EUROPEAN COMMISSION INTRODUCES BOLD NEW TAX PLAN FOR THE DIGITAL ECONOMY

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A NEW DIGITAL SERVICES TAX (…FOR NOW)

The European Commission is taking significant actions to address the taxation of the digital economy that would impose a 3% tax on digital services until a global and longer-term solution can be reached. The tax would apply to gross revenues from advertising, transmission of data collected about users generated from users' activities, and intermediation services that allow users to find and interact with other users. The tax would apply to businesses that meet certain revenue thresholds in the EU or residenced or incorporated in non-EU member states if they are doing digital business within the EU.

While the taxation of mobile income has long been problematic for tax administrators, the explosion of the digital economy has exacerbated their concerns. *Where to tax, who to tax and what to tax* are questions with which many tax officials are struggling. Given the mobile nature of income arising from the digital economy, a global approach to the issue is considered by many to be necessary. At the behest of the G-20, the OECD is scheduled to release a full report in 2020 on taxing the digital economy.

U.S. Secretary of the Treasury Steven Mnuchin recently stated that the U.S. firmly opposes proposals by any country to single out digital companies but supports international cooperation to address tax challenges arising from the modern economy.

All companies with a "digital presence" in the EU should carefully monitor developments going forward. In particular, business groups with multiple branches of activity that include digital services should carefully consider whether they are captured by the proposed rules or not. Even if that is not its declared purpose, it is expected that a DST will mostly hit global U.S. digital platforms. The Commission has estimated that around 180 businesses should fall within the scope, half of which are from the U.S., and a third from the EU.

BACKGROUND

On 21 March 2018, the European Commission put forward its expected proposals to modify the way large digital companies are taxed in Europe. The most important proposal in the short term is the introduction across the EU of a new Digital Services Tax (DST). The new tax would apply only for as long as a larger, more comprehensive and complex reform of taxation in the digital economy is approved and enters into force.

The new DST would be an indirect tax, intended to apply to revenues created from certain digital activities which escape entirely the current tax framework of Member States. In the words of the Commission, the tax will apply to revenues created from activities where users play a major role in value creation, such as those revenues: created from selling online advertising space; created from digital intermediary activities which allow users to interact with other users and which can facilitate the sale of goods and services between them; and created from the sale of data generated from user-provided information. In other words, the measure intends to tax digital platforms, and not just any digital activity. The scope of the measure will require careful examination: most e-commerce activities, as well as streaming services, online gaming and cloud computing services are not included in the scope of the proposal.

The current proposals are the result of a process within the EU, and must be examined within their larger international context.

On 21 September 2017, the European Commission ("Commission) published a Communication on a "Fair and Efficient Tax System in the European Union for the Digital Single Market" highlighting the significant disparities between the taxation of traditional international businesses and modern digital companies. Consequently, on 26 October 2017 the Commission launched apublic consultation with the objective to define an approach to the taxation of the digital economy in a fair way.

As a result of the Consultation, which ran until 3 January 2018, the Commission has been working on defining a new framework for the taxation of digital companies. This has resulted in the proposals presented on 21 March 2018. With them, the Commission has shown its readiness to not only depart from (somewhat lagging) international cooperation on digital taxation, but also from some of the key principles underpinning the international corporate tax system.

Meanwhile, the Organization for Economic Cooperation and Development ("OECD") struggles to build global consensus among its members on making the existing international tax rules "digital-proof". With no global agreement in sight before 2020, the Commission aims for the EU to lead this tax agenda.

THE PROPOSALS

There are two different proposals, to be implemented through two different legal instruments (two European Directives, later requiring their implementation by Member States through national legislation). One includes a long-term, permanent solution; the other introduces a short-term quick fix, to deal with the issue pending agreement among EU Member States on the former.

Short term quick fix: taxation of activities with the user at the center stage of value creation

Faced with the risk of a proliferation of digital tax measures at national level, the Commission issued a quick fix Digital Services Tax ("DST") in the form of a separate draft Directive, estimated to generate EUR 5 billion for the Member States' coffers. The revenues included in the scope of this tax (taxable revenues) would be those derived from the provision of any of the following services (taxable services):

services consisting in the placing on a digital interface of advertising targeted at users of that interface;

services consisting in the transmission of data collected about users which has been generated from such users' activities on digital interfaces;

services consisting in the making available of multi-sided digital interfaces to users, which may also be referred to as "intermediation services", which allow users to find other users and to interact with them, and which may also facilitate the provision of underlying supplies of goods or services directly between users.

The detail of the scope of the new measure will require detailed analysis. For example, the supply of digital content by an entity to users through a digital interface is a service outside the scope of DST; but "the making available of a multi-sided digital interface through which users can upload and share digital content with other users, or the making available of an interface that facilitates an underlying supply of digital content directly between users" are to be considered a service of intermediation and therefore fall within the scope of DST, regardless of the nature of the underlying transaction.

Businesses covered by the new tax should prepare to tax their gross revenues (rather than profits) at a rate of 3%. There is a proposed annual global revenue threshold of EUR 750 million at the level of the multinational group, and a European threshold on revenues derived from digital services set at EUR 50 million.

Double taxation should be prevented by the possibility to deduct the DST as a cost for corporate tax purposes. The Commission aims to limit the companies' reporting burden by introducing a *one-stop shop solution*. The Commission's assessment of the new rules confirms that non-resident taxpayers will be faced with higher compliance costs and administrative burden. The geographical apportionment of the new tax will be determined, but such factors as the number of times an advertisement was displayed or the number of users concluding transactions in the concerned territory. The Commission acknowledges that the DST is likely to increase consumer prices, but argues that the high price sensitivity of online consumers should limit such negative impact. Furthermore, the DST Directive is likely to raise compatibility questions on a number of fronts, including World Trade Organisation rules as well as the EU single market and subsidiarity rules.

Long-term solution: forget physical presence

The long-term solution proposed by the Commission for the taxation of the digital economy is a draft Directive introducing the concept of "significant digital presence" enabling the EU Member States to tax profits of tech companies based on the location of their digital users. A business with an annual revenue exceeding EUR 7 million, and/or having more than 100 000 users a year in a certain EU Member State, will be deemed to be digitally present and thus liable to pay taxes. Businesses with over 3000 digital services contracts concluded by users located in an EU Member State would also be affected.

As such, the proposed Directive does not imply a new tax, but rather re-allocates corporate taxation rights by marking a shift in the way profits are allocated to the EU Member States. While the existing OECD approach on profit splits remains the point of reference, additional criteria, such as the contribution of users and data to the creation of value will be included among the splitting factors.

The proposed Directive would not apply to tech firms having their tax residence in third countries that have signed double taxation treaties with the EU Member States. For this reason, the Commission issued a Recommendation to Member States (a non-binding instrument recommending a certain approach) to implement in their double tax treaties the new rules on digital presence and profit allocation. Furthermore, the Commission suggests that the proposed rules could eventually be integrated into the scope of the Common Consolidated Corporate Tax Base ("CCCTB") currently being negotiated (or rather stuck) in the Council of the EU.

GLOOMY OUTLOOK?

In theory, both Directives have a common date of entry into force: the 1st of January 2020. However, that may not be a realistic forecast. And that seems to be the very reason why two different texts have been drafted, so that one (the short term) can be applied while the other (the changes to the criteria on location of companies) is still under discussion. In any case, the DST would cease to apply once the comprehensive, long-term solution is in place.

For the laws to be finalized and adopted, the unanimous agreement of all EU Member States in the Council is necessary. According to the Commission's impact assessment accompanying the proposals, only 10 out of 21 national EU tax authorities that responded to the Commission's consultation consider the quick fix option the preferred approach. There is speculation on the fact that a special legal procedure included in the EU treaties could be used, allowing a group of EU Member States to move forward on their own on a particular regulatory matter, while leaving the door open for others to follow. This "enhanced cooperation" procedure would therefore allow progress among a subset of EU Member States. A good occasion to get more clarity on the EU Finance Ministers' views will be their informal gathering at the end of April.

No doubt the proposed rules will be at the center of heated negotiations among EU Member States in the coming period.

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