This should not stop countries – as a first step – adopting interim solutions, preferably on a coordinated basis to deal with the issues raised in the shorter term."

It is therefore likely that we will see a draft Directive at some point in 2018.

But it would be wrong to focus solely on Commission activity in regard to this tax; Member States, of course, retain overall sovereignty over their tax regimes, and it is therefore equally possible that some will move unilaterally before the ink dries on such a Directive. Indeed, on 13 March 2018, UK Chancellor of the Exchequer Philip Hammond published a paper that, in keeping with the work of the Commission, sets out a two-phased approach; in a key difference from the Commission work, however, the UK paper (foreshadowing the exit of the UK from the EU) focuses on work to revise the OECD Model Tax Convention to provide a long-term solution, and not the Commission work on a stand-alone Directive.

So in summary:

- ▶ It is highly likely that there will be a new tax
 - ▶ It will be levied on gross revenues (i.e., turnover)
 - ▶ It will potentially not be deductible against CIT, and;
 - ▶ Member States will not be encouraged to amend their tax treaties with third countries in order to deliver any form of relief from double taxation
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Other challenges pile up

Those four issues overleaf are not the only things that taxpayers should consider:

- ▶ The gross revenues tax could potentially have a lengthy lifespan: The CCCTB has been seen potentially as the end game, but has been on the Commission's agenda since 2010. Despite successive attempts to drive CCCTB forward (including removing the consolidation element in 2016, taking instead a phased approach to implementation) success has not yet been achieved.
- ▶ Turnover taxes can be penal in nature: and because of this it could undermine the potential to invest – or may even halt sales in particular markets.
- ▶ Gross revenue taxes do not generally represent good tax policy: The argument for a turnover tax is usually that it can be a proxy for the profits that are made on sales. But making sales isn't the same as making profit, particularly when you consider the high number of loss-making start ups in the digital space.
- ▶ Setting a "one-size-fits-all" rate or approach that would fit all the different digital business models that it will need to cover will be difficult: as margins in businesses vary significantly. Indeed, in another context, Her Majesty's Revenue and Customs, the UK tax authority, has estimated that the margins of food retailers are less than a third of that of financial services firms. With such variations, a tax at one rate that might be deemed fair to some would be penal to others. For low-margin businesses, a high rate might make sales unprofitable and result in prices having to increase or may even halt sales in a particular market.
- ▶ Double taxation may also occur within a single Member State: Given that the new tax would apply equally to revenues derived from the provision of digital activities not only in cross-border scenarios but also purely domestic ones, there is a risk that double taxation arises where the same revenues are taxed under both the new tax and existing corporate income tax rules. Fixing this (by removing the gross revenues tax where there is a PE in that Member State) may be discriminatory and hence this level of double tax may need to remain even in wholly domestic situations – something clearly not in line with the desires of policymakers.

What to expect next

At the present time, the OECD appears to be sticking to its timetable of delivering an interim report to the 20 April G20 Finance Ministers' and Central Bank Governors' meeting in Washington, DC.

The most likely outcome appears to be that the OECD will list the pros and (many) cons of temporary measures, emphasizing the cons to try and discourage Commission action, and will also then make an initial attempt to describe potential long-term measures. These would likely be a combination of nexus and profit attribution rules – as set out by the Commission, but potentially differing. The OECD may also wish to address how this may be achieved in both more detail and also in terms of aligning to existing international tax norms.

With the formal version of the leaked paper expected to be released by the end of March 2018, we can expect this debate to continue to develop quickly.

The Commission has indicated that a Directive could be ready this year and this could be flexible enough that individual Member States could implement their own tax regimes in advance of any finally approved EU text, on the basis that their regimes would satisfy any minimum blueprint in the Directive. So a 2019 implementation may not be an unrealistic expectation for the EU policymakers.

A key question remains whether the Commission could deliver a gross revenues tax given the need for unanimity in tax matters. Given the number of Member States supporting this issue, however, and the ability for the proposal to proceed if 9 or more Member States support it (under the 's enhanced cooperation process) it seems likely that this will continue.

One issue remains, though: after so many years of consensus building on some of the biggest international tax challenges, it will be regrettable if we take a step backward to a world of misalignment and double taxation.

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