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Taxing clicks: The European Commission's new digital tax

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At the end of its base erosion and profit shifting (BEPS) process, following a comprehensive multilateral dialogue and a raft of proposals and recommendations, the Organisation for Economic Co-operation and Development (OECD) concluded that it would be difficult, if not impossible, to ring-fence the digital economy for tax purposes because of the increasingly pervasive nature of digitalisation. The BEPS process has not, however, removed the topic of taxing digital companies from the spotlight, nor has it prevented various countries from proposing measures specifically targeted at the digital economy.

The European Commission (the Commission) is the latest body to enter the fray. On 21 March 2018, the Commission published two draft directives: one proposing a comprehensive reform of the existing corporate tax system to permit EU member states to tax the profits of companies which have a significant digital presence in that state; and a second on an interim Digital Services Tax (DST).

Corporate taxation of significant digital presence

The draft directive to extend taxing rights to significant digital presence is an attempt to bring long-established international tax rules into the digital age (*see box "The current model"*).

The proposed directive would radically extend the concept of a permanent establishment (PE). A business would have a significant digital presence in a member state and so be subject to tax on its profits if, in relation to digital services, it had: total revenues in a member state above a threshold of €7 million; over 100,000 users; or over 3,000 business contacts. This would be the case even if the business had no physical presence in the jurisdiction.

If a significant digital presence is established, the draft directive then determines how profits would be attributed to that presence. Instead of using established transfer pricing rules, based on an analysis of function, assets and risk, the draft directive proposes analysing the value of activities associated with the development, enhancement, maintenance, protection and exploitation of intangible assets in the performance of digital services.

The current model

The existing Organisation for Economic Co-operation and Development Model Tax Convention allocates taxing rights on business profits to one of either:

- The jurisdiction from which a business is controlled.
- The jurisdiction in which a business has a physical presence (a permanent establishment) either through a fixed establishment, that is, "bricks and mortar", or an agent, that is, "boots on the ground".

In an increasingly digital economy, these concepts are less relevant; substantial activity can take place in a territory without a physical and taxable presence.

Countries seeking to expand their taxing rights beyond pre-existing international norms is not a new concept. It has been a growing trend over the last few years. The UK's own diverted profits tax with its concept of an avoided PE is a good example (*see News brief "Diverted profits tax: the next step down the road" www.practicallaw.com/8-610-3069*). However, comprehensive reform that avoids a material risk of double taxation will require multinational support. This seems unlikely in the short term.

Irrespective of whether the proposals are permanent or interim, the US fundamentally disagrees with the concept of a two-tiered system where internet companies are singled out and taxed differently. Instead, the US would be willing to support international co-operation to address broader tax challenges arising from the modern economy.

Digital services tax

Given the rather doubtful prospects of comprehensive multilateral reform, in the second draft directive, the Commission proposes a new DST limited to member states. The DST would be levied on gross revenues derived from the supply of certain digital services to EU users where user-value drives revenue generation.

The proposal will only apply to entities or groups which meet two qualifying thresholds (determined on a consolidated basis):

- Worldwide revenues of more than €750 million.
- EU taxable digital revenues of more than €50 million.

The Commission has identified three sources of taxable revenue that will be subject to DST, targeting businesses where the participation of a user is essential in generating revenue. These are revenues earned from:

- Advertising on a digital interface directed at users of that interface.
- Making available a multi-sided digital interface which allows 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 transmission of data collected about users and generated from users' activities on a digital interface.

The targets are clear: social media platforms and search engines that rely on users to post content and promote interaction while directing advertising to them; online market places that match users and facilitate the sales of goods or services between themselves for commission; and businesses that sell user data.

The explanatory note states that e-commerce activities are considered to be out of scope. The draft directive itself contains a number of exemptions for circumstances where the users' interaction is regarded as ancillary, and so not critical, to the generation of revenue. These include the supply of digital content, communication services, payment services, certain EU-regulated trading facilities, regulated crowdfunding platforms and facilities for granting loans.

It is proposed that DST will be levied at a rate of 3% on taxable revenues and then allocated to member states in accordance with the number of users in each member state. This seems straightforward enough, but it means that determining a user's location is pivotal to the operation of DST. This may require tracking users across member states and across multiple devices in circumstances where it has not previously been necessary.

The draft directive suggests that DST will be an interim tax, but there is no provision for an expiry date. If enacted, presumably DST would only be repealed if the longer term goal of reforming the existing corporate tax system is achieved. During this interim phase, many digital businesses with users in the EU will be subject to parallel taxes: one on profit and one on revenue. The Commission has suggested that in order to alleviate instances of double taxation, where the same revenues are subject to both corporate income tax and DST, it is expected that member states will allow businesses to deduct DST as a cost from the corporate tax base.

Where to go from here?

The impetus for the Commission acting now follows from several countries having either implemented or indicated they are prepared to implement unilateral policies, such as Italy's web service tax. A uniform DST across the EU is viewed more favourably than a fragmented and diverging range of digital taxes that could undermine the single market.

Although the prospects for DST are perhaps brighter than those of the significant digital presence, there will be hurdles to overcome. Firstly, it breaches wider international consensus. The recent OECD report concluded that there was no consensus on the need for, or merits of, interim measures, and a number of countries consider that these measures will give rise to risks and adverse consequences. This will cause concern in some member states.

Secondly, EU-wide tax changes usually require unanimous support and already nine member states have reportedly expressed their reservations regarding the DST, preferring to focus on the existing OECD process to develop a multilateral fix to the existing system. In the past, the Commission has struggled to get the unanimous support for tax changes and, if unanimity is not possible, then nine or more member states could club together and take the proposal forward under enhanced co-operation.

The alternative is a myriad of digital taxes across the EU. The UK has produced its own proposals. These adopt much the same structure as the Commission proposals; that is, reforming of the international tax regime by extending taxing rights to include a digital presence and the UK's own unilateral interim revenue tax. The UK's proposed digital revenue-based tax has many similarities to the EU's DST. The basis for both rests on the belief that users are a key driver of value creation for certain digital business models. The UK takes a more nuanced view on revenues derived from collecting data, noting that the mere collection of data from users does not mean that those users can be said to be participating in the creation of value. The government has said that it intends to work closely with the EU and if the EU's DST gathers enough support, it seems unlikely that the UK would pursue its own version.

Given the sentiment expressed by some member states, a smooth passing of the DST draft directive seems unlikely. But, if successfully implemented, it could well coincide with Brexit. A transposition date during the transition period would mean that the UK would be compelled to implement DST. Even if the effective date is after the UK has left the EU, the similarity of the UK's digital revenue tax may mean that the UK is inclined to take the off-the-shelf policy of DST rather than develop its own.

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