Key players in digital tax reform: Pascal Saint-Amans, director of the OECD's Centre for Tax Policy and Administration, (left) and Pierre Moscovici, European Commissioner for Economic and Financial Affairs, Taxation and Customs

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The big read

Tax reform in the digital economy: recent OECD and EC activity

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Speed read

Last month, the OECD and the European Commission published their views on reform of the taxation of the digital economy. The OCED released its long-awaited interim report on 16 March, although the 'non-consensus' document did not reach many firm conclusions. It largely describes the competing views of stakeholders, though it still provides useful commentary regarding user-generated value, long term reforms and interim measures. The following week, the Commission published its own proposals, which largely confirmed previously leaked material. It proposes the introduction of a short-term revenue tax for digital businesses and, in the longer-term, a new Directive on digital permanent establishments and profit allocation. Member states are not unanimously in favour of these proposals, and the views of other stakeholders are divided. The OECD's report and the EU's proposed reforms are by no means the only source of change in this area, however; many countries are going it alone in deciding to address concerns about tax in the digital economy.

The rapid march towards tax reform in the tech world has shown no signs of abating in the first quarter of 2018, with both the OECD's and the Commission's proposals on this topic being published a month earlier than initially expected. When considered alongside the multitude of actions taken recently by individual countries, the statement of Pierre Moscovici, the EU taxation commissioner, that 'digital taxation is no longer a question of "if" – this ship has sailed', seems accurate. The direction of movement may be clear, but uncertainty remains about how – and indeed if – international consensus will be reached.

The OECD's interim report

Less than a week before the Commission published its own proposals in relation to tax in the digital economy, the OECD released its long-awaited interim report on 16 March 2018. The 218-page document, *Tax challenges arising from digitalisation*, lays bare the divergence of opinion between countries about taxation in the digital economy. Amongst the 113 inclusive framework members are countries firmly of the opinion that the BEPS project has addressed the key problems in the field of international taxation, meaning no further reforms are appropriate at this point. Others (including the US) accept that some issues remain post-BEPS, but are of the opinion that these problems are not specific to digital companies and therefore any reforms should be of general application. A third set (including many EU member states) believe that digitalisation and globalisation are putting intense pressure on existing taxation regimes, meaning targeted solutions are needed to correct a state of current inequity.

These divides meant the report (which is a 'non-consensus' document) did not reach many firm conclusions, and instead largely confined itself to describing the competing views of stakeholders. Even so, the report provides helpful commentary in regards to the current landscape, and should form a strong foundation from which further work can be carried out.

User-generated value

The report highlights three prevalent features of highly digitalised businesses:

- the ability to have a significant economic presence in a country without a major physical presence there ('scale without mass');
- a particularly heavy reliance on moveable intangible assets (including IP); and
- a business model based on data, user participation, network effects and user-generated content.

Of itself, this is uncontentious. However, and notably, countries are divided as to whether this third limb contributes to value creation. Some countries argue it does, on the basis that users provide digital companies with data that can be monetised (either by using it to improve services or by selling it to third parties) and content that can be used to attract and retain other users. In addition, these countries argue, network effects mean that by participating via a digital platform, users increase the value of the platform to advertisers and potential users alike. This

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idea of user-generated value underpins the Commission's proposals (see below). Other countries, however, disagree: user-generated data and content is equivalent to sourcing inputs from independent third parties, and thus under normal taxation principles should not be seen as value-creating.

Long term reforms

The report then discusses the possible implications for international tax rules arising from the above-mentioned features of highly digitalised businesses, making it clear that in a digitised economy, such features are increasingly being seen in traditional sectors too. At stake here are two fundamental pillars of international tax law:

- nexus (what is the threshold for becoming subject to tax?); and
- profit allocation (once taxable in principle, how much profit is to be charged?).

Over time, an increase in the scale without mass phenomenon will reduce the number of jurisdictions where taxing rights can be asserted over the business profits of multinational companies. To the extent that data and user participation create value, problems in applying the profit allocation and nexus concepts may be exacerbated. Further, a reliance on moveable intangible assets both: (a) increases the ability of companies to structure themselves to minimise their tax liabilities; and (b) makes it more difficult for tax authorities to assess how income from such assets should be allocated amongst different parts of multinational groups.

As discussed above, the extent to which tax reforms are needed to address these possibilities is not universally agreed upon. Although all countries have agreed to undertake a coherent and concurrent review of the profit allocation and nexus rules and work towards a consensus-based solution, how the OECD will bridge this gap before the 2020 deadline for its final report remains to be seen.

Interim measures

Perhaps the starkest difference in opinions is in relation to interim measures. Again, here the OECD largely limits itself to describing the differing views, giving no opinion about the merits of interim measures.

One group of countries, the report states, oppose interim measures on the basis that there is no sound conceptual basis for them. In addition, these countries believe they carry a high risk of adverse consequences: revenue taxes (such as that proposed by the Commission) risk reducing innovation, investment and welfare; over-taxation is possible as revenue bears no necessary relationship with profit; deductions would not be readily available as new taxes would need to be separate to existing corporate income tax regimes for international law reasons; and large compliance and administration costs are likely to arise.

Other countries, although acknowledging the risks that such measures pose, hold the view that interim measures can be justified. The report outlines their concerns that the current system means they cannot tax all the value generated in their jurisdiction, in turn undermining fairness, sustainability and public acceptability. This, they suggest, means action is needed in advance of longer-term reform.

The countries that fall into this latter category further support their view by arguing that interim measures can be designed to mitigate many of the risks they carry. To this end, the OECD report lists a number of principles (agreed by the countries who favour interim measures) that should underpin their design. These include:

(a) complying with all international obligations;
(b) being temporary in nature;
(c) being targeted in scope (e.g. not capturing the delivery of goods ordered online);
(d) minimising over-taxation (e.g. avoid cascading issues);
(e) minimising the impact on start-ups, business creation and small businesses; and
(f) minimising cost and complexity.

In particular, in relation to design principle (c), the report notes that many countries are of the view that interim measures should focus on only two business models: platforms which create revenue from online advertising, and platforms which provide intermediation services.

A European call to arms

On 21 February 2018, the European Parliament's Committee for Economic and Monetary Affairs voted 39 to 11 in favour of the idea that a permanent establishment (PE) could be based on a company having a 'digital platform or any other digital business model based on the collection and exploitation of data for a commercial purpose' active in a jurisdiction. The European Parliament supported this notion, and included it as a significant addition to the Commission's original proposal when voting to approve the common consolidated corporate tax base (CCCTB) and the common corporate tax base (CCTB) on 15 March 2018.

Under the amended drafts, a digital PE would be established when a platform generated revenue in excess of €5m from remote transactions in that jurisdiction, provided that one of the following conditions is satisfied:

- the platform has at least 1,000 registered users outside the jurisdiction in which it is resident for tax purposes;
- at least 1,000 digital contracts have been concluded per month with customers in that jurisdiction throughout the taxable year; or
- the volume of the digital content collected by the company in the taxable year exceeds 10% of the group's overall stored digital content.

Initially, CCCTB will only apply to groups with revenues exceeding €750m.

It is against this backdrop of activity that the Commission's proposed Directives were published on 21 March 2018, largely confirming previously leaked material. On the website containing the proposals, the Commission argues that there is a 'mismatch between where value is created and where taxes are paid' which has arisen because businesses operating in this space benefit from scale without physical presence, often rely heavily on moveable IP assets and experience user value creation. To address this problem, the Commission has proposed the introduction of an interim revenue tax and, in the longer-term, a new Directive on digital PEs. It is unclear how this latter proposal will interact with the amendments tabled by the European Parliament outlined above.

So why is the Commission acting now? In the conflict between wanting to find a long-term structured solution versus wanting to address the supposed serious tax gaps arising from the digital economy in a shorter time frame, the latter appears to be emerging triumphant in the European arena. There are a number of reasons for this: the Commission is eager to avoid unilateral action by member states, believes that it is unjust for value created in the Union to remain outside the scope of European tax for any longer, and is responding to political pressure to be (seen

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to be) tough on tech giants. With the upcoming European Parliament elections in May 2019 – and the fight against tax avoidance likely to remain a key campaign theme – this pressure is unlikely to fade away anytime soon.

Short term measure: revenue tax for digital businesses

When introducing the proposals on 21 March 2018, Moscovici stated that because this had been a problem for a number of years, and because the EU is the world-leading market for digital businesses, the loss of tax revenues in this area has been keenly felt across the EU. To address this concern, and ease the shortfall in budgetary revenues of member states, the Commission has proposed a brand new interim tax – the 'digital services tax' (DST) – of 3% levied on the gross revenues of companies attributable to the supply of certain digital services. This rate is part way along the spectrum discussed previously: the French finance minister, Bruno Le Maire, had suggested that it could be between 2% and 6%.

To be a taxable person for the purpose of DST, a company must belong to a group with worldwide revenues above €750m and 'taxable revenues' within the EU above €50m. These thresholds are to include the revenues of associated enterprises and are to be applied on a financial year basis (in contrast to the tax itself, which is calculated by reference to revenues in the past calendar year).

Taxable revenues, in turn, are defined as revenues resulting from the provision of the following services:

- placing on a digital interface advertising targeted at the users of that interface;
- making a multi-sided digital interface available which allows users to find and interact with other users, and which may also facilitate the provision of goods or services between the users directly (unless the sole or main purpose of doing so is to supply digital content, communication services or payment services to users); and
- transmitting data collected about users and generated from user activities on digital interfaces.

These categories mean that companies providing online content or services in return for a fee – the 'subscription model' – and e-retailers will generally not be caught. However, businesses based on the 'advertising model' (e.g. social networks and search engines) will be within the scope of the tax. Businesses based on the 'agency model' (e.g. online marketplaces) will also be caught, although revenues from the sale of their own goods and services will not be taxable. Likewise, the tax will not be levied on users who sell their own goods and services via third-party platforms. Specific exclusions also exist in the draft Directive for certain securities trading venues, crowd-funding services and digital platforms that facilitate the granting of loans.

The proposal suggests that the revenue tax could be levied based on the location of:

- the advert being displayed;
- the user who generated the data being transmitted;
- the user who concluded the transaction; or
- the user of a multi-sided digital platform (as the case may be).

To minimise the administrative burden on companies, the proposal envisages a one-stop shop system whereby companies will only need to file paperwork in one member state in relation to the DST due in all EU countries (as currently exists for VAT). Double taxation is to be mitigated by allowing the tax to be deducted from the corporate income tax base, irrespective of whether taxes are paid in the same or different member states.

Although an interim measure, there is no fixed duration for this new tax. Instead, it is envisaged that the tax will remain in force in relation to businesses from a third country until the member state has renegotiated their double tax treaties with that third country.

Whatever one's opinion on the interim measure (and opinions will be divided, see below), it is apparent that the Commission has drafted a measure which appears consistent with the design principles outlined in the OECD report.

Long term measure: digital permanent establishment and profit allocation

To address the longer term, the Commission proposes the introduction of a Directive on digital PEs. Contrary to expectations, this Directive is presented as a new standalone instrument, rather than an amendment to the CCCTB (although see comments above regarding the approach of the European Parliament in this regard; the Commission acknowledges that the measure could eventually be integrated into the CCCTB).

Under the Directive, a business will have a 'significant digital presence' – and therefore a PE – in a member state if in that tax period:

- the revenues from providing digital services to users in that member state exceed €7m;
- the number of users of one or more of those digital services located in the member state exceeds 100,000; or
- the number of contracts for supplying digital services concluded by business users located in the member state exceeds 3,000.

Revenues are defined in the draft Directive to exclude equity raised by, and debt repaid to, the company. A consolidated group exemption is also provided.

Digital services are defined as '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', and a list of non-exhaustive examples is provided. Digital services supplied through a digital interface by the entity carrying on the business and any associated enterprises are to be considered when applying the test for a PE.

It is suggested that the Directive would apply intra-EU and with third countries where there is no double tax treaty which prevents the use of the broadened PE concept.

This draft Directive also includes profit allocation rules. Profits attributable to businesses' significant digital presences in member states will be determined by a functional analysis. The 'economically significant activities' they perform through their presence via digital interfaces will be included in this assessment, with a particular focus on the DEMPE functions usually related to intangibles (development, enhancement, maintenance, protection and exploitation). Five examples are listed, which include activities relating to user data, user-generated content, online advertising and digital marketplaces.

More specific guidance at the EU or OECD level on profit allocation is expected to complement the Directive, making it difficult at present to assess how these factors will interact (and how the proposed splitting factors should be applied). However, the commentary at the front of the draft Directive is clear that because the economically significant activities contribute to value creation in digital business models in unique ways, profit splitting will 'often be considered as the most appropriate method to attribute profits'.

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The Commission also envisages a recommendation to member states to implement rules to this effect in their double tax treaties. Going forward, the Commission is keen to see unified action with the OECD: the 'ideal solution' is for these measures to be inserted into the OECD Model Tax Convention. However, as discussed below, the lack of international consensus on the merits of the way forward renders this ambitious to say the least.

Diverging views of member states

Member states are not unanimously in favour of the proposals.

France's finance minister, Bruno Le Maire, is widely seen as a leading proponent of the idea of a tax on digital revenues. France – together with Austria, Bulgaria, Spain, Italy, Germany, Slovenia, Greece, Portugal and Romania – signed a letter asking the Commission to explore the possibility of a revenue tax on digital companies. The UK, although not a signatory, stressed in the introduction to its updated position paper (published on 13 March 2018) that it 'continues to actively support' the Commission's work in this area.

On the other side of the fence are Sweden, Denmark, Ireland, Luxembourg and Malta, all of which have urged caution in this area. Swedish MEP Gunnar Hökmark, for example, has criticised the Commission for interfering in an area of law that 'is the sole right of EU member state governments' and for failing to conduct proper economic analysis about how the reforms would impact the tax bases of smaller European countries.

The Commission, in return, is increasing the political pressure on those dissenting countries: the latter three listed above, together with Belgium, Cyprus, Hungary and the Netherlands, were publicly accused of engaging in 'aggressive tax planning structures' during the presentation of the European Semester Winter Package on 7 March 2018. National tax regimes are not normally addressed in this package, and it remains to be seen how the named member states will respond.

Any decision to introduce the proposals into European law must be made unanimously. In light of the lack of consensus, it is unsurprising that media reports indicate the Commission is seeking a basis for qualified majority voting (QMV) on this issue.

Other reactions

Views of other stakeholders are equally divided.

The multiple choice questionnaire ordered by the Commission ahead of formulating its proposals appears to support change: almost two-thirds of respondents agreed that current international tax rules do not allow fair competition between traditional and digital companies, and over four-fifths supported action regarding the taxation of the digital economy. However, elements of discord did emerge. For example, the international level was seen by respondents as the best forum for taking action; over half agreed that a digital tax would lead to an increase in tax disputes; and only half of respondents were in favour of an interim solution. Respondents were also divided as to whether SMEs should be exempt from a digital tax and whether a digital tax would slow down the development of digital technologies in the EU.

Both ICAEW and the Confédération Fiscale Européenne (CFE) also provided written responses to the questionnaire, arguing against the implementation of a tax on the revenue of digital businesses (interim or otherwise), especially in the absence of OECD consensus. ICAEW highlighted the problems that this would cause loss-making businesses, the possible deterrent effect it would have on start-ups and the risk of double taxation. ICAEW suggested 'the attempt could prove as doomed to failure as Sisyphus pushing his boulder up a hill in Greek mythology' in light of the number of distinct digital business models to which the tax would apply. CFE concurred with many of these points, also suggesting that it is impossible accurately to ring-fence the digital economy.

Concerns were raised by both about the possibility of 'stifl[ing] the growth of the digital economy or discourag[ing] innovation within the EU'. Although Moscovici has been clear that the EU does not want to harm the digital economy, the 'big four' firms and tax commentators have warned that the proposed interim measure could do just that. Stephen Quest, the director general of DG TAXUD, is alert to these concerns. He has confirmed that an in-depth impact assessment to justify the Commission's stance will follow shortly. In particular, he has suggested that the issue of what business models are captured by the new tax will be closely examined.

Media reports suggest that digital companies themselves are (unsurprisingly) opposed to the new tax. On 7 March 2018, the Commission held a closed-door roundtable discussion with a select number of tech giants. Although the agenda and outcomes have not been publicly shared, some industry participants have suggested that the unanimous view was that a tax on revenue was a bad idea.

In any case, the Commission seems keen to continue to engage with the tech giants. On 1 March 2018, the European Parliament approved the creation of a new special Committee on financial crimes, tax evasion and tax avoidance. Its mandate specifically refers to the possibility of organising hearings with representatives of businesses, meaning digital multinationals may well receive an invitation to participate later in the year.

It is not just the proposed interim measure that has caused concern. Will Morris, chair of the BIAC Tax and Fiscal Affairs Committee, has criticised the idea of expanding the concept of PEs: there is no consensus for change; it would allow the bypassing of the complexities built into the physical PE rules; it is unclear where value is created; and it would lead to an increase in disputes. Similarly, he has levelled criticism at the Commission's proposed additions to the formula for apportionment on the basis that it is unclear whether raw data is valuable; whether its value is independent; how its value should be calculated; and why it should be treated differently to industrial data.

Unilateral actions worldwide

The OECD's report and the EU's proposed reforms may be grabbing the most headlines, but they are by no means the only source of change in this area. Rather – contrary to the idea of cooperation that underpinned the BEPS project – many countries are themselves going it alone in deciding to address concerns about tax in the digital economy.

The EU's proposal to amend the scope of PE so as to capture companies with a solely digital presence is not a novel idea: Argentina, Italy, Israel, Slovakia and Taiwan have all introduced changes along these lines in recent months. Likewise, the introduction of a revenue tax is mirrored by unilateral actions in Greece, India and Italy. The UK's recently updated position paper (see below) supports such a tax as an interim measure.

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Other actions have also been taken. For example, Australia and the UK have each introduced a diverted profits tax (DPT) in order to prevent large multinationals from avoiding domestic corporation tax by diverting profits offshore to low tax jurisdictions. In a range of countries, changes to the VAT regime have been introduced to capture services provided by an electronic agent, electronic communication or over the internet. The UK supports a reallocation of the profits recorded by companies to 'user jurisdictions' where user participation creates value.

Taken together, the foregoing seems to support the Commission's belief that without prompt, effective, multilateral action in relation to tax reform and the digital economy, the outcome will be a mismatch of overlapping, country-specific rules which together cause inconsistency, uncertainty and unintended consequences.

The UK's updated position paper

The UK government's Spring Statement on 13 March 2018 was somewhat quiet on the tax front. A consultation was launched regarding the role online platforms should play in ensuring the tax compliance of their users, with a deadline for comments of 8 June 2018. More importantly for these purposes, however, is the publication of an updated position paper on taxing the digital economy.

In the original paper (published in November 2017), the UK government advocated an interim tax on the revenues generated by the provision of digital services to the UK market. Businesses providing intermediation services and selling online advertising were highlighted as potential targets, and the paper indicated that double tax relief provisions, de minimis thresholds and mitigating provisions for loss-making and new businesses would be considered.

The case for this interim revenue tax is made again in the updated paper. It explains in more detail how users create value for digital companies, highlighting user-generated content; data on users' behaviour, interest and consumption habits; network effects; and contribution to brand as four examples. The paper remains focused on intermediation services and online services, but does seem to suggest that businesses for which the primary revenue stream is the collection and monetisation of data could also be captured (bringing the UK discussion in line with the Commission's proposals). Further business model considerations are also noted, including the need to ensure that marketplaces cannot avoid the tax by changing their legal form momentarily to become the owner of the third-party product and thus be classified instead as an e-retailer.

Looking ahead, the updated paper reiterates the UK government's previous call for long-term reforms to reward user-generated value through a tax on the residual profits realised by group companies. It suggests that the tax would need to be tailored according to the materiality of user participation, but beyond suggesting that 'revenues [may be] attributable to users in a jurisdiction', few concrete proposals were put forward in this regard. The paper remains firm that to achieve this aim, the international tax framework (including articles 5, 7 and 9 of the OECD Model Tax Convention) would need to be amended. US opposition to change casts doubt on whether such a reform is in fact possible.

With the updated paper clear that it does not represent 'the government's final position' on these issues, it remains to be seen how the UK's position will evolve.

An American/European tax trade war?

As alluded to above, there is no doubt that the US is opposed to the reforms supported by some other OECD members and the Commission. As Chip Harter, deputy assistant secretary (international tax affairs) at the US Department of the Treasury, spoke publicly about last month, the US does not believe that digital businesses are sufficiently unique to warrant separate treatment. The US holds the opinion that no changes to the scope of PE are needed (on the basis that large multinationals are changing their structures to use local, low-risk distributors anyway), but even if they were, the better approach would be to do so in a broader context. Steven Mnuchin, the US treasury secretary, reaffirmed this stance on 16 March 2018, arguing that a digital tax would be a 'redundant burden' which would 'inhibit growth and ultimately harm workers and consumers'.

The accusation that the current approach to taxing tech giants permits base erosion is also something that the US denies. In December 2017, a number of amendments were made to US federal tax laws, alongside the cut in the headline corporate income tax rate to 21%, including:

- The accumulated profits and earnings of any foreign company with a 10% US corporate shareholder were deemed to be repatriated as of the end of 2017, and therefore: (a) were subject to US corporation tax (at reduced rates); and (b) can be repatriated without further taxation.
- Under the global intangible low-taxed income (GILTI) regime, a 10% US corporate shareholder of a foreign company must include in its own gross income total the net-income of that foreign company (subject to limited exceptions) above a deemed fixed return on its tangible assets.
- Under the foreign-derived intangible income (FDII) regime, corporate tax deductions are available for such income earned directly by a US corporate, meaning there is no incentive to transfer intangibles outside the US to low tax jurisdictions.

Taken together, the US argues, there is no problem to address: value is created in the US, and it is now fully taxed there.

The US's evident opposition to digital tax reforms casts significant doubt on the prospects of the OECD successfully being able to introduce fully consensual changes in the area. If the result of this is that the EU (and other countries around the globe) push ahead with reform on a unilateral basis, what would happen? At this point, no one can say for certain. It is, however, possible to imagine Donald Trump's likely reaction to any suggestion that European countries are trying to 'steal' a share of the tax income due to America from its famed tech giants. It is certainly not beyond the realms of possibility that disagreements in this space could trigger a tax trade war. One only needs to look at the president's approach to steel and aluminium tariffs, and the recent EU response, to be concerned about this possibility. ■

The author thanks his colleagues Laura McDaniel, trainee, and Léa Bareil, EU regulatory and public affairs consultant, for their contributions to this article.

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- The OECD's interim report on tax and digitalisation (Alenka Turnsek, 22.3.17)
- Spring Statement 2018: corporate tax and the digital economy (Heather Self, 14.3.18)
- Taxation of the digital economy: unilateral measures (Ben Jones, Susan Seabrook, Sebastiano Sciliberto & Georgina Jones, 1.3.18)

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