BRIEFING

EU Legislation in Progress

Corporate taxation of a significant digital presence

OVERVIEW

Despite achieving unprecedented growth and profit rates, the digital economy seems to be relatively undertaxed when compared to more traditional 'bricks and mortar' companies. The current rules are based on the physical presence of taxpayers and assets, and there is a general understanding that they are not suited to taxing a digital economy characterised by reliance on intangible assets and ubiquitous services whose location is often hard to determine. International bodies are currently working on how to adapt tax rules to the digital reality.

The European Commission adopted a proposal in March 2018. It would allow taxation on the basis of digital rather than physical presence linked with the EU, for digital activities generating turnover of over €7 million, and with more than 100 000 users or 3 000 business-to-business contracts annually.

The proposal has met with mixed reactions from stakeholders. Although there is growing recognition that digital companies should pay similar tax rates to traditional companies, some consider the initiative to be premature given the ongoing search for a compromise at the level of the Organisation for Economic Co-operation and Development (OECD), which is thought of as the permanent solution. The report by Parliament's Committee on Economic and Monetary Affairs (ECON) proposes to widen the scope and reach of the tax, and increase clarity for tax authorities and companies. The plenary vote on the report is expected during the December session.

Proposal for a Council directive laying down rules relating to the corporate taxation of a significant digital presence

Committee responsible:	Economic and Monetary Affairs (ECON)	COM(2018) 147 21.3.2018
Rapporteur:	Dariusz Rosati (EPP, Poland)	
Shadow rapporteurs:	Paul Tang (S&D, the Netherlands) Ashley Fox (ECR, UK) Petr Ježek (ALDE, Czech Republic) Martin Schirdewan (GUE/NGL, Germany) Eva Joly (Greens/EFA, France) Marco Valli (EFDD, Italy) Barbara Kappel (ENF, Austria)	2018/0072(CNS) Consultation procedure - Parliament adopts a non-binding opinion only
Next steps expected:	Vote in plenary	

EPRS | European Parliamentary Research Service

Author: Marcin Szczepański
Members' Research Service

PE 623.571 – December 2018

EN

Introduction

Deepening the digital single market has long been an EU priority. Since incoherent tax policies can lead to market fragmentation, the EU is striving to create a common, fair and transparent taxation system for online activities. This is in line with a broader policy trend in the Union which, since the recent financial and economic crisis, has focused on improving the taxation framework. The big push towards clear, efficient and just rules includes measures against tax avoidance, mandatory exchange of taxation information,[1] action to tackle non-cooperative jurisdictions, changes to the ways in which companies are taxed, improved transparency of information on tax paid in the EU by multinationals, and an updated value-added tax (VAT) framework for cross-border e-commerce. However, much remains to be done, particularly in the field of digital taxation. The digital single market would be better supported by appropriate tax rules that correctly recognise the value of digital activities and enable economic actors to operate in a predictable and fair business environment.

As the controversies around the tax practices of some large technology companies began to arise, the EU and its Member States became increasingly interested in finding solutions to secure a global level playing field and prevent non-taxation or transfers of tax base and consequently tax revenues from digital activities. This was echoed in discussions in the context of the September 2017 digital summit in Tallinn as well as the ensuing European Council conclusions of October 2017, which called for the Commission to propose relevant measures by early 2018. Member States then broadly agreed in December 2017 that the proposals should include both long-term and temporary solutions.

International context

There is an understanding on the part of international bodies, such as the OECD, that corporate tax rules need to be adapted to the realities of the digital economy. This is reflected in the OECD's focus on this issue in the context of the base erosion and profit shifting project.

The OECD delivered a report on the implications for taxation of digitalisation to the G20 finance ministers in March 2018. It has been endorsed by more than 100 countries, which agreed to review their tax rules by 2020, with particular regard to the allocation of taxing rights between jurisdictions and the share of multinationals' profits that are subject to taxation.

However, given the differing views of countries on the topic, reaching a global, consensus-based agreement is likely to be challenging.

The communication accompanying the legislative proposal on digital taxation states clearly that: 'By being a first mover in proposing an overarching response to fix the issue and mitigate the immediate risks, the EU and its Member States will be at the forefront in shaping a global solution'. The Commission finds the best long-term approach is to reach multilateral and international agreement, but acknowledges that achieving that will take time on account of the complex nature of the problem and the great variety of issues to be tackled.[2]

Context

Digital activities are generating significant and ever-growing value. Digital companies have higher growth rates than the economy at large, and the largest among them have unprecedented user and consumer bases within the EU. For example, digital firms are showing annual growth of 14 % on average, while IT and telecoms are growing at 3 % and other multinationals at 0.2 %. Over 40 % of Europeans use Facebook. The scale of this 'digital revolution' may be illustrated by the fact that in 2006, only one digital technology company was among the top 20 global companies, accounting for a 7 % market share. Today, nine digital technology companies are in the top 20, accounting for a far more significant 54 % market share.

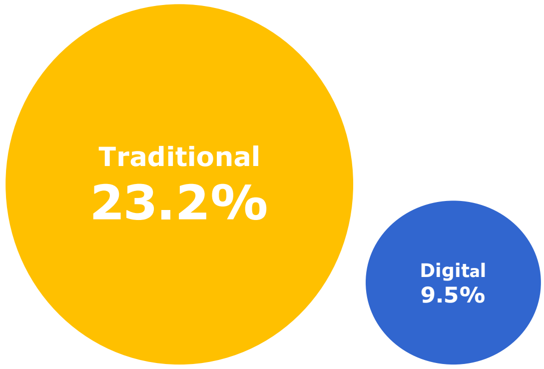
However, new business models created by digitalisation are putting pressure on the international tax system, which can often not catch up with the rapidly evolving sector. Essentially, digital services cross borders at the click of a mouse and are not grounded in a specific territory; corporate tax rules meanwhile are based precisely on a territorial link (place of establishment, explained in the next section). This, and incentives from governments that wanted to support the growth of this promising sector and attract such companies to their jurisdiction, leaves significant digital revenues uncaptured by the tax system. According to the European Commission, real tax rates paid by digital companies are much lower[3] than those paid by traditional businesses (see Figure 1).

There are also some other undesirable economic effects. Digital enterprises can offer services and conclude contracts with citizens in a given country, benefiting from facilities there such as infrastructure and connectivity, but without being regarded as present there for tax purposes. According to the Commission, this creates unfair advantage vis-à-vis companies with a physical presence in a country.[4] Also, digital companies that are active solely on domestic markets are at a disadvantage compared with companies that operate across tax jurisdictions.

Existing situation

There are currently no EU rules that deal specifically with the digital aspects of corporate taxation. Corporate tax rules in general are based on the concept that profits should be taxed where the value is created. Specific tax treaties determine the distribution of taxing rights between the taxpayer's country of residence and the country in which the income originated. These treaties, usually bilateral, are generally based on OECD and United Nations model tax conventions. Neither of the two models is legally binding so international tax law is a patchwork of bi- and multilateral treaties with different scopes and reservations as regards content.

Figure 1 – Effective average tax rate in the EU for international enterprises



Data source: European Commission, 2018.

As the current tax rules were originally designed for 'bricks and mortar' establishments they are often outdated when it comes to dealing with online businesses. Mainly, they connect the right to collect corporate tax to value creation, specifically to tax jurisdictions where the development and production of a product or service occurs. This concept of 'permanent establishment' is essential for corporate taxation because a foreign company becomes liable to taxation in a country only if it has a presence that is equivalent to such establishment. It is broadly defined as the place where the business of an enterprise is wholly or partly carried on.

In other words, a tax nexus needs to be established before a company is liable for taxation in a given jurisdiction. However, establishing such nexus is challenging in a tax jurisdiction where businesses provide services digitally, having a commercial presence but minimal or no physical presence and hence no permanent establishment. The nexus may therefore not be established or be of negligible value. Furthermore, value, or parts of it, may often not be created where a company is physically present. Or, on the other hand, a company may base the bulk of its value creation in a country with an advantageous tax system, and claim that its activities in other countries are negligible, even if it generates a significant amount of its profits there.

What compounds the challenge is that, under current tax rules, it is difficult to determine the value created by intangible assets such as algorithms, which can be easily shifted, and to assess the role of users in value creation. While the profits from data analysis increase with the amount of information accumulated (from growing the number of users), it is often difficult to quantify the monetisation of data and tax it properly.

The Commission accordingly explains[5] that 'the application of the current corporate tax rules to the digital economy has led to a misalignment between the place where the profits are taxed and the place where value is created'.

As has been discussed for some time in the context of EU policy, there is therefore a need to set new indicators for economic presence, and identify and evaluate the intangible assets used by digital companies as well as their contribution to value creation. Interestingly, the OECD has approved the destination-based taxing principle in Action 1 of its base erosion and profit shifting (BEPS) report, which states that: 'For consumption purposes internationally traded services and intangibles should be taxed according to the rules of the jurisdiction of consumption'. BEPS is however not hard law and its measures need to be implemented in national legislation in order to have an impact.

Comparative elements

Momentum seems to be gradually building up for taxing the digital economy. Italy is introducing a 'tax on digital transactions', with a new definition of permanent establishment, levied at a 3 % rate on the value of each digital transaction and paid by the buyers of the service. Residents and non-resident enterprises that conclude more than 3 000 digital business to business transactions in a calendar year are eligible. In the United Kingdom, the government is contemplating tax reform, intending to tax royalty payments made to low- or no-tax jurisdictions even if the seller has no taxable UK presence. The United States reportedly believes that the digital business is not so inherently distinct as to require a separate tax regime.

Parliament's starting position

In its resolution of 16 December 2015, the European Parliament called for an updated definition of 'permanent establishment' to accurately reflect digital presence and to introduce a clear definition of 'minimum economic substance'. This call was also made in two reports drafted by the special Committee on Tax Rulings, approved as resolutions by Parliament on November 2015 and July 2016, as well as the report by the Committee of Inquiry into Money Laundering, Tax Avoidance and Tax Evasion (PANA), adopted by Parliament in December 2017.

Furthermore, during discussions on the proposed common consolidated corporate tax base (CCCTB) and the common corporate tax base (CCTB) directives, the European Parliament voted in favour of emphasising the digital dimension of corporate tax with a view of creating a single, clear and fair EU corporate tax regime. The European Parliament proposed benchmarks that would identify whether a company had a digital presence in the EU and was therefore liable for tax. The Parliament also called on the Commission to set these benchmarks (such as the number of users or the volume of digital content collected) with a view to clearly determining where a company generates its profits. The European Parliament proposed that enterprises set their tax liabilities by adding up the profits and losses of their constituent companies in all EU Member States. The final allocated tax amount would be shared between EU countries, depending on where the profits had been generated.

CCCTB proposal and the digital economy

In 2016 the Commission re-launched the proposal for a common consolidated corporate tax base (CCCTB). The Commission mentions that such rules could be the optimal solution for fair and efficient corporate taxation in the Union. However, it deems the current CCCTB proposal unsuitable for tackling the specific challenges of taxing businesses in the digital economy for various reasons: its limited scope (it concerns only large multinationals), inadequate definition of a permanent establishment in the CCCTB (based on the one presently applied internationally), and insufficient profit allocation rules that would not capture precisely the value of digital activities of the company. The European Parliament voted to amend the proposal substantially, increasing its relevance for the digital economy, but the final decision has yet to be made by the Council.

In the explanatory memorandum to the present legislative proposal on digital tax, the Commission 'welcomes the amendments in the reports of the Committee on Economic and Monetary Affairs of the European Parliament on the CCTB and the CCCTB as a good base for further work on ensuring fair taxation of digital activities.'

Council and European Council starting position

In its conclusions of 19 October 2017, the European Council called for efforts to ensure that 'all companies paid their fair share of taxes and to ensure a global level-playing field in line with the work currently underway at the OECD'. It also underlined the need for 'an effective and fair taxation system fit for the digital era'. The Council conclusions of 5 December 2017 called for exploration of a nexus in the form of virtual permanent establishment, which should take into account the origin of value creation.

Preparation of the proposal

The Commission ran a consultation, which received a total of 446 replies, from 26 October 2017 to 3 January 2018, and also sent a survey to all the Member State tax administrations. The majority of respondents agreed that the current rules allowed digital companies to pay less tax and that action is needed. The impact assessment examined the reform options and their compatibility with the existing international tax system. A solution only within the framework of the proposal for a CCCTB was rejected. The assessment recommended a standalone directive to revise the concept of permanent establishment and the profit attribution rules, with a recommendation to change rules vis-à-vis third countries.

The changes the proposal would bring

On 21 March 2018, the European Commission adopted the fair taxation of the digital economy package, comprised two proposals to tax the digital revenue of companies. In addition to a short-term solution to be delivered by a directive on the common system of a digital services tax on revenues resulting from the provision of certain digital services, the Commission proposes a long-term solution, with a reform of corporate tax rules so that they include significant digital presence.

The latter proposal would concern corporate taxpayers incorporated or established in the EU, as well as enterprises incorporated or established in a non-Union jurisdiction with which there is no double taxation treaty with the Member State where a significant digital presence of the taxpayer is identified. According to the proposal, Member States would be able to tax profits generated in their territory even if a company did not have a physical presence there. A taxable 'digital presence' or a virtual permanent establishment in a Member State would be determined if at least one of the following criteria were met in a taxable year for an enterprise:

- its annual revenue was higher than €7 million;
- it had over 100 000 users in a Member State;
- more than 3 000 business contracts for digital services had been made between the company and business users.

Having established that such a virtual nexus existed, a proportionate share of company's profits would then become taxable in the country where it had a nexus, at a level equivalent to bricks and mortar companies. Furthermore, the Commission proposed that rules on allocation of profits be modified to better reflect how companies can create value online, taking into account factors such as user data.[6]

Advisory committees

The European Economic and Social Committee (EESC) adopted its opinion in July 2018. The EESC considers that there is a need to develop rules on how the proceedings from corporate tax are attributed to the Member States, but also underlines that the ultimate solution must be global, i.e. world-wide. The opinion stresses that the impact assessment should be complemented with an analysis of what effects the interim measure will have on SMEs, investment, start-ups, jobs and growth. The Committee of the Regions adopted its opinion on taxation in the digital economy in plenary session on 5 December.

National parliaments

The deadline for the submission of reasoned opinions was set at 17 May 2018. The Danish, Irish, Maltese and Dutch parliaments sent reasoned opinions saying that the proposal was not compatible with the subsidiarity principle. These countries argued that taxation was a national competence and that the legal basis for the proposal was therefore unclear. They also questioned the need for an EU solution, taking into account the ongoing work of the OECD.

Stakeholders' views[7]

The G5, composed of Germany, Spain, France, Italy, and the United Kingdom, welcomed the proposal and agreed that, in the absence of a global consensus under the G20/OECD, it was necessary to move forward at EU level. However, there are reportedly significant differences of opinion among the 28 Member States.

The Tax Justice Network welcomed the proposal, underlining that it would ensure that taxable profits were allocated proportionately to the share of activity in the EU Member States. The network argued that the EU had set a course to a dramatic shift in international tax rules, which needed to be followed globally in order to protect the tax base of lower income countries in particular. Framing this policy in an international forum would enable all countries to act against the tax abuses of multinational companies.

Oxfam considered that the proposal was what EU tax rules needed in the 21st century. It stated that the challenge of addressing the way in which technological change transformed industries and business models had been recognised in the new rules and that they could help both richer and poorer countries who were all currently missing out on tax revenues. It also called on the Member States to work together in order to fundamentally reform the tax system to 'ensure that the tech industry pays its fair share of tax.'

The think-tank Global Digital Foundation argued that it might be in the interests of digital companies to address the prevalent criticism regarding their tax obligations. It maintained that normalising the fiscal relationship with the EU under the new proposal would be helpful in improving their relationship with policymakers.

Trade unions represented by Public Services International welcomed the proposal as a 'good first step to address public outrage over the dodgy tax practices of some of the world's biggest corporations'. It reiterated that tech companies needed to pay their fair share of taxes and that the EU proposal highlighted problems with the current lack of an effective tax tool in the digital realm.

Abdulkadir Kahraman, of consultancy firm KPMG Turkey, argues that taxing digital businesses requires global policy consensus to be successful in reaching its objectives and avoid possible double taxation. On the other hand, he recognises that the proposal provides a solution to two of the main challenges of taxing digital activities: it would eliminate the need for physical presence in a Member State for tax purposes and include user data, which has increasing economic significance in terms of distribution of earnings.

The Association of Chartered Certified Accountants (ACCA) underlined that the EU proposal for digital taxation could not be separated from global tax policy. The ACCA added that the line between pure digital businesses and conventional ones was increasingly blurred for taxation purposes as the latter also utilised digital tools when conducting business.

The OECD recognises the significance of 'a shift in value creation' occurring in the digital economy, underlining that there is no roadmap on how this phenomenon should be reflected in the tax policy of its members, which are divided on the issue. However, it also considers[8] that developing an EU-level solution before a global one, while likely to increase taxation of the digital economy, comes with the risk of 'economic distortions, double taxation, increased uncertainty and complexity, and associated compliance costs for businesses operating cross-border and, in some cases, may potentially conflict with some existing bilateral tax treaties'.

Lobby groups for large technology companies have reportedly criticised the proposal, saying that the EU should focus on OECD efforts to find an international solution and that linking revenue-based taxation to the number of users would also increase the burden on start-ups and scale-ups.

Academic views

In response to the Commission consultation, researchers from the Oxford University Centre for Business Taxation stated their preference for an in-depth reform of the corporate tax system that seeks to tax companies where their *immobile* factors (shareholders or consumers) are located. It recommended allocating taxing rights to the destination country (i.e. where consumers are located).

Gómez Requena and Moreno González analyse the concept of permanent establishment in international tax law and its validity in the digital era. They show that the current framework facilitates a loss of tax revenue and recommend establishing a 'new taxable nexus for taxing ... in source countries adapted to the current context of digital commerce'.

Similarly, Santos and Lopes find that the permanent establishment concept is obsolete in a digital economy and see an increasing need for its definition to be updated.

Legislative process

To adopt the directive, the Council needs unanimity, after consulting the European Parliament. The examination of the proposal is being carried out under the 'Working party on tax questions (direct taxation)'. The Commission gave a presentation to the Council in April 2018 and to Parliament's Economic and Monetary Affairs Committee (ECON) in May 2018.

In Parliament, the ECON committee appointed Dariusz Rosati (EPP, Poland) as rapporteur. He published the draft report on 18 September 2018 and the Committee adopted its report on 3 December. The ECON committee insists that the concept of significant digital presence and the proposed solutions should become an integral part of the directives on CCTB and CCCTB, which are currently under discussion in Council. The report suggests widening the scope of the tax by including in the definition of digital services the sale of goods or services contracted online via digital interfaces (e-commerce platforms), and by including in the economically significant activities the exploitation and transmission of user-level data. It adds a threshold to determine a significant digital presence: if the volume of data in the form of digital content collected by the taxpayer in a taxable year exceeds 10 % of the group’s overall stored digital content.

To clarify the practicalities, the Commission would issue guidelines for tax authorities on how a significant digital presence and digital services are to be identified, measured and taxed. Based on these, the Commission would also establish another set of guidelines, with a clear methodology for companies to self-assess which of their activities constitute a significant digital presence. Both EU and non-EU companies would be allowed to appeal a decision that the services they provide are digital, in accordance with national law. The committee calls to ensure that small and medium-sized enterprises are not unduly taxed. The report also requests the inclusion of an observer from the European Parliament in the 'DigiTax Committee'. That committee would evaluate the correct implementation of the directive and be able to gather data from national tax authorities. Its role would also include facilitating cooperation between national authorities in order to minimise the possibility of double-taxation and double non-taxation. The report also seeks to clarify the rules for delegated acts. The proposed time for evaluation of the implementation of the directive by the Commission would be shortened from five to three years. The evaluation results would be presented not only to the Council but also to the European Parliament. In the evaluation, the Commission should focus on administrative burden and additional costs for companies, especially for SMEs and on the impact of the taxation system on the Member States' revenues, the users' personal data and on the Single Market.

The report will be put to the vote during the December 2018 plenary session.

EP SUPPORTING ANALYSIS

Delivorias A., Common consolidated corporate tax base (CCCTB), EU legislation in progress, EPRS, European Parliament, September 2017.

Remeur C., Understanding the OECD tax plan to address 'base erosion and profit shifting' – BEPS, EPRS, European Parliament, June 2017.

Remeur C. and Delivorias A., Common (consolidated) corporate tax base, EPRS, European Parliament, March 2017.

Tax Challenges in the Digital Economy, Policy Department for Economic and Scientific Policy, European Parliament, April 2016.

FURTHER READING

Corporate taxation of a significant digital presence, European Parliament, Legislative Observatory (OEIL).

ENDNOTES

1 See Council Directives (EU) 2015/2376, 2016/881 and 2016/2258 as well as proposed directives COM(2016) 198 and COM(2017) 335.

2 The Commissioner for economic and financial affairs, taxation and customs, Pierre Moscovici believes that given the differences in the positions of the global players, reaching a workable international deal for digital taxation seems to be an 'illusion' at the moment. He has also said that the US policymakers 'shared awareness that the problem is at international level, as it is not enough to tax companies on their physical presence and the question of digital presence has to be resolved'. He added that the USA had agreed to advance the work at G20 level but understood that the EU needed to move forward to avoid the fragmentation of its single market.

3 One free-trade think tank takes the opposite view and argues that the average corporate tax rates of many digital companies are actually much higher than the Commission estimates.

4 A United Nations Report shows that companies with predominantly digital activities have less need to be physically present when operating abroad: only half of the affiliates of digital multinationals are foreign-based, compared with 80 % for traditional multinationals (p. 174).

5 See p.1 of the proposal for a directive.

6 In separate recommendation, the Commission advised Member States to adapt their double tax treaties with non-EU countries in line with the proposal, with particular regard to the definition of permanent establishment and rules for how profits should be attributed to a significant digital presence.

7 This section aims to provide a flavour of the debate and is not intended to be an exhaustive account of all different views on the proposal. Additional information can be found in related publications listed under 'EP supporting analysis'.

8 See the 2018 report on Tax challenges arising from digitalisation, p.159.

DISCLAIMER AND COPYRIGHT

eprs@ep.europa.eu (contact)

www.eprs.ep.parl.union.eu (intranet)

www.europarl.europa.eu/thinktank (internet)

http://epthinktank.eu (blog)

Second edition. The 'EU Legislation in Progress' briefings are updated at key stages throughout the legislative procedure.