

European Commission issues proposals for taxation of digitalized activity

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Executive summary

On 21 March 2018, the European Commission (the Commission) issued [two proposals](#) (The Proposals) for new Directives that will deliver new ways to tax digitalized forms of business activity.

The Commission's proposals focus on a two-phased approach: an interim solution, referred to as the Digital Services Tax (The DST or DST proposal) and a longer term *Council Directive laying down rules relating to the corporate taxation of a significant digital presence* (SDP or the Significant Digital Presence proposal).

The DST proposal is for a gross revenues (i.e., turnover) tax, set at a uniform rate of 3% across all European Union (EU) Member States, while the Significant Digital Presence proposal focuses on a new concept of digital permanent establishment (PE), along with revised profit attribution rules.

According to the Question and Answer (Q&A) document issued alongside the proposal, this DST will ensure that those activities which are currently not effectively taxed would begin to generate immediate revenues for Member States to the tune of an estimated €5 billion a year. If the revenues were split by gross domestic product (GDP), this would imply revenues of approximately €3.4b to the five Member States that have been publicly in favor of this tax, being France, Germany, Italy, Spain and the UK.¹

In a [press release](#) issued alongside the proposals, the Commission notes that the SDP measures could eventually be integrated into the scope of the Common Consolidated Corporate Tax Base (CCCTB), but sets out no distinct interdependency between these two activities.

Both solutions would be delivered by new Directives. The proposals will be submitted to the Council for adoption and to the European Parliament for consultation, and the Commission hopes that final adoption will occur by 31 December 2019, for 1 January 2020 transposition into national law.

The [Q&A document](#), noted above, sets out the Commission's justifications for action, proposed delivery methods and potential timing. A [factsheet](#), also issued with the proposal, sets out additional contextual information.

Detailed discussion

Justification for action

The Q&A document sets out the Commission's view that *today's international corporate tax rules are not fit for the realities of the modern global economy and do not capture business models that can make profit from digital services in a country without being physically present.*

Current tax rules also fail, it says, to recognize the new ways in which profits are created in the digital world, in particular the role that users play in generating value for digital companies. As a result, the Commission believes that there is a disconnect – or “mismatch” – between where value is created and where taxes are paid, and that companies with digital business models pay on average half the effective tax rate of companies with traditional business models (9.5% for digital business models versus 23.2% for traditional business models, according to the Commission's factsheet).

This situation, the Commission notes, poses several risks that should be tackled urgently, including:

- ▶ The system is unfair and there is no level playing field, as traditional companies tend to carry a heavier tax burden than digital ones.
- ▶ Member States' tax revenues are at risk if they cannot tax profits arising from digital activities.
- ▶ Digital companies need a stable, competitive environment to thrive and the EU needs modern, fair and growth-friendly tax rules to support the growth of the Digital Single Market.

The proposals further describe the role of users in value creation, stating that value is often created from a combination of algorithms, user data, sales functions and knowledge. For example, the Q&A document says, a user contributes to value creation by sharing his/her preferences (e.g., liking a page) on a social media forum. This data will later be used and monetized for targeted advertising. The profits are not necessarily taxed in the country of the user (and viewer of the advertisement), but rather in the country where the advertising algorithms has been developed, for example. This means that the user contribution to the profits is not taken into account when the company is taxed, says the Commission.

Interim solution: The Digital Services Tax

The Q&A document sets out that the Commission has responded to calls from several Member States for an interim tax – the DST – which would cover digital activities that the Commission say currently escape tax altogether in the EU.

The DST, notes the Q&A document, would take the form of a gross revenues tax which would be applied to those revenues derived from certain digital activities which escape the current tax framework entirely. The rate of tax, to be uniform across all EU Member States, is proposed to be 3%.

The DST, the press release notes, will apply only until the SDP solution has been implemented.

As outlined in the proposal, such a tax will be delivered via a Directive on a common system of tax on certain digital activities, the legal basis for which will be the Treaty on the Functioning of the European Union, Article 113 regarding other forms of indirect taxation.

Scope of revenues subject to tax

The tax will apply to revenues created from activities where users play a major role in value creation and which are the hardest to capture with current tax rules, such as those 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
- ▶ The sale of data generated from user-provided information

Thresholds

The DST proposal sets out two key thresholds, both of which must be met for the DST to apply:

- ▶ The company has total annual worldwide revenues of €750 million or more
- ▶ The company has annual EU revenues of €50 million or more

As the proposal sets forth, the first threshold will limit the tax to companies of a certain scale and ensure legal certainty for companies and tax authorities in determining who is liable to tax. At the same time, it will help to ensure that smaller start-ups and scale-up businesses remain unburdened. The second threshold will ensure that the tax only applies to companies with a significant digital footprint in the EU. No provisions for companies in loss-making situations were outlined in the Commission's materials.

The proposal also notes that the DST 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 Organization's (WTO's) legal framework.

Only after a Member State has renegotiated its double taxation treaty with a third country should the DST cease to apply to businesses from such third country.

Deductibility

The Commission's communications set out their belief that the DST does not breach any double tax treaties with third countries or WTO rules and that it remains fully grounded on the most basic principle of corporate taxation – namely, that profits should be taxed where value is created.

Moreover, the Commission has included measures in the proposal to mitigate the risk of double taxation, as companies will be able to deduct the tax as a cost from their corporate tax base, thereby alleviating the risk of being taxed twice on the same income. At the same time, simply by introducing this coordinated EU tax, the Commission believes it is averting the risk of new burdens for business due to interim unilateral measures in individual Member States.

Compliance issues

The DST will be based on a system of self-declaration by taxpayers. Member States will be able to carry out tax audits to check that taxpayers are fulfilling their obligations (as they do in the traditional economy). A digital portal, known as the One-Stop-Shop, will be set up to help companies comply. As part of that system, one Member State will be responsible for identifying the taxpayer, collecting the tax and allocating it to other Member States as appropriate.

Timing

The DST proposal sets out proposed adoption dates in brackets, indicating that consensus among EU Member States has not yet been reached on timing. It notes that *Member States shall adopt and publish, by [31 December 2019] at the latest, the laws, regulations and administrative provisions necessary to comply with this Directive and that they shall apply those provisions from [1 January 2020].*

Significant Digital Presence proposal

The details of the Significant Digital Presence solution set out in the proposal are aligned to the Commission's briefings in the final quarter of 2017. The SDP focuses on a new definition of what will constitute a digital PE, along with revised profit allocation rules. This, the proposal says, will be delivered via a standalone EU Directive. According to the Q&A document, these measures should also be included in the CCCTB negotiations; but it appears that such a Directive could be introduced separately in the meantime, and would not be dependent on the CCCTB proceeding.

Defining digital services

According to the SDP proposal, "digital services" means services which are delivered over the internet or an electronic network and the nature of which renders their supply essentially automated and involving minimal human intervention, and impossible to ensure in the absence of information technology, including in particular:

- (a) The supply of digitized products generally, including software and changes to or upgrades of software
- (b) Services providing or supporting a business or personal presence on an electronic network such as a website or a webpage
- (c) Services automatically generated from a computer via the internet or an electronic network, in response to specific data input by the recipient
- (d) The transfer for consideration of the right to put goods or services up for sale on an internet site operating as an online market on which potential buyers make their bids by an automated procedure and on which the parties are notified of a sale by electronic mail automatically generated from a computer
- (e) Internet Service Packages (ISP) of information in which the telecommunications component forms an ancillary and subordinate part, in other words packages going beyond mere internet access and including other

elements such as content pages giving access to news, weather or travel reports, playgrounds, website hosting, access to online debates or any other similar elements

(f) The services² listed in [Annex II](#)

Digital services shall not include the services listed³ in [Annex III](#) or the sale of goods or other services which are facilitated by using the internet or an electronic network.

Nexus

The concept of a significant digital presence is intended to establish a taxable nexus in a jurisdiction. A company will be considered to have a significant digital presence if one of the following three criteria is met:

- ▶ It exceeds a threshold of €7 million in annual revenues from digital services in a Member State
- ▶ It has more than 100,000 users who access its digital services in a Member State in a taxable year
- ▶ Over 3000 business contracts⁴ for digital services are created between the company and business users in a taxable year

Profit attribution

The SDP proposal lays out the Commission view that the authorized Organisation for Economic Co-operation and Development (OECD) approach (AOA) remains the underlying principle for attributing profits to a significant digital presence. It further notes, however, that the OECD framework needs to be adapted in a consistent manner, to reflect the way value is created in digital activities.

The proposed rules lay down the general principles for allocating profits to a significant digital presence. These build on the current corporate tax rules which look at the risks managed, the functions performed and the assets used by a PE and the criteria for allocating profits. The proposal also includes additional tests in the profit allocation process to reflect the fact that a significant part of a digital business' value is created where users are based and data is collected.

The proposal sets out that the economically significant activities performed by the significant digital presence through a digital interface include, inter alia, the following activities:

- (a) Collection, storage, processing, analysis, deployment and sale of user-level data
- (b) Collection, storage, processing and display of user-generated content

(c) Sale of online advertising space

(d) Making available of third-party created content on a digital marketplace

(e) Supply of any digital service not listed in points (a) to (d).

Rate of tax

The SDP proposal does not contain information regarding the rate of tax which may ultimately be applied under the SDP solution. An earlier Commission paper, (which was leaked into the public domain⁵) however, noted that EU Member States would apply their national corporate income tax rules with respect to the profits attributable to a digital PE in their jurisdiction, and that the rate of tax to be applied to the digital activities would be determined by each Member State. If such an approach were ultimately taken forward, it would appear that this could therefore be a different rate to the general corporate rate. The earlier leaked paper further stated that 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.

Addressing third countries

The SDP proposal notes that the introduction of such measures would supersede double taxation treaties between Member States and that the proposed new rules will also apply if a Member State does not have a double taxation treaty with a third country.

When a Member State does have a double tax treaty with a third country, the proposed new rules will not apply. However, this means that, unless the tax treaties of EU Member States are adapted, the new provisions will not apply in situations where a business with EU users is tax resident outside the EU. The Commission therefore recommends that Member States should make the following changes to their double tax treaties:

- ▶ Change the definition of a PE to take into account situations where a company has a significant digital presence in a given country/jurisdiction.
- ▶ Include rules for how profits should be attributed to a significant digital presence, in line with the provisions proposed by the Commission.

The Q&A document notes that the Commission stands ready to help Member States identify the key third countries to prioritise in their negotiations to implement this solution

at international level. A [separate recommendation](#) to EU Member States, providing them with guidance on how to negotiate the necessary adaptations to their double tax conventions with non-Union jurisdictions was also published alongside the proposals.

Alignment to existing internationally-accepted rules for PE and profit attribution

The Q&A document further sets out the Commission's view that progress at the international level on digital taxation is challenging, and that the EU cannot afford to delay any longer given the growing number of problems related to digital taxation.

In developing these proposals, it says, the Commission has been in close and regular contact with the OECD, G20 and other international partners, to keep the EU and global approach as aligned as possible.

It further notes that the EU proposal should feed the international debate and help *push our global partners into action by providing a clear example of how the principles under discussion at the international level can be transformed into a modern, fair and efficient corporate taxation framework adapted to the digital era.*

Timing

The SDP proposal sets out that Member States shall adopt and publish, by 31 December 2019 at the latest, the laws, regulations and administrative provisions necessary to comply with this Directive and that they shall apply those provisions from 1 January 2020 with respect to tax periods beginning on or after that date.

Implications

The publication of these proposals by the Commission represents a potential landmark moment in the development of the international tax system. It does, however, also set up a challenging situation, with two multilateral organizations - the European Commission and OECD (with a majority of EU Member States being part of both organizations) both working on the challenges of taxing digitalized business.

While the Commission acknowledges that the ideal approach would be to find multilateral, international solutions to taxing the digital economy, given the global nature of this challenge,

the OECD in their 16 March [Interim report on tax challenges arising from digitalization](#) note that "There is no [global] consensus on the need for, or merits of, interim measures, with a number of countries opposed to such measures on the basis that they will give rise to risks and adverse consequences." The OECD further noted that *an update on this [OECD] work will be provided in 2019 and the BEPS IF is working towards a consensus-based solution by 2020.*

Such perspectives were also highlighted by US Secretary to the Treasury, Stephen Mnuchin, in a 16 March communication in which he stated that "The U.S. firmly opposes proposals by any country to single out digital companies. Some of these companies are among the greatest contributors to U.S. job creation and economic growth. Imposing new and redundant tax burdens would inhibit growth and ultimately harm workers and consumers. I fully support international cooperation to address broader tax challenges arising from the modern economy and to put the international tax system on a more sustainable footing."

The Commission's legislative proposals will now be submitted to the EU Council for adoption and to the European Parliament for consultation. It should also be noted, however, that EU Member States (including the United Kingdom, at this point) may also potentially move forward unilaterally with their own national implementation of a DST or similar tax.

Both proposals will require unanimity among EU Member States in order to be implemented. While the EU's enhanced cooperation mechanism (via which a group of nine or more Member States may proceed as a bloc - but without it being mandated that all Member States must also proceed) is a possibility, it is viewed as a fallback provision intended to be used when the Council has reached an advanced state of consensus but final adoption is blocked by a small number of Member States. Its use is therefore not foreseen at this stage.

With the main contours of each proposal now identified, businesses have the high level data points required to put in place framework solutions to assess, quantify and plan for digital taxation developments at both multilateral and national levels.

Endnotes

1. France - €1.01b, Germany - €1.49b, Italy - €540m, Spain - €360m, UK - €766m: Using World Bank GDP figures.
2. Website hosting and webpage hosting; automated, online and distance maintenance of programs; remote systems administration; online data warehousing where specific data is stored and retrieved electronically; online supply of on-demand disc space; accessing or downloading software (including procurement/accountancy programs and anti-virus software) plus updates; software to block banner adverts showing, otherwise known as Bannerblockers; download drivers, such as software that interfaces computers with peripheral equipment (such as printers); online automated installation of filters on websites; online automated installation of firewalls; accessing or downloading desktop themes; accessing or downloading photographic or pictorial images or screensavers; the digitized content of books and other electronic publications, subscription to online newspapers and journals; weblogs and website statistics; online news, traffic information and weather reports; online information generated automatically by software from specific data input by the customer, such as legal and financial data, (in particular such data as continually updated stock market data, in real time); the provision of advertising space including banner ads on a website/web page; use of search engines and Internet directories; accessing or downloading of music on to computers and mobile phones; accessing or downloading of jingles, excerpts, ringtones, or other sounds; accessing or downloading of films; downloading of games on to computers and mobile phones; accessing automated online games which are dependent on the Internet, or other similar electronic networks, where players are geographically remote from one another; automated distance teaching dependent on the Internet or similar electronic network to function and the supply of which requires limited or no human intervention, including virtual classrooms, except where the internet or similar electronic network is used as a tool simply for communication between the teacher and student; workbooks completed by pupils online and marked automatically, without human intervention.
3. Radio and television broadcasting services; telecommunications services; goods, where the order and processing is done electronically; CD-ROMs, floppy disks and similar tangible media; printed matter, such as books, newsletters, newspapers or journals, CDs and audio cassettes, video cassettes and DVDs, games on a CD-ROM, services of professionals such as lawyers and financial consultants, who advise clients by e-mail; teaching services, where the course content is delivered by a teacher over the internet or an electronic network (namely via a remote link); offline physical repair services of computer equipment; offline data warehousing services; advertising services, in particular as in newspapers, on posters and on television; telephone helpdesk services; teaching services purely involving correspondence courses, such as postal courses, conventional auctioneers' services reliant on direct human intervention, irrespective of how bids are made; telephone services with a video component, otherwise known as videophone services; access to the Internet and World Wide Web; telephone services provided through the internet.
4. The threshold on the number of business contracts should reflect that only 'business-to-business' contracts should be taken into account as the value represented by these contracts is likely to be more substantial than that of contracts concluded with individuals.
5. [Brussels' digital tax move raises transatlantic stakes](#), Politico, 28 February 2018.

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