BLOG POST **11.05.2017**

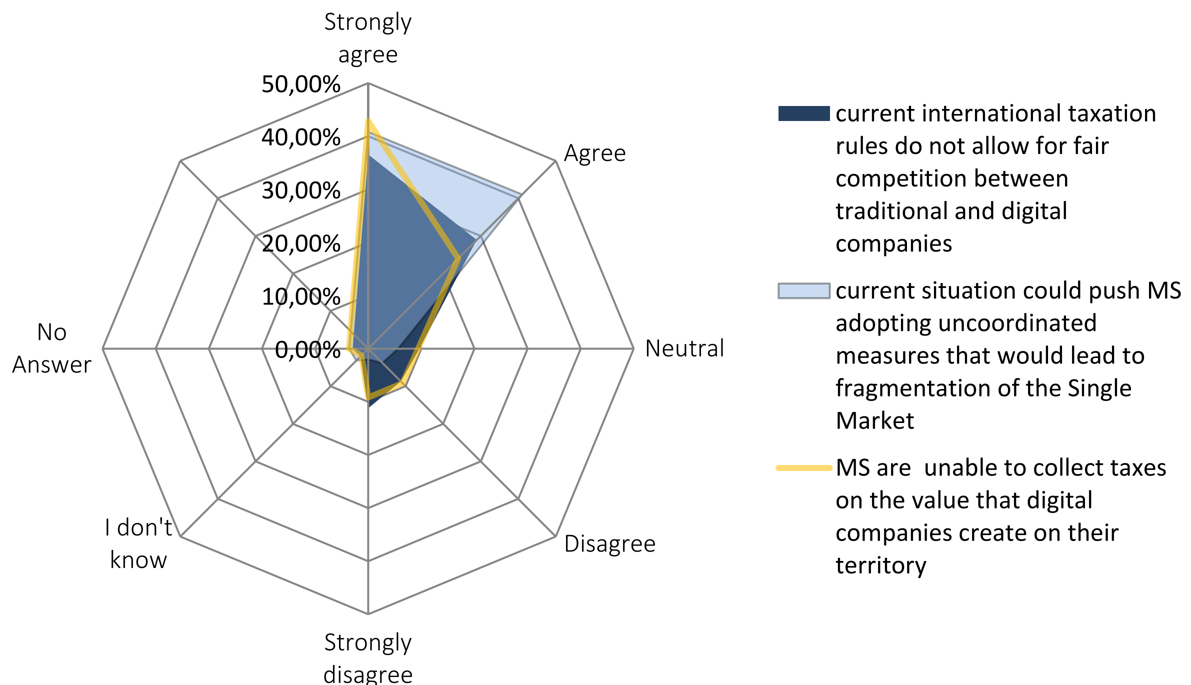
Takes Two to Tax. On fair taxation of the digital economy

Pola Schneemelcher
Research Fellow at the Jacques Delors Institut – Berlin

The ongoing digital transformation poses enormous challenges to current tax law. This is, because value creation through intangibles raises problems to two core paradigms of international tax rules: where to tax and what to tax. In order to solve these problems, the European Commission published two proposals, a so-called interim tax and a comprehensive solution. In this blogpost, Pola Schneemelcher assesses the proposals and makes the case that they do not sufficiently address the crucial question of how to value data.

1 Introduction – Commission under pressure

Talking taxes, the Commission recently published a package of proposals for the fair taxation of the digital economy, after its consultation earlier this year resulted in a clear finding: everybody agrees that something must be done and nobody agrees upon what should be done (see Graph 1 & 2).



Graph 1

Source: EU Commission, Consultation „Fair Taxation of the Digital Economy" Statistical Report, 2018

The proposal is meant to resolve problems in international taxation rules when dealing with value creation through digital business models. Value creation in the digital economy comes about through intangible assets, such as software and patents. Intangibles can easily be used simultaneously, at many different places, and they are difficult to price - how can one tell if one algorithm is worth more or less than another? Alas, when allocating taxation rights, current international rules refer to (a) the place where (b) value is created. Thus, two challenges arise in the digital economy: *where to tax* and *what to tax*? In other words: defining how intangibles create value is key to their solution.

The Commission is now trying to address the aforementioned issues via:

(1) a new (temporary) **revenue tax** - an EU-wide 3% levy on revenues generated from certain digital activities such as online advertising that is closest to the initially named "equalization tax" promoted by a group of forerunner states around France and clearly aimed at American tech giants; and

(2) a new (comprehensive) **profit tax** - where profits generated at a newly defined “taxable digital presence” are taxed at the relevant corporate rate of the respective Member State. This is considered a long-term solution replacing the interim tax. It comes along with the recommendation it should be implemented together with the Common Corporate Consolidated Tax Base (CCCTB), a sure sign that not even the Commission believes in a swift political agreement.

Both proposals have their flaws and leave too many difficult questions unanswered: the interim solution defines value creation solely through users, which does not capture the variety of digital business models; the comprehensive solution introduces a new definition of the place where intangibles are to be taxed - but leaves other traditional international rules unchanged. Without defining how intangibles create value, current problems in international tax rules remain unaltered.

The Commission justifies its half-hearted *démarche* by expressing its fear of unilateral measures being adopted by the Member States and a fragmented single market. On closer examination, it is probably more the result of (a) public pressure by larger Member States to take action against American tech giants and (b) the wish to gain discursive prerogative against the OECD, which is also working on solutions for tax challenges arising from digitalization, and which the EU criticizes for not being ambitious enough in the search for an international solution. Last but not least, timing is key here: with the Commission knowing no agreement will be taken before, let’s say, late May 2019, another proposal or two will do no harm.

Nevertheless, the proposals represent the start, however incipient, of muddling through to what will become a new paradigm of taxation: there are hardly any business models even today that are entirely analogue. And, in no time at all, there will be no such a thing as a “digital economy”. There will just be “economy”, where value creation through data will be the rule. Against this background, the proposal gives us a clue as to what could be the basis for further development.

2 Killing two birds with two stones – problems and proposals

Briefly, (more details here), the current international taxation system is ill-prepared to deal with taxing digital business models due to one paradigm that it holds on to: *profits should be taxed where the value is created*. This paradigm is difficult to combine with two core characteristics of digital business models:

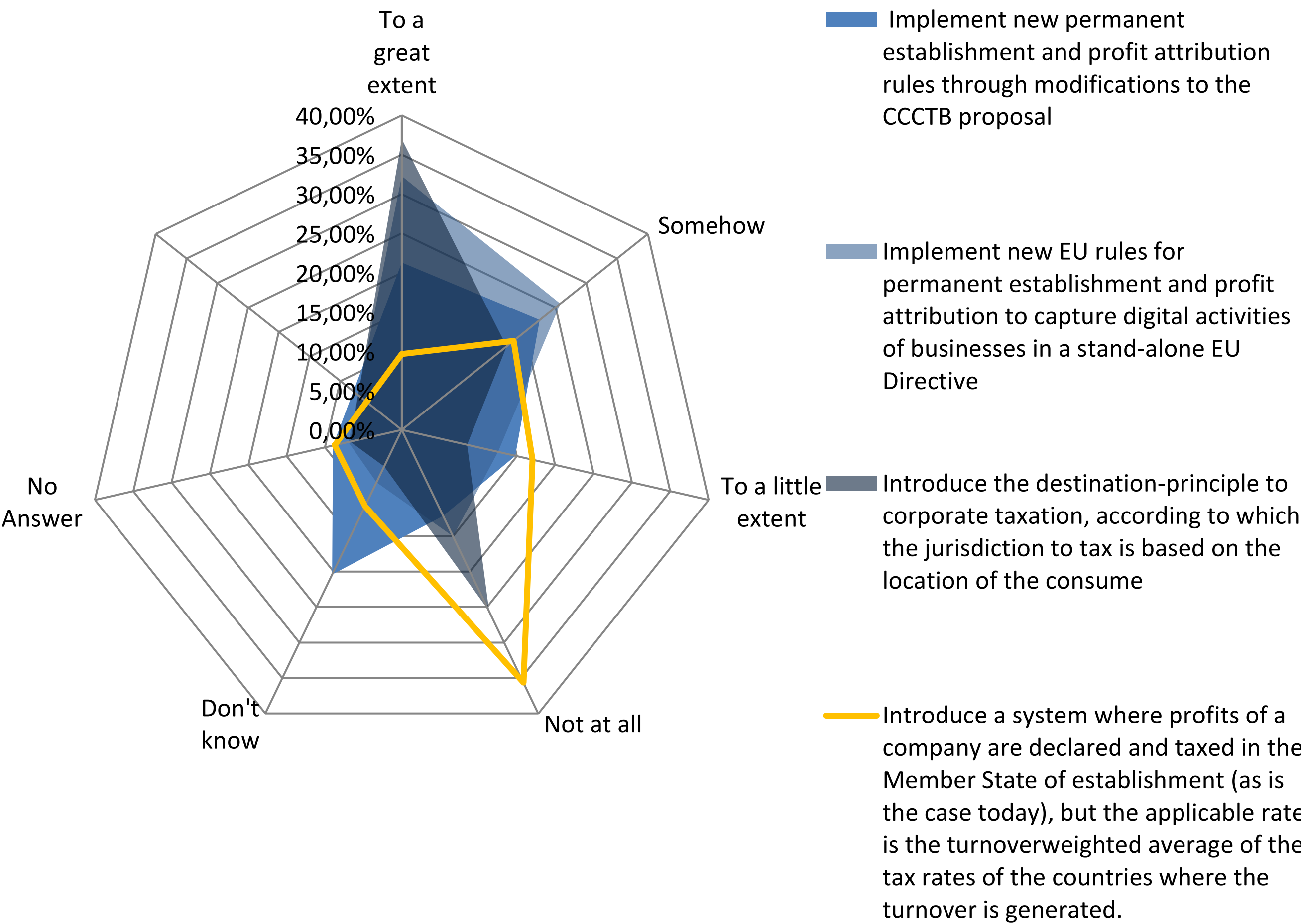
- digital business models make profits at places where they are not necessarily physically present - challenging the “where to tax” part of the paradigm;
- digital business models create value through intangible assets, for example patent-protected algorithms or pieces of software conducting data mining with a big amount of data as an input source. But, according to current OECD guidelines, many data processing operations are considered a “routine task” so not part of (taxable) value creation. Therefore, the “what to tax” part of the paradigm is challenged.

These attributes provide *inter alia* profit shifting opportunities: sub-licensing intellectual property rights (IPR) to the local subsidiary of a global company at high cost and declaring close-to-zero profits is not exclusive to the digital economy, but certainly easier for digital businesses under the OECD guidelines. These prescribe that internal transactions have to be made at comparable market prices (so-called “arm’s length principle“). However, intangible assets are often unique structures. It is thus very difficult to determine a comparable value for them (i.e. price them) and apply the arm’s length principle, which would otherwise prohibit charging unduly high royalties for licenses

on assets used within the same company. These characteristics can lead to unfair competition between digital and non-digital businesses as well as to declining Exchequer revenues.

In a nutshell: digital businesses are basically free to choose where they pay taxes. So, why only a European solution?

Regarding its scope, the Commission does not miss the opportunity to stress that a multilateral, international solution of a piece with the OECD's base erosion and profit shifting (BEPS) initiative is the more desirable option – mainly to avoid among other things double taxation issues and extensive tax competition with third countries. However, facing political pressures from the Member States and the difficulties of finding international consensus, it justifies its initiative with the wish to speak with one voice at the international level. The Commission thus provides a two-tier solution with two different proposals, a (1) short-term solution ("interim tax") to head off unilateral action by the Member States and, subsequently, a (2) comprehensive long-term solution to solve international problems.



Graph 2

Source: EU Commission, Consultation „Fair Taxation of the Digital Economy" Statistical Report, 2018

3 Interim Tax

The "interim tax" or "Digital Service Tax (DST)" as per the proposal is an indirect tax that is levied on revenues (not profits) from certain digital activities - basically a special tax.

Spotlight on users - value creation defined through user participation

What is taxed? - revenues are taxed at 3% if created through the following digital services:

(1) online advertising space,

(2) intermediary activities which allow users to interact with other users and which can facilitate the sale of goods and services between them,

(3) sale of data generated from user-provided information.

In other words: for a digital service to fall within the scope of the DST requires user involvement. The interim proposal defines user participation and contributions as crucial part of digital value creation. Employing this definition, it then provides an amended concept of the "significant physical presence" - a *de facto* digital presence: "Taxable revenues obtained by an entity in a tax period shall be treated [...] as obtained in a Member State [...] if users with respect to the taxable service are located in that Member State [...]" (Art. 5 I). A more hands-on definition: the place of taxation is identified only through the user's IP address (or other means of geo-location). How the user "creates value" (through money or data) is irrelevant.

Who is taxed? - the taxable person is a company providing the above-mentioned services. The proposal prescribes the following indicators for a company to be taxed accordingly:

(1) total annual worldwide revenues of €750 million and
(2) EU revenues of €50 million.

Where does the money go? While France brought up the idea of making a digital tax part of a reformed EU own resources system, the DST does not appear in the Commission's proposal as a standalone option. Thus under current thinking, tax revenues will go to the Member States.

Under the "One-Stop-Shop" system, one Member State ("Member State of identification") will be responsible for collecting the tax, carrying out tax audits and further control measures and allocating revenue to other Member States as appropriate. The taxable person is obliged to notify via self-declaration to the Member State of identification.

Assessment – hardly implementable and desirable

It may be introduced as the temporary placeholder but political reality might turn the interim tax - if ever adopted - into a (semi-)permanent solution.

For now, the interim levy is planned to be implemented swiftly in order to head off unilateral measures in the Member States. Accordingly, the Commission has built its proposal on a supposedly strong legal base: Art. 113 TFEU, which allows for indirect taxes. Nevertheless, Art. 113 TFEU also requires unanimity and not just usual suspects like Ireland are only lukewarm about the proposal.

This is also because the interim tax is clearly a ring-fenced solution exclusive to large digital businesses and very specific digital services. Evil to him who thinks that this is meant to target American tech giants (GAFA) and spare most European businesses; the Commission adopts it with the honorable intention to safeguard small startups and scale-up businesses instead. Nevertheless,

it is almost certain that discriminatory issues could arise; resistance is already mounting in the US. What's more, the question of how to deal with "mixed businesses" like SAP or Siemens remains. Already providing e.g. cloud services, they are at risk of being subject to both the DST and corporation tax. The Commission, however, bars this potential double taxation, making the DST paid deductible from the corporate income tax base. At best, this will incentivize digital businesses to declare their taxes; at worst, this could lead to revenue losses for Member States. Either way, it leads to uncertainty among businesses.

Finally, the desire for a common European approach is likely to be put at risk with Member States enforcing payment of DST directly and carrying out tax audits as well as control measures. This could lead to a race-to-the-bottom competition among national tax administrations and a fragmentation of the Single Market.

To sum up: one can only use the conditional tense in talking about the interim solution as too many uncertainties remain: will the initially ring-fenced solution within an ever-developing economy spill over to e.g. partially digitized business models eventually? What effect does a tax on revenues have on exporting nations when shifting taxation rights to destinations where users are located? And what effect on loss-making companies? The DST leaves too many questions unanswered to be a solid solution. But first and foremost, it defines value creation solely through direct user participation. Thus, it fails to take digital business models, which work without identifiable user involvement, into account. Consequently, considering the possibilities that value creation through intangibles has acquired by now, the levy is already too outmoded to serve as a real solution for an ever-digitizing economy.

4 Comprehensive Tax

While the interim tax approaches the definition of a taxable digital nexus cautiously, the comprehensive solution goes in at the deep end: First, it lays down a definition for establishing a taxable nexus for corporate taxation of digital businesses with no physical presence in a given jurisdiction; second, it determines how to attribute profits to a digital business, trying to capture value creation through intangibles.

A taxable digital presence - a paradigm shift

What is taxed? - Profits liable to be taxed are those generated from

(1) user data (e.g. placement of advertising),
(2) services connecting users (e.g. online market places and platforms for the sharing economy) and
(3) other digital services as laid down in the Annex.

While the comprehensive solution targets profits instead of revenues, it leaves international transfer pricing rules basically unchanged: in essence, the Commission recommends basing the attribution of profits on current transfer pricing rules (namely the "profit split method"), while adding that they should particularly reflect value creation through digital activities. Nevertheless, it provides no proposal on how to reflect these special characteristics of digital value creation. So the challenge of valuing intangible assets and their contribution to value creation within a business remains. Instead of amending transfer pricing rules to ensure a just attribution of profits, the Commission recommends combining the comprehensive solution with the so-called Common Consolidated Corporate Tax Base (CCCTB), which is meant to fight profit shifting opportunities.

Who is taxed? - under the proposal's definition, a digital platform has a "digital presence" for corporate tax purposes if it fulfils one of the following criteria:

(1) exceeds a threshold of €7 million in annual revenues in a Member State
(2) has more than 100,000 users in a Member State in any taxable year, and
(3) Over 3000 business contracts for digital services are created between the company and business users in any taxable year

In practical terms, the user is the pivotal point again: taxation rights are where the Internet Protocol (IP) address of a user's device is located.

The newly introduced digital presence serves as supplement, not as substitute for the formerly described "physical presence" or the jurisdiction where profits are taxed. The paradigm change is thus accompanied by proposals for dealing with potential double taxation issues: Double taxation means that the same source of income is taxed twice, for example when an international company has a taxable presence in two different countries. In order to avoid double taxation, countries conclude bilateral Double Taxation Agreements (DTA). If a taxable digital presence is introduced, DTAs need to be changed accordingly. Under the proposal, the Directive would supersede double taxation treaties (DTTs) between Member States and would also apply in cases where a DTT between a Member State and a third country is non-existent; furthermore, the proposal comes with a recommendation to Member States to amend any current DTTs with third countries.

Where does the money go? - Profits are taxable in the Member State where the significant digital presence is identified and taxed within the corporate tax framework of that Member State alone. Thus, there no common tax rate is proposed.

Assessment - New words, old problems?

In spite of the Commission's recommendation to change DTAs, double taxation will remain an issue. This is not only because the proposal takes the form of a non-binding recommendation, but also because this process could be lengthy and lead to a fragmented single market with even more bureaucratic hurdles.

But this knockout argument would not acknowledge what the proposal is really all about: it tries to re-define *the* core concept of international taxation, the permanent establishment – and it does so on only five pages.

Providing a new definition of a taxable digital presence is an important step, especially as the comprehensive solution merits its title and covers a broad range of businesses and digital services.

But this is where the plus side ends and fades away in a host of questions: as the proposal does not go into more detail, it leaves two points dangerously vague. As mentioned above, value creation is defined through user participation. But this does not comprehensively define all kinds of value creation through intangibles, i.e. how to price data. Why is that important? Because the proposal seems to leave transfer pricing rules for profit allocation as they were: Under it, profits would be attributed to a significant digital presence in a single Member State that would then tax them according to its own corporate tax framework only. Unlike in the interim solution, a common tax rate is absent. Thus, tax competition among Member States remains likely. Adding to the likelihood of there being no level playing field, the Commission recommends that attributable profits should be determined through current transfer pricing rules. In other words: if a global digital company owns a subsidiary, again in the form of a taxable digital presence in a low-tax country, it could shift profits just as in the "old economy". Problems would remain the same: as they trade intangible assets, the "arm length principle" still does not bite. The combination of both – the lack of a

common tax rate plus “old” profit allocation rules – could lead to profit shifting to tax havens, this time moving between taxable digital presences.

That would be less of a problem if the Directive were included in the CCCTB as the Commission recommends. But the implementation of the CCCTB is likely to take several more years. How profit shifting and tax evasion opportunities will be avoided if the Directive is implemented as a standalone measure outside the scope of the CCCTB remains unclear.

Thus, before talking taxes, the Commission should talk about the real value of data - and reform transfer pricing rules.

In summary, the comprehensive tax delivers by creating a new definition of a taxable digital presence. But by adopting the *status quo ante* for everything else, taxation rules face similar problems to those pertaining in the non-digitalised economy. Owing to its limited scope, it also leaves fundamental questions unanswered, i.e. how to reconcile a digital presence based on the IP-address of user devices with data protection principles?

5 Conclusion

In both proposals, the Commission fails to acknowledge that there will soon be no such a thing as a non-digitalized economy anymore. A standalone tax for the “digital economy” is thus short-sighted. Fundamental questions need to be answered first before adopting proposed initial solutions. The core questions of how to determine intangibles’ contribution to value creation and how to price them remain.

Only an answer to these questions can ultimately determine how digital business models create value, how we should reform existing transfer pricing rules and, finally, how to tax these businesses models.

This publication is part of the research project „Repair and Prepare“, a joint project of the Bertelsmann Stiftung and the Jacques Delors Institut. For more information, please visit www.strengthentheeuro.eu

Herausgeber: Prof. Dr. Henrik Enderlein. Die Publikation gibt ausschließlich die persönliche Auffassung der Autoren wieder. Alle Rechte vorbehalten.

Nachdruck und sonstige Verbreitung – auch auszugsweise – nur mit Quellenangat

Originalfassung © Jacques Delors Institut – Berlin, 2018.