European Commission Presents 'Fair Taxation of the Digital Economy' Package

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On March 21, 2018, the European Commission released a draft legislative package for "fair taxation of the digital economy," which would establish new tax rules for digital business activities within the European Union.[1] This proposal comes in response to calls from certain Member States, including France and Germany, to adapt existing rules that are otherwise not well-equipped to tax certain digital business models. In particular, many Member States are concerned about the growing disconnect between the limited physical presence required to create a significant market share in their country and the taxable profits created by that market share.

The Commission also aims to rein in unilateral measures that have been, or are threatened to be, adopted by several Member States to address the same issues, which could create confusion and fragmentation with the European Single Market.

It is already clear that not all Member States are aligned with the proposed measures. Given that European legislation relating to tax can generally be passed only with unanimous consent, the nature and timing of the successful enactment of this package remains uncertain.

A Two-Pronged Approach

The Long-Term Proposal: A Directive on the Corporate Taxation of a Significant Digital Presence

The Commission's proposal rests on the principle that profits should be taxed where value is created, but with a significant twist: While the current rules largely allocate to a country the right to tax the profits of a business on the basis of the physical presence that the business maintains within its borders — which must be significant enough to amount to a "permanent establishment" — the proposal would extend this test to include, with respect to the provision of digital services, the existence of a "significant digital presence."

In substance, this means that where a nonresident business provides "digital services" through a "digital interface" to users "located"[2] in a European Member State, and this business maintains a "significant digital presence" in that Member State, the profits derived through this significant digital presence will be taxable in the Member State in question.

Member States would be required to implement this Directive in their domestic legislation and make it effective starting January 1, 2020.

What Counts as a Digital Service? The term encompasses all services delivered over the internet that are of a nature that renders their supply essentially automated, involving minimal human intervention and impossible to ensure in the absence of information technology. This definition is meant to include the sale of software, website hosting services, the supply of e-books or online newspapers, services for downloading or

[1] Proposal for a Council Directive laying down rules relating to the corporate taxation of a significant digital presence (COM(2018) 147 final); proposal for a Council Directive on the common system of a digital services tax on revenues resulting from the provision of certain digital services (COM(2018) 148 final).

[2] With respect to the use of digital services, a user will be deemed located in the Member State in which a device is used to access the digital interface through which the services are supplied, as determined by the device's IP address; with respect to business contracts, the user will be deemed located in the Member State in which it is resident for corporate tax purposes or, absent a tax residence in the EU, where it has a permanent establishment.

streaming music and movies, access to online marketplaces, and services automatically generated online in response to data that a user provides. The sale of physical goods, even if performed online, would not be covered. Similarly, services realized in the physical world but delivered electronically (such as advice prepared by a lawyer and sent by email or a course given by a teacher via video conference) are excluded.

What Is a Substantial Digital Presence? A nonresident entity has a "substantial digital presence" in a Member State if any one of three tests is satisfied in any given taxable period:

- The gross income derived from the supply of digital services by the entity's group to users located in that Member State exceeds €7 million;
- The number of users of digital services supplied by the entity's group located in that Member State exceeds 100,000; or
- The number of business contracts for the supply of digital services concluded by users located in that Member State with that entity's group exceeds 3,000.

According to the Commission, these thresholds have been set in a manner that excludes situations in which the profits attributable to the digital presence would not even cover the tax compliance costs for a permanent establishment. The second and third tests, however, appear rather crude: Having a very wide audience but limited added value, or creating a more niche market but with a potential for higher revenue or margins, do not seem to necessarily reflect an entity's capacity to generate profit from that jurisdiction.

How Do Profits Get Attributed to a Digital Presence? Article 5 of the proposed Directive deals with the determination of the profits attributable to the significant digital presence. In this respect, the Commission claims to build on the traditional Organisation for Economic Co-operation and Development (OECD) principle that a permanent establishment should be allocated the profits that it would have realized had it been independent but engaged in similar activities, under similar conditions, taking into account the assets used, functions performed and risks assumed. However, the Commission proposes a new reading of this principle by deeming the following two factors to be "economically significant activities" weighing in the attribution of profits:

- the activities undertaken through a digital interface related to data and users, and
- the activities relevant to the development, enhancement, maintenance, protection and exploitation (DEMPE) of the enterprise's intangible assets.

These will include, for instance, the collection and exploitation of user-related data or user-generated content, the sale of online advertising space or the distribution of third-party content on an online platform. Based on these factors, the Commission's preferred method for attribution of profits to the digital presence is a profit split, unless the taxpayer can prove that another internationally recognized principle is more appropriate.

Impact on Double Tax Treaties. The Commission acknowledges that the extension of the definition of "permanent establishment" resulting from the introduction of the "significant digital presence" concept is likely to contravene the provisions of currently applicable tax treaties to which Member States are parties. Accordingly, the territorial scope of the Directive excludes entities that are resident outside the EU in a country that has a tax treaty with the relevant Member State (unless that treaty incorporates rules similar to those of the Directive); in parallel, the Commission encourages Member States to introduce in their tax treaties provisions that mirror those of the Directive.

Interaction With the Proposal for a Common Consolidated Corporate Tax Base (CCCTB). The Commission readily acknowledges that the significant digital presence concept is only a partial solution; the adoption of the more comprehensive CCCTB proposal — the ambitious plan to harmonize corporate income tax rules for large groups operating in the EU, which the Commission has revived — would in its view be a more appropriate regime for creating a level playing field for businesses operating within the Single Market and reducing aggressive tax planning. The CCCTB, however, still relies on the traditional definition of permanent establishment and profit allocation rules, which insufficiently deal with certain specific features of the digital economy. In the longer run, therefore, the Commission suggests incorporating the content of the present digital presence proposals into the CCCTB effort.

The Short-Term Proposal: The Digital Services Tax

The second proposal put forward by the Commission is designed to be temporary but is likely to prove the more controversial of the two. It aims to close what a number of Member States appear to consider loopholes in the taxation of digital activities that rely significantly on the value created by or obtained from users.

More specifically, the proposal takes the form of a new indirect tax that would be levied on the revenues derived from the supply of the following two categories of services:

- the placing on a digital interface of advertising targeted at users of that interface, as well as the transmission of data collected about users that has been generated from such users' activities on digital interfaces (*e.g.*, ads displayed by search engines such as Google);
- intermediation services relying on network effects and consisting in online platforms that allow users to find and interact with other users (*e.g.*, social networks such as Facebook), and which also may facilitate the provision of goods or services directly between them (*e.g.*, eBay's or Amazon's marketplaces).

This digital services tax (DST) would be levied at a 3 percent rate on the gross revenue generated by the entity and charged in each Member State in proportion to:

- the number of times an advertisement has appeared on the device of a user located in that Member State (for advertising services),
- the number of users in that Member State having concluded underlying transactions (for online marketplaces),
- the number of users in that Member State holding an account on that network (for social networks), and
- the number of users in that Member State from whom data so monetized has been generated as a result of such users having used a device to access the taxpayer's digital interface (for the monetization of data obtained from or generated by users).

Taxpayers would be subject to the DST if:

- The total amount of worldwide revenue of the entity for the relevant financial year exceeds €750 million; and
- The total amount of taxable revenue obtained by the entity in the EU for the relevant financial year exceeds €50 million.

If the relevant entity belongs to a consolidated group, the revenues reported by such group are decisive. However, it remains unclear whether the parent of that group will be the "taxable person." Also, in targeting gross revenue rather than net profits, the Commission's proposal avoids a limitation that is inherent in the directive on the corporate taxation of significant digital presences. Under the tax treaties currently in force between most Member States and the U.S., for instance, no tax assessed on net profits can generally be imposed on a U.S. firm providing digital services into the EU absent an actual "permanent establishment." It seems unlikely that the U.S. would agree to amend its treaties to include a digital permanent establishment provision in the short term. A tax on gross income, by contrast, would not normally be covered by such treaties and would accordingly not require any cooperation from the EU's trading partners.

On that basis, the Commission expects that, at a rate of 3 percent, the DST will raise approximately €5 billion per year in the EU.

By Commissioner Pierre Moscovici's own assessment, up to 150 companies would fall within the scope of the DST, of which approximately half could be U.S. firms, one-third European and the balance Asian. The possibility of such limited and selective scope raises the issue of whether the DST could violate the right to equality under the EU Charter of Fundamental Rights or even be regarded as state aid.

Where the same revenues are subject to the corporate income tax and DST, it is expected that Member States will allow taxpayers to deduct their DST charges from their corporate income tax base in their territory, irrespective of whether both taxes are paid in the same Member State or in different ones. Even if this principle is only mentioned in the preamble to the Directive, this means that double taxation could be partially mitigated for firms established in the EU, but it leaves open the question for those established outside the EU. For firms established in the U.S., the DST — as a tax levied on gross revenue rather than income — presents significant issues regarding the creditability of the tax, thus potentially resulting in an additional tax burden on such firms.

The DST would enter into force in 2020 but is intended as an interim solution until the more comprehensive Directive on the corporate taxation of significant digital presences is agreed on by the Member States and implemented in the European Union.

Next Steps

From a procedural perspective, the draft directives will be submitted to the European Parliament for consultation and to the European Council for adoption. But, as is generally the case in tax matters, unanimity is required, and this effectively gives veto rights to Member States such as Ireland, Luxembourg, Malta and Cyprus, which have historically attracted technology firms and may fear that their economy or the access of their citizens to services will be negatively affected if the EU goes ahead with this plan. Alternatively, if unanimity cannot be secured, those willing to proceed could implement a modified version of the Commission's proposals among themselves under the so-called "enhanced cooperation" procedure, which requires a minimum of nine Member States to participate. However, such a watered-down format of the package does not seem to be seriously considered at the moment.

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On March 16, 2018, ahead of the publication of the Commission's package, U.S. Treasury Secretary Steven Mnuchin issued a strongly worded warning against tax measures by "any country to single out digital companies." The plan unveiled by the European Union is unlikely to assuage his fears that U.S. technology firms are being specifically targeted.

The OECD has not shown much enthusiasm for immediate action, either; an interim report the organization published on March 16, 2018, discusses potential tax techniques to apply to the digital economy — including some very similar to those proposed by the European Commission — and notes their shortcomings and the absence of a sufficient consensus to implement them on an international basis.

Against this backdrop, the odds of either of the Commission's proposals being adopted anytime soon seem uncertain at best. The ill-fated European financial transaction tax, which is still in limbo five years after the Commission submitted its initial draft, should serve as a reminder that tax harmonization in the European Union is an arduous task.

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