International Taxation in the Digital Era: The Rapidly Evolving European Perspective

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Europe's politicians worry that international tax rules have not kept pace with the digital economy and too easily allow multinationals to organize their global operations to minimize net taxable profits in high-tax European countries.

Pressure has been mounting throughout the European Union to crack down on what some perceive to be aggressive tax planning. The European Commission, France, Italy and the U.K. have now taken initial steps in this area.

New Taxation Efforts

The European Commission first took steps — using competition law rather than tax law — by suing individual countries for employing attractive tax regimes that allegedly violate European state aid rules. (See our September 2017 *Insights* article "EU State Aid Enforcement: What Multinationals Need to Know.") It remains to be seen whether these novel challenges can survive review in the European Court of Justice.

These challenges also have been limited to relatively specific situations in which a particular taxpayer allegedly benefited from a deviation in the host country's normal tax treatment. The same argument cannot easily be made against groups selling goods or services, particularly electronic ones, in one country, while maintaining a base physically in another country, such as Ireland, where they enjoy standard low corporate rates.

International and Regional Reforms

The view expressed by the Organisation for Economic Co-operation and Development (OECD) in its base erosion and profit shifting (BEPS) project — *i.e.*, that profits are to be taxed where value is created and economic activity undertaken — is widely shared, but there is no general global agreement on what constitutes "value creation" in the context of digital business and how to apportion it. Accordingly, Action 1 of BEPS on the digital economy highlighted that because reaching any consensus was not going to be easy, it would not make formal recommendations — although that admittedly was two years ago. Nor did the OECD's multilateral treaty initiative, containing new permanent establishment definitions and anti-tax avoidance provisions to be introduced in approximately 3,000 tax treaties when it enters into force, revolutionize the way tech groups are taxed. In any event, the U.S. (a key jurisdiction for digital businesses) declined to sign the treaty, and now its newly enacted international tax reform seeks to subject to U.S. tax foreign source income derived from foreign low-tax intangibles assets as well as levy a new withholding tax on payments by U.S. groups to non-U.S. entities. Therefore, global consensus seems a long way off.

The European Commission is considering various short- and long-term responses to this lack of global consensus. It is reviving its common consolidated corporate tax base initiative, which aims to harmonize the corporate tax framework in Europe, in the hope that this will curb multinationals' tax planning within the EU single market. Building support for such a framework has proven technically very complex given the history of different tax systems within the 28 member states of the EU. Furthermore, any such legislation would require the unanimous support of member states, and it is hard to see why Ireland or Luxembourg, which have created thousands of jobs for their residents by attracting tech giants with favorable tax policies, would agree.

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The European Commission also is considering as a short-term solution other forms of Europe-wide taxation, such as revenue-based models or deemed permanent establishments, where the focus is collection either at the source from customers within the EU or through direct assessment on the turnover generated by non-EU groups from such customers.

Country-Specific Initiatives

Individual jurisdictions have looked to tackle these issues, but international taxation treaties have hampered them. The recent *Google* case before the Administrative Court of Paris illustrates this difficulty, with the French authorities failing to tax an Irish corporate resident selling services over the internet to the French. Although authorities throughout Europe have intensified information exchanges and multijurisdictional audits, they face having to comply with the high procedural bar set by the European Court of Justice in *Berlioz* to protect taxpayers in these matters using the EU Charter of Fundamental Rights. (See Johannes Frey, Alex Jupp and Frank-Michael Schwarz's August 14, 2017, *Tax Notes International* article "The CJEU's *Berlioz* Judgment: A New Milestone on Procedural Rights in EU Audits.") So far, insufficient evidence appears to have been collected to launch many similar actions to *Google*.

The U.K. has adopted a 25 percent diverted profits tax that applies to "artificial" shifts of profits offshore by large multinational groups. France, followed by Germany, is threatening to adopt an "equalization tax" that would be imposed on the gross revenue generated in a particular state, rather than on net profits. The trend evidenced by these individual initiatives is concerning: Not only are they likely to be over-reaching as to the taxable base, but they could also result in double taxation in the absence of international coordination. Questions are almost certainly going to arise on their compatibility with new or existing treaties, European law and domestic constitutional principles.

Additionally, the U.K. has announced new withholding taxes for royalties linked to online sales in the U.K., where payments are earned by a low-tax jurisdiction, even where the payer of the royalties is not U.K.-based. Italy also has taken first steps toward an equalization tax that withholds on gross revenues. Again, treaties may impose limits here.

Conclusion

Certainly, one can see a dissonant world where the U.S. is increasing the tax on non-U.S. profit creation, the EU is forcing its member states to adopt one or several measures to tax revenues earned in its member states, and the U.K. is forging its own taxation and political path outside the EU. With no agreed-upon treaty resolution to resolve these tensions, avoiding double or even triple taxation on cross-border revenues is going to be a very difficult task in the short term. It may also spell the end for many zero-tax regimes in offshore jurisdictions. The next five years will for sure see a radical shake-up of cross-border tax planning for all multinationals with digital businesses. One can only hope that the rapidly assembled OECD Task Force on the Digital Economy can report some emerging consensus when it presents its interim conclusions to the G-20 in 2018.