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Building a better working world

Europe’s digital tax proposals

Finish line approaching, or end of the first lap?

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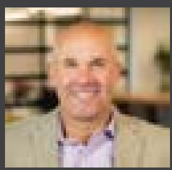

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Politics can be a fascinating spectator sport. But the rules are as complex as those of cricket, and reading between the headlines is an art that only long-term spectators are usually able to master.

The oratorical journey we have seen develop on digital taxation – unarguably a highly political issue from the very start – has been especially fascinating: “It is essential that the [OECD] report comes to appropriate and realistic conclusions on the way ahead and identifies genuine policy options to tackle the challenge,” wrote the European Commission at the outset of their journey in of the second half of 2017.

“The time to act has now come,” it concluded.

That is all well and clear, a concise call to action. But fast forward exactly one year, and the question of what messages lies among the complexities of politicians’ words has become harder to decipher.

"Singling out a key global industry dominated by American companies for taxation that is inconsistent with international norms is a blatant revenue grab."

On the one hand, those in favor of implementing a European Union (EU)-wide Digital Services Tax (DST) sound bullish in recent edicts:

- Pierre Moscovici, European Commissioner for Economic and Financial Affairs, Taxation and Customs, said a deal [on the DST] was "doable by Christmas."[1]
- "The prospect of reaching agreement by the end of this year [on the DST] is realistic," confirmed Austrian Minister of Finance Hartwig Löger (Austria currently holds the Presidency of the European Commission and is a solid supporter of the DST).
- "EU countries could agree a new short-term digital sales tax before the end of the year, according to Pascal Saint-Amans, the OECD's leading tax expert" was the headline of an *Irish Times* article on 20 September 2018.[2,3]
- "#V4 countries have signed joint declaration at #TatraSummit2018 today, underscoring the need for long-term and interim European solution on fair taxation of #digital #economy" tweeted the V4, a cultural and political alliance of four Central European states (the Czech Republic, Hungary, Poland and Slovakia).

Finding politicians in opposition certainly seems to be getting easier, too: "After running the numbers, we have determined that the costs of administering the DST will be higher than the revenue,[4]" said Finnish Finance Minister Petteri Orpo on 7 September 2018. "This is one of the reasons we are reluctant to agree to it," he concluded. "I think we should be very careful not to tax what we are going to live on in the future," said Danish Finance Minister Kristian Jensen, on the same day. "We think the sequencing is wrong to agree on a short-term tax," Swedish State Secretary for Finance Karolina Ekholm told journalists on 8 September, in slightly stronger words. "The most important thing is to first agree in the OECD," Ekholm said.

Even more to the point was a statement[5] from House Ways and Means Committee Chairman, Kevin Brady, on 31 October 2018 which said that (our bolds for emphasis:) "The United Kingdom's introduction of a new tax targeting cross-border digital services – which mirrors a similar proposal under consideration in the European Union – is troubling. Singling out a key global industry dominated by American companies for taxation that is inconsistent with international norms is a blatant revenue grab. The ongoing global dialogue on the digital economy through the OECD framework should not be pre-empted by unilateral actions that will result in double taxation. If the United Kingdom or other countries proceed, that will prompt a review of our U.S. tax and regulatory approach to determine what actions are appropriate to ensure a level playing field in global markets."

The above proclamations – both for and against – all came after a recent Economic and Financial Affairs Council (ECOFIN) meeting in Vienna, Austria on 7-8 September 2018.[6]

Going into that meeting, delegates were basing their discussion on a "compromise" DST proposal issued by the Austrian Presidency. While the compromise proposal is not a final document (it represents ongoing negotiations, and takes the form of a copy of the current DST proposal with a series of open questions include) its content is important. In the compromise proposal there are perhaps 15 to 20 suggested amendments, but two stand out among others.

First, the Presidency asks, "Would delegations consider narrowing down the scope of the Directive by the excluding the services in Art. 3(1)(c) (i.e., "The transmission of data collected about users and generated from users' activities on digital interfaces")?

In a second major potential amendment, the proposed DST threshold of €750m of worldwide revenues (which aligns with the current BEPS Action 13 Country-by-Country reporting threshold),, one of two DST thresholds, is marked for potential deletion, with the Presidency asking, "Would Member States consider reviewing the thresholds regarding worldwide revenues…?" This could potentially leave the DST with a single monetary threshold, that of €50m of taxable revenues obtained by the entity within the Union during the relevant financial year.

Outside of Presidency actions, individual Member States have also been trying to push the DST proposal forward. Prior to the ECOFIN meeting, France floated the idea of a two-year sunset clause for the DST, whereby it would cease to apply within two years of any long-term solution being adopted. While that is something that many other commentators had also floated, the intricacies of such a sunset clause operating in practice still need to be considered. For example, would it take effect:

- When the long-term solution is agreed (assuming at the OECD) by vote?
- When the long-term solution is adopted into national level legislation?
- When any necessary double tax treaties have been updated to take into account the workings of any long-term solution?
- At some other point in time altogether?

Whether or not this suggestion is enough to grease the wheels of the DST proposal into action remains to be seen and there has not been any formal news coming out of recent ECOFIN meetings.

1. Kamal Ahmed, "EU pushes for new tax on tech giants 'by Christmas,"' BBC News, 10 October 2018, https://www.bbc.com/news/business-45813754.
2. Charlie Taylor, "Short-term digital sales tax agreement possible before end of 2018," The Irish Times, 20 September 2018, https://www.irishtimes.com/business/economy/short-term-digital-sales-tax-agreement-possible-before-end-of-2018-1.3635845
3. The Irish Times were careful to note in the same article that those were Mr. Saint-Amans' personal views, and not those of the OECD.
4. https://www.bna.com/eu-races-solve-n73014482428/
5. https://waysandmeans.house.gov/brady-statement-on-u-k-tax-on-digital-services/
6. This is not the most recent ECOFIN meeting, but the most recent meeting at which discussion of the DST has been on the agenda.

One key question stands out: should the DST be adopted under Art. 115 TFEU, would taxpayers be provided with the legal basis for arguing that it should be creditable and not just deductible?

It is understood that several major EU Member States, Germany among them, were being pressed to make official announcements of DST support in advance of the ECOFIN meeting was of interest, but no such announcements were made.

Conflicting legal opinions: player 2 joins the game

More recently, the Financial Times (FT) on 9 October 2018 reported[7] that "EU lawyers question Brussels digital tax plan." While that headline may at first glance seem to question the entire viability of the DST proposal, reading further would indicate that what was being referred to was a confidential legal opinion of the EU Council's (and not the Commission's) legal team that had been seen by the FT and which raised doubts about its legal basis, not its actual existence.
The DST as proposed by the Commission would fall under Article 113 of the Treaty for the Functioning of the European Union (TFEU), the article via which all indirect taxes are adopted.

The EU Council legal opinion, according to the FT, "says the digital turnover tax would not constitute an 'indirect tax' on companies – raising doubts about the appropriateness of the legal basis under which it has been proposed." Taking into account the aim and characteristics of the DST, the opinion says, the legal basis should be Article 115 TFEU (via which all direct taxes are adopted and the Article under which the Commission's longer term solution, the Significant Digital Presence, is being pursued). The opinion also analyzes the principle of proportionality and opines that the DST proposal complies with said principle.

The Council's legal opinion sets out that there are four essential characteristics against which the compatibility of national turnover taxes with VAT is assessed; "deduction of the amounts paid during the preceding stages of the process from the tax payable by a taxable person, with the result that the tax applies, at any given stage, only to the value added at that stage and the final burden of the tax rests ultimately on the consumer" is the fourth of these characteristics, and "it seems obvious that the DST does not fulfil the fourth one" says the opinion.

Without delving any further into the technical details of the opinion, one key question stands out: should the DST be adopted under Art. 115 TFEU, would taxpayers be provided with the legal basis for arguing that it should be creditable and not just deductible?

While the language of the opinion is clear, what happens next is not; the Commission's own legal team first issued their opinion in 2017 that the DST should progress under Article 113. So they – and the Commission – are likely to be confident that they are correct. The EU Council legal team, however, may arguably be less used to dealing with the tax concepts being discussed. But there is no official hierarchy or ranking which states which legal opinion trumps the other. Instead, it becomes a process of which side can collect more Member States behind them, in much the same manner as the legal debate on whether to Country-by-Country reports are made available to the general public is a tax matter (requiring unanimity) or an accounting matter (requiring only qualified majority voting).

Pierre Moscovici, however, was unequivocal in his response to the Council's opinion, confirmed a few days later:

"*The EU-wide digital tax will be rolled out in time for Christmas… … adding that the talks were developing in a good direction… …Commissioner Moscovici warned that if they are unable to reach the agreement by Christmas, the European Union will enter a different timeline, which will be more focused on topics like Brexit and European elections. His comments may come as a surprise to Ireland, the Czech Republic, Finland and Sweden, the member states who recently signed a joint statement highlighting their opposition*."

European Parliament committee publishes report on the European Commission's digital tax proposals

A few days after the Vienna ECOFIN meeting, the Economic and Monetary Affairs Committee (ECON), a committee of the European Parliament (EP), published[8] two reports discussing the Commission's digital tax proposals.

Significant Digital Presence (SDP) report

The main element of the SDP report is a call to allow Member States to set the tax rate of the SDP themselves; this is something that was not explicit in the Commission's original draft, but something that we assumed would be the case anyway.

7. https://www.ft.com/content/88e0a81a-cbf0-11e8-b276-b9069bde0956
8. http://www.europarl.europa.eu/sides/getDoc.do?pubRef=-%2f%2fEP%2f%2fNONSGML%2bCOMPARL%2bPE-627.747%2b01%2bDOC%2bPDF%2bV0%2f%2fEN

While there has been no shortage of political commentary on the DST, the opposite is true of the work of the OECD on a long-term solution. This is to be expected, as the OECD has a long history of building consensus without fanfare.

DST report

ECON's DST report generally supports the Commission's DST proposal, in particular the view that this tax should be limited to companies generating in excess of €750m of worldwide revenues in order to limit the negative impact on startups and smaller companies. The report proposes a number of targeted amendments to the Commission proposal, and the explanatory statement on pages 23 and 24 of the report provide a useful overview behind the changes proposed and their rationale.

These key proposed changes are:

- Creating a "level playing field" by increasing the DST tax rate from 3% to 5% for all Member States
- Broadening the DST's base by including in the scope of taxable revenue the supply of digital content such as video, audio or text via a digital interface and the sale of goods or services that are contracted online via e-commerce platforms.
- Clarifying that DST should also apply to the sale and transmission of data attained through active participation of users on digital interfaces.
- Introducing a sunset clause conditional on the proposed EU permanent measures, whereby the DST would lapse with the adoption of proposals for a SDP or the Common Consolidated Corporate Tax Base (CCCTB) that includes the EP's position on digital permanent establishment. This is similar to the sunset clause proposed by France. The French proposal, however, was linked to reaching agreement and at the OECD level, and not to the CCCTB.
- Asking the Commission to review the Directive after three years.
- Introducing an audit mechanism where DST returns filed with a Member State are audited every three years.

It is important to note, though, that under the rules of how the EU operates[9], ECOFIN is not legally bound to do anything in response to the ECON reports.

Changes to the EU voting model ahead?

One important procedural point of note that may potentially impact the digital tax debate was contained in EU President's Jean-Claude Juncker's "State of the EU" speech around the same time as the ECOFIN meeting.

During the speech, Juncker confirmed that a key initiative for the future was to move from unanimity to majority voting in fields such as taxation. While the timing and ultimate likelihood of such a voting change coming to pass is unclear, it could have a potentially significant impact on much of the Commission's tax agenda.

But achieving unanimous support on the DST proposal remains the objective of the European Commission: "The objective is to get unanimity, as it is with all of our proposals," said Stephen Quest, Director-General of TAXUD, the Directorate General of Taxation and Customs Union at the European Commission.

"We've had quite a lot of success on that over the last three years, so I think there's no reason why we shouldn't continue to aim for that on this proposal" Quest said.

What of the long-term solution?

While there has been no shortage of political commentary on the DST, the opposite is true of the work of the OECD on a long-term solution. This is to be expected, as the OECD has a long history of building consensus without fanfare.

June 2018 saw the Bulgarian Presidency, right at the end of its term, release a road map for the Commission's digital tax proposals. The road map notes that technical analysis in relation to the DST was expected to be completed by June 2018. The road map, however, makes no mention of a similar deadline on the SDP, instead noting that "… work on this legislative proposal will have to be calibrated with a view to monitoring and reflecting, as appropriate, progress made in the G20/OECD debate, which is expected to be concluded by 2020."

Was the strong focus on the DST by the Commission signaling that it had effectively handed back the reins on the development of a longer-term digital proposal to the OECD?, we asked Stephen Quest. "I don't think that comment is exactly the way I would put it," he responded. "The long-term solution remains very much on the Commission's table. Of course, there is an interface between us and the OECD. We'll see an interim report from the OECD in 2019 and we will need to see whether that leads to more clarity about the OECD solution and how we can shape the EU solution as a contribution to that," Quest said.

Unilateral developments

So, overall, while there have been few or no formal updates from the Commission, the DST does seem to be progressing, if leaders' words are to be taken at face value. Indeed, that's the message from a recent German press reports, which suggested that the European Commission has a list of 112 tech companies that the draft DST would target. The Commission has responded that the list is not intended as a list of companies that would be subject to the digital services tax.

9. For more information on the EU's tax legislative processes, see this article from the last issue of the Tax Policy & Controversy Global Briefing: https://www.ey.com/Publication/vwLUAssets/ey-understanding-the-european-unions-tax-legislation-process/$File/ey-understanding-the-european-unions-tax-legislation-process.pdf

> According to our EY colleagues in Australia, it [Australia's discussion paper] does not provide any recommendations, nor expresses a clear preference for any particular measure for taxing the digital economy either on a long-term structural basis or an interim basis. However, it implies that an interim DST may be warranted if no long term global solution is in sight.

Unilateral developments certainly seem to point to countries – and not just in the EU – gearing up to adopt DST of some type, whether under the umbrella of the EU or unilaterally.

- Australia issued[10] a Discussion Paper on 2 October 2018 that explores a corporate tax system for the digital economy in Australia, highlighting the possibility that a DST-like levy may be replicated around the world. The paper, effectively a public consultation, was announced in Australia's 2018-19 Federal Budget. According to our EY colleagues in Australia, it does not provide any recommendations, nor expresses a clear preference for any particular measure for taxing the digital economy either on a long-term structural basis or an interim basis. However, it implies that an interim DST may be warranted if no long term global solution is in sight. Fuller coverage of the paper is available in an *EY Global Tax Alert*.[11]
- On 23 October 2018, the Spanish Government released a preliminary draft bill (the Draft) introducing a Digital Services Tax (DST). If approved, the DST would be applicable as of 2019 as an indirect tax. The tax rate would be 3%, applicable to gross income derived from certain digital services in which there is an essential *user* participation in the company's value creation process. Thus, the DST should apply only to services that could not exist without user involvement. Apart from some details, its main features (scope and DST taxable events) are mainly in line with the Directive proposal presented by the European Commission (the Commission) on 21 March 2018.[12]
- British Chancellor Philip Hammond used his Budget on 29 October 2018 to announce that the UK will implement a Digital Services Tax from April 2020 onwards. The DST will apply a 2% tax on the revenues of specific digital business models where their revenues are linked the participation of UK users. The tax will apply to: search engines; social media platforms; and online marketplaces, since the government considers these business models derive significant value from the participation of their users. On the same logic, financial and payment services, the provision of online content, sales of software/hardware and television/broadcasting services will not be in scope of the DST.

  The UK DST will include a double threshold; this means businesses will need to generate revenues from in-scope business models of at least £500m globally to become taxable under the DST. The first £25m of relevant UK revenues are also not taxable. It also includes a safe harbor, meaning that businesses can elect to calculate their liability on an alternative basis, which will be of benefit to those with very low profit margins. Whist the DST will be an allowable expense for UK Corporate Tax purposes under ordinary principles, as the DST will not be within the scope of the UK's double tax treaties, it will not be creditable against UK Corporate Tax.

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10. "The digital economy and Australia's corporate tax system," Australian Government – The Treasury, 2 October 2018, https://treasury.gov.au/consultation/c2018-t306182/.
11. "Australian Treasury Discussion Paper on the digital economy and Australia's corporate tax system: A detailed review," *EY Global Tax Alert*, ey.com/gl/en/services/tax/international-tax/alert--australian-treasury-discussion-paper-on-the-digital-economy-and-australias-corporate-tax-system-a-detailed-review.
12. "Spain releases draft bill on Digital Services Tax",´ *EY Global Tax Alert*, 25 October 2018, ey.com/gl/en/services/tax/international-tax/alert--spain-releases-draft-bill-on-digital-services-tax

Moving forward

On the basis of the above points, and taking into account the lack of major news coming out of the ECOFIN meeting, we think the potential for four (or more) potential outcome scenarios remains in place for the DST:

1. EU Member States choose not to use their veto for what is a politically sensitive issue, and we see a new DST via unanimity – potentially as noted by Commissioner Moscovici, by the end of 2018.
2. EU Member States feel that the new UK DST (with UK outside the EU in 2019) will put them at a competitive disadvantage and ask for EU DST to be deferred / renegotiated.
3. A group of (nine or more) EU Member States move forward under the enhanced cooperation mechanism.
4. A group of EU Member States move forward with a set of measures that are largely consistent in terms of their design, but outside of the Commission's remit.
5. EU Member States (and potentially others, such as Australia) who want a DST move forward with unilateral measures.

How do we see this unfolding? That is an incredibly hard question to answer. One important issue should be taken into account though – as Chris Sanger notes in his Brexit article on page 40, those Member States who previously aligned with the UK on providing checks and balances to federalism now lose the ability to seek protection from the UK's stance; the same is true for the DST proposal, where at least six or seven smaller Member States are known to oppose it, but are now losing the protection of the UK – not only because of Brexit, but because the UK, as noted above, has confirmed it will have a DST from April 2020, joining Spain in confirming a new tax.

All things considered, we have to take the bullish language of officials, coupled with the preparation activity of so many jurisdictions to mean that a DST is in Europe's future. The pressure – on both sides of the debate – has reached what seems to be a peak, and with year-end approaching (as well as the European Parliaments) we are clearly entering some kind of end game.

Let's just hope that the lack of official messaging on technical points right now means that policy-makers are instead focusing on ensuring that it creates as few impediments to business activity as possible.

OECD provides an update on tax and digitalization

On 29 October 2018 the OECD released a policy note on tax and digitalization. It provides a summary of the challenges faced in taxing digital firms and the work the OECD has done to date.

It also highlights other issues, such as improving the effective taxation of activities facilitated by online platforms and digital tax administration (including exchange of information).

http://www.oecd.org/going-digital/topics/tax/tax-and-digitalisation-policy-note.pdf

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