



13 July 2018

Taxation of the Digital Economy

KEY MESSAGES

- 1** BusinessEurope believes that agreements on changes to international tax rules regarding the digitalised economy should take place at the global level. This can ensure a global level playing field encompassing all major tax jurisdictions. We therefore welcome the European Commission's efforts to find a global solution to issues around digital taxation and believe discussions at international level should be intensified.
- 2** However, we are concerned that the European Commission's proposal for a short-term solution for a Digital Services Tax (DST), breaks with the international convention of taxing company profits not revenue, and thus risks increasing double taxation of companies as well as damaging our competitiveness, jobs and investment if applied unilaterally in the EU.
- 3** The OECD will already in 2019 present another report on the matter and will issue a final report in 2020. Whilst allowing the OECD a reasonable opportunity to reach global agreement, the European Commission should, in parallel, to its joint and continued efforts with the OECD, undertake a thorough analysis with a view to identifying ways forward for the EU to address any clearly identified distortions in the taxation of the profits of digital and non-digital businesses, without undermining the competitiveness of EU industry. All analysis and impact assessment conducted by the European Commission should be made public. One of the objectives, while respecting the sole competence of Member States in the field of taxation, must be to avoid any unilateral action by Member States.



Taxation of the Digital Economy

Background

The European Commission presented on 21 March their proposals on the taxation of the digital economy, following their September 2017 Communication 'A Fair and Efficient Tax System in the European Union for the Digital Single Market'. The Commission has put forward both a short-term measure, the Digital Services Tax (the DST), and a more comprehensive, long-term proposal.

The long-term proposal introduces the concept of a significant digital presence, which allows Member States to tax profits generated in their territory by companies who do not have a physical presence. The new rules will also change how profits are allocated to Member States depending on where the user is based at the time of consumption. The European Commission has recommended including this proposal in the proposed Common Consolidated Corporate Tax Base (CCCTB).

In the absence of a global consensus, the European Commission made a proposal for a targeted temporary tax, the DST, to be levied at 3% on the revenues gained by companies from selling online advertising space, user-generated data and digital intermediation services which allow users to interact with other users. The tax, due in the Member States where the users are located, would apply to companies with both annual worldwide revenues exceeding €750 million and EU-revenues exceeding €50 million.

1. A global agreement is needed regarding the taxation of the digital economy

The on-going digitalisation of our society is already transforming our everyday-lives, showing potential to significantly improve our standards of living, reducing costs and creating many jobs. Ensuring that more European companies can generate the technical know-how, attract skilled employees, and build their businesses to become global leaders must be a priority for the EU. The Commission estimates that removing the remaining barriers of the Digital Single Market could add over €400 billion per year to the European economy.

Completing the Digital Single Market is both a priority and a matter of urgency for business, and we have welcomed the Commission's commitment to this in its September 2017 Communication, 'A Fair and Efficient Tax System in the European Union for the Digital Single Market'. We also believe that developing an efficient and fair tax framework that is embedded in a competitive business environment to support the take-up and innovation of digital technologies for the whole economy and society is essential. The recent adoption of the VAT/E-commerce directive, including the abolition of the customs exemption for small consignments and the increased VAT-obligations for digital platforms, is also a good step in this direction.

We believe that it is fundamental for any EU-action in this field to take into account the global nature of the challenge being addressed. Through a global consensus, on the appropriate division of taxation rights over corporate profits derived from the digitalisation



of the economy, can we hope to modernise the international tax system in a coherent and lasting way, preserving the benefits of both globalisation and digitalisation.

While we welcome the Commission's desire to give impetus to the ongoing debate, we are also concerned that a unilateral EU legislative proposal, aiming to define a digital permanent establishment (PE) may be interpreted by third countries as a means to anticipate and bypass the international consensus. Even if an EU-proposal succeeds in spreading the tax principle among the Member States, it risks jeopardizing the international scenario, leading to an adoption of different digital PE-definitions between the EU and the rest of the world, eventually resulting in increased uncertainty and double taxation. In the light of this, we reiterate that an agreement must be taken forward through the OECD, to be shared among the largest possible number of countries and to be incorporated as a new standard in the OECD model tax convention. We stand ready to provide the Commission with further analysis on this proposal, particularly on the issue of digital permanent establishment, as the discussions continue to develop at international level.

2. The DST-proposal, by taxing revenue rather than profits, breaks with international tax conventions, risks increasing double taxation, distorting the EU-economy and damaging competitiveness, jobs and investment.

However, we are concerned that the Commission's short-term proposal for a Digital Services Tax (DST), breaks with the international convention of taxing company profits not revenue and in addition risks increasing double taxation of companies. Such a tax also risks damaging our competitiveness, if applied unilaterally in the EU. Any proposal to introduce new taxes specific to digital business models needs to be supported by robust public evidence regarding both competitiveness impacts, and relative under-taxation of digital business models. This work should take into account recent changes in global taxation rules, notably the implementation of BEPS agreements and the US tax reform, which are heavily impacting on firms' effective tax rates.

In this context, we believe that the EU should seek to preserve the integrity of the Single Market and avoid unilateral actions by the Member States. However, the Commission's current proposal for an interim measure, the DST, may endanger the Commission's objective to grasp the full potential of the Digital Single Market. Furthermore, any EU-wide proposal needs to include provisions that ensure the elimination of double taxation.

We have set out below our key concerns in more detail:

Taxation of revenue and not profits leads to double taxation

We are very concerned that implementing the DST, whereby companies would be taxed on their revenue, would mean a violation of the long-standing international principle of taxing corporate profits. Ensuring that the EU is exemplary in its adherence with the global agreements that it and its Member States have entered into is the best way of securing support for the long-term proposal at the OECD.

The Commission's impact assessment also acknowledges that levying a revenue tax can cause further instances of double taxation. In particular, given the DST can only be



offset as a business expense and not as a credit against corporation tax, there will only be an alleviation rather than full avoidance of double taxation.

Similarly, a tax on revenue rather than profits increases the possibility of a cascading effect if, as the OECD and others note, an important share of the tax is passed onto employees, users, sellers, buyers, etc in the form of lower margins, higher prices and fewer jobs. Cascading could occur both if the final product is also subject to VAT (with VAT now levied on the increase in the price as well as the pre-tax price), and with multiple cascading possibilities if the digital service is an input to a number of other digital services.

We share the Commission's desire that there should be a level playing field in terms of taxation between companies engaged in digital activities and others. However, it should be noted that there could be legitimate reasons why some companies face lower effective tax rates than others, for example by benefitting from government R&D incentives or immediate expensing of costs. The potential effectiveness of such policies risks being decreased or eliminated by the proposed DST on revenue.

The Commission used a joint study by Centre for European Economic Research-PwC in its impact assessment to argue that companies with digital business models pay less than half the tax rate of businesses with traditional models. Given the importance of this justification for the Commission in bringing forward the DST, we believe it is essential that the Commission provides more background to the underlying study and its arrival at the 9.5% and 23.2% calculations by an analysis based on a theoretical model and how it differs from other research on actual effective tax rates paid by digital firms, such as that by the European Centre for International Political Economy (ECIPE). Such background should also look into the concerns expressed by PwC on how the Commission draws conclusions from the study regarding corporate tax paid by the digital economy. We also note that the Commission in its impact assessment states that digital businesses are expected to have a lower effective tax rate.¹ An effective tax rate below the average is not a justification for increased taxation.

Recent changes in global taxation increase the possibility that the DST will lead to double taxation.

Empirical studies, such as those noted above, are by definition backward-looking, with data availability often meaning that company behaviour from a number of years ago is being modelled. Given the rapid ongoing changes in corporation tax policy in countries across the globe, we are concerned that such studies will provide an inaccurate picture of the effective corporation tax liabilities of corporations in the coming years.

For example, in recent years countries around the globe have started implementing agreed standards from the OECD's BEPS project, the implementation of which, as the OECD's 2015 Action 1 report has noted would, 'substantially address the BEPS issues exacerbated by digitalisation.'

¹ SWD(2018) 81 Final (page 18, footnote 26).



Furthermore, the EU's Anti-Tax Avoidance Directive (ATAD), which in many areas goes beyond BEPS-minimum standards, is to be implemented next year, whilst the recent US tax reform will bring important updates to the CFC-rules, permanent establishment and the taxation of intangibles.

If such changes have increased the effective tax rates of companies with digital models then there is an increased likelihood that the DST will significantly increase the incidence of double taxation. Therefore, we strongly urge the European Commission and Member States to carefully take the impact and results of all these provisions in the global corporate tax system into account in order to have an informed debate.

Impact on Growth, Competitiveness and Innovation

The OECD's interim report on the challenges of the digital economy notes that 'an interim measure will increase the cost of capital, reducing the incentive to invest, with a resulting negative effect on growth'. It also adds that 'a measure only applicable to digitalised sectors risks slowing down investment in innovation for those businesses that are subject to the tax or indirectly affected by it.'

While the European Commission's impact assessment provided some useful information, particularly regarding the likely revenue streams from the tax, it does not provide a full analysis of the likely impact on innovation and growth. Even if the tax is specifically levied on larger companies, we are concerned that the flow-down effect would mean that SMEs and start-ups will bear much of the tax burden and that the cost of doing business will increase. As a result, prospective investors of, for example, a start-up technology company, will to some extent lower their valuation, and the likelihood of finding investors in the company decreases if future revenues are subject to the tax.

Furthermore, any solution, short-term or longer-term, to taxation of digital business models must not unduly undermine the possibility of Member States to collect corporate taxes in order to meet their social objectives. The DST's objective of taxing revenue where users are based, rather than where the revenues were generated, does not cover the possibly large investing costs and losses in the country of residence. This may bring relocation of the activities from the country of residence to bigger countries of consumption.

In addition, by imposing a tax based on the number of users may have the potential to incentivise countries with large consumer bases (including the USA, China, and India) to assert a destination-based approach to taxing premium profits of imported goods and services. This would be harmful to EU exporters and Member States' tax bases.

Risk of Reducing International Tax Cooperation

We are very concerned that introducing a revenue tax, would mean a violation of the long-standing international principle of taxing corporate profits. By unilaterally applying this tax, the EU may face similar measures from third countries. EU-Countries may also be less motivated to find a global, comprehensive solution related to all digital services with the EU's major trading partners if the DST is in place.



Ensuring that the EU is exemplary in its adherence with the global agreements that it and its Member States have entered into is the best way of securing support for the long-term proposal at the OECD.

Implementation and Transition

From an implementation perspective, the DST would also require the collection and retention of user Internet Protocol (IP) addresses or, if more accurate, other means of geolocation. This user data would need to be retained for an unspecified period of years and maintained for inspection by EU or Member State audit.

While the DST has been outlined as a short-term measure, we are concerned that the proposal itself is not clear as to how the transition from the DST to the long-term proposal would be envisioned. With no mechanism in place to ensure the withdrawal of the tax, the temporary DST runs the risk of becoming permanent. Lack of clarity surrounding the implementation period of the DST can create significant uncertainty for all businesses operating in Europe.

Next Steps

The OECD will already in 2019 present another report on the matter and will issue a final report in 2020. Whilst allowing the OECD a reasonable opportunity to reach global agreement, the European Commission should, in parallel, to its joint and continued efforts with the OECD, undertake a thorough analysis with a view to identifying ways forward for the EU to address any clearly identified distortions in the taxation of the profits of digital and non-digital businesses, without undermining the competitiveness of EU industry. All analysis and impact assessment conducted by the Commission should be made public. One of the objectives, while respecting the sole competence of Member States in the field of taxation, must be to avoid any unilateral action by Member States.