EU Commission's proposals for fair taxation of the digital economy

The EU Commission has proposed two directives to reform the taxation of digital businesses operating in the EU, including an interim 3% tax on certain digital revenues and a long term proposal to recognise a "significant digital presence" for tax purposes based on a local user base.

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Update

Reports suggest that the Commission's proposal failed to gain political support at an ECOFIN meeting in Brussels held on 06 November 2018. In the meantime, the UK has announced plans to impose its own Digital Services Tax.

The EU Commission has published proposals for a package of measures to tackle the taxation of the digital economy, including two draft Directives putting forward both long-term and short term tax measures. Whilst the Commission fully supports the work of the OECD, there is a recognition that progress at an international level will be "challenging" and, therefore, the EU should not delay its own measures pending international agreement.

The two measures proposed target only the largest digital businesses and are an amendment to the concept of a permanent establishment (PE) for those businesses and an interim measure for a tax on revenue from certain types of digital service such as those exploiting user data or those providing intermediation services between users.

The focus of the proposals is very much targeted on similar business models to those identified in the recently released HM Treasury report on taxation of the digital economy, including social media, search engine and auction sites.

Background

The tax treatment of the digital economy was specifically addressed by the Organisation for Economic Co-operation and Development (OECD) in Action Point 1 of its Base Erosion and Profit Shifting (BEPS) Project. In its final Report, the OECD essentially concluded that, because the digital economy is increasingly becoming the economy itself, it would not

be feasible to ring-fence the digital economy from the rest of the economy for tax purposes.

However, since then a number of jurisdictions have concluded that more is needed to ensure fair taxation of businesses acting within the digital space. As a result, the G20 mandated the OECD to bring forward further work in this area. In the meantime, EU Finance Ministers agreed to progress proposals to address the tax treatment of companies operating in the digital economy, see "Taxation of the digital economy" and the EU Commission released a communication, " A Fair and Efficient Tax System in the European Union for the Digital Single Market", seeking to influence developments in relation to the taxation of the digital economy and ensure that the EU acts in a co-ordinated manner.

In addition, several jurisdictions have commenced implementation of unilateral, domestic measures. In the UK, HM Treasury has recently released an updated position paper entitled, "Corporate tax and the digital economy: position paper update", designed to inform the UK's input into these ongoing international developments. See " HM Treasury's updated position paper on taxation of the digital economy".

On 16 March 2018, the OECD published its Interim Report into the "Tax Challenges Arising from Digitalisation". The report noted that there is, at this stage, no general consensus among participating jurisdictions as to whether, and if so what, further measures to tackle taxation of digital services are needed. The OECD will continue to progress a "coherent and concurrent review of the nexus and profit allocation rules" and work towards a "consensus-based solution" with a final report due in 2020.

In response, on 21 March 2018, the EU Commission published its proposals to tackle the challenges of the digital economy.

EU package

The EU Commission's proposals stress the need for a new tax framework that is up-to-date with digital business models. There is a recognition that the international tax system is not currently adapted to recognise value creation in a number of areas of digital business. In particular, the value created by users on a social media platform that allows the platform provider to record data and use that data to sell marketing and other services, without the need for any physical presence in the jurisdiction where that user data is generated. Similar considerations arise in relation to sites which bring together users (such as auction sites).

Whilst the Commission recognises that the ideal solution to taxing the digital economy would be at a global level, the OECD Interim Report has clearly signposted the fact that any such solution is a long way off. Therefore, whilst the Commission and Member states continue to actively support the work of the OECD, there is also recognition that the "EU cannot afford to delay any longer". Both the demands of fair taxation and the need to prevent a proliferation of uncoordinated measures from individual Member States has led to the decision to put forward proposed Directives without further delay.

The EU package consists of two draft directives. The first contains a proposal for a Council Directive "laying down rules relating to the corporate taxation of a significant digital presence". There is also an accompanying Recommendation to the this proposed Directive dealing with the double taxation aspects of the proposal.

The second is a proposal for a Council Directive "on the common system of a digital services tax on revenues resulting from the provision of certain digital services", which the EU Commission considers a short-term, interim solution to the issue, pending wider agreement on a long-term solution.

Significant digital presence

Under this proposal, Member States will be able to tax profits of a digital business which are generated in their territory even in the absence of a physical presence. This proposed Directive represents the long-term, comprehensive solution. In particular, a business will be considered to have "a significant digital presence" if:

- the business carried on consists wholly or partly of the supply of digital services through a digital interface, and
- one or more of the following criteria are met:
  - total revenues obtained from supplies of those ditigal services to users located in that Member State in a tax period exceed €7m
  - the number of users of those digital services in the Member State exceed 100,000, or
  - the number of business contracts for supply of any such digital services concluded in that period by users in that Member State exceeds 3000.

Digital services is defined to encompass supplies of software, social and business media related supplies, online marketing sites, ISP packages etc. However, digital services do not, for these purposes, include the sale of goods or services which are merely facilitated by the internet.

The proposed Directive also sets out principles for attributing profits to that significant digital presence. For attribution of profits, it should be assumed that the "significant digital presence" is a separate and independent enterprise and a functional analysis should be performed to determine attributable profits based on "economically significant activities performed... through a digital interface". In determining the attributable profits, the profit split method should be the default unless the taxpayer can demonstrate that there is an alternative method which is more appropriate having regard to the results of the functional analysis.

The proposed Directive would apply to all entities, whether resident in the EU or outside the EU, if they have a significant digital presence in a Member State. However, the proposed Directive recognises that it would not apply if an entity is resident in a non-EU jurisdiction that has a double tax treaty unless the treaty includes similar provisions on a significant digital presence and the attribution of profits to those in the draft Directive. In effect, this recognises that most existing treaties determine the allocation of taxing rights over business profits based on the traditional PE concept. Accordingly, the Commission has also released a Recommendation looking at how Member States should amend their treaties with non-EU jurisdictions to reflect the provisions on significant digital presence.

The Commission proposes that the Directive should apply with effect from 01 January 2020. However, given that the proposal for an interim tax is also intended to apply with effect from 01 January 2020, it seems that this date may well be somewhat ambitious.

Interim taxation of digital service revenues

This second proposed Directive puts forward a short-term, interim solution. It proposes a Digital Services Tax (DST) at an EU level at a rate of 3% on gross revenue (net of VAT and other similar taxes) derived in the EU from two main types of digital services:

- services where the main value is created by user data, either through advertising or by the sale of the data collected by companies such as social media or search engines, and
- services of supplying digital platforms that facilitate interaction between users who can then exchange goods and services via the platform (such as peer-to-peer sales).

Only businesses with both total annual worldwide revenue of €750m and total annual taxable digital revenues in the EU of €50m would be subject to the DST, irrespective of whether they are established in a Member State or in a non-EU jurisdiction. For these purposes, taxable digital revenues are treated as obtained in the EU if users of the service are located in the EU. The proposed Directive contains provisions for determining the location of a user and determining the proportion of an entity's total taxable revenue allocated to the EU.

In terms of compliance, the Commission proposal anticipates the setting up of a One-Stop-Shop mechanism for those subject to the tax.

In order to alleviate cases of double taxation, the Commission proposes that companies should be able to deduct DST as a cost from their corporate tax base where the same revenues are subject to corporate tax and DST.

The Commission initially proposes that this Directive should also commence with effect from 01 January 2020. Recent experience with implementing (or failing to implement new EU wide taxes, such as the FTT) would suggest that this timetable is highly ambitious.

Next steps

The Commission's proposals will now be sent to the Council and the European Parliament for consultation. The Directives need to be unanimously adopted by the Council. In the meantime, the Commission will continue to actively contribute to the global discussions with the G20 and OECD.

However, there are already suggestions that some Member States will not support the Commission's measures. In particular, the ability of Ireland and Luxembourg to attract multinationals is likely to be adversely impacted. It seems certain, therefore, that the process at an EU level has a long way to go before any concrete measures actually come into effect. The question remains as to whether individual Member States may seek to introduce their own measures in the absence of EU agreement.

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