

# Digital taxation

## State of play and way forward

### SUMMARY

The digitalisation of the economy and society poses new tax policy challenges. One of the main questions is how to correctly capture value and tax businesses characterised by a reliance on intangible assets, no or insignificant physical presence in the tax jurisdictions where commercial activities are carried out (scale without mass), and a considerable user role in value creation. Current tax rules are struggling to cope with the emerging realities of these new economic models.

The European Union (EU) and other international bodies have been discussing these issues for some time. In March 2018, the EU introduced a 'fair taxation of the digital economy' package. It contained proposals for an interim and long-term digital tax. The European Parliament supported both proposals, widening their scope and coverage and backing integration of digital tax into the proposed Council framework on corporate taxation. However, there was no immediate political agreement in the Council. As finding a global solution at Organisation for Economic Co-operation and Development (OECD) level or a coordinated EU approach was not yet feasible, some Member States started implementing or designing national digital taxes. As an indication of difficulties around this issue, the introduction of these taxes in France heightened trade tensions between the EU and the United States of America, with the latter favouring a 'voluntary' tax system – a position which may prevent a global agreement.

Over the last few years, the OECD has nevertheless made progress on developing a global solution and proposed a two-pillar system: while the first pillar (unified approach) would grant new taxation rights and review the current profit allocation and business location-taxation rules, the second (GloBE) aims to mitigate risks stemming from the practices of profit-shifting to jurisdictions where they can be subjected to no, or very low, taxation. The EU is committed to supporting the OECD's work, but if no solution is found by the end of 2020, it will again make a proposal for its own digital tax.



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## Main challenges of taxing the digital economy

The rise of the [digital economy](#) has elicited new fundamental policy questions, which revolve around its effects on competition and the need to adapt existing tax systems to a digitalised economy. The current international taxation framework, based largely on principles developed in the early 20th century, is no longer entirely relevant and is increasingly called into question as it is tailored to a less globalised economy and relies on a physical presence in a territory that allows for a nexus between business and tax jurisdictions. The European Commission estimates that digital businesses pay a lower effective [tax rate](#) than traditional business models. While under-taxation of the digital economy is challenged by some [studies](#), there is a growing international consensus that the current rules need to be adapted. This is even more important when taking the sheer [scale](#) of online transactions and their ever-expanding reach into account.

The academic literature and international bodies, such as the Organisation for Economic Co-operation and Development ([OECD](#)), International Monetary Fund ([IMF](#)) and the United Nations ([UN](#)), have identified the main [tax challenges](#) of the digital economy. To start with, online business can be carried out without any physical presence, while the current tax rules were originally designed for the 'bricks and mortar' type of business, or in other words, those that have permanent establishment. Broadly, most tax treaties are based either on the UN Model Tax Convention or the OECD Model Tax Convention, both of which use the 'permanent establishment' concept when determining whether a company is liable to taxation. Foreign enterprise is taxable only if it has a presence that is equivalent to such [establishment](#), which is broadly defined as the place where the business of a given company is wholly or partly conducted. Jurisdictions can tax companies only if the 'tax nexus' is determined to exist in a given jurisdiction.<sup>1</sup> However, digitalisation allows companies to engage in significant business activities without meeting a criteria for a permanent establishment in the jurisdiction. This is what the OECD calls 'scale without mass'. Such commercial presence need not be accompanied by a physical presence, which can lead to a situation in which taxes do not reflect the value and profits created by an enterprise. The assets and activities of digital businesses can easily be moved across jurisdictions to avoid a taxable presence in those where taxes are higher. Furthermore, there is a risk that vendors on online platforms skip registration in third countries where they effectively conduct transactions. Companies may create [value](#), or parts of it, in a different jurisdiction to that where they are physically present. These practices render determination of the jurisdiction competent to tax a multinational or digital company complex and current rules might result in substantial activity without a right of taxation.

Another difficulty arises due to the increasing reliance of digital or transnational businesses on [intangible assets](#), such as software and algorithms, which are crucial to many new business models. These [assets](#) are easy to move around the [world](#), which facilitates the process of [structuring](#) companies in such a way that their tax liabilities are minimised. Tax authorities subsequently find it increasingly difficult to determine correctly how to identify income generated by intangibles and how such income is allocated amongst different entities forming the multinational groups. The '[arm's length principle](#)' determines how to value transactions between these related entities by setting the amount that they charge each other, known as the 'transfer price'.<sup>2</sup> This price should be the same as if the entities were independent, in other words, what they would have to pay on an open market. The principle aims to prevent price manipulation and tax avoidance. However, in the digital economy, a large part of profits are generated from unique intangibles such as databases, software and algorithms, and marketing activities making use of brands and trademarks, which are specific and valuable only to a given company. As such, a comparable, free market price is often difficult to determine, which impairs the application of the arm's length principle. As a result, digital businesses (due to the nature of their activities) and multinationals (due to their global activity) can actively use transfer pricing rules to maximise [costs](#), which are attributed to their subsidiaries in higher-tax jurisdictions, thereby reducing the taxable income. In parallel, they can increase the taxable income realised by the entity located in the lower-tax jurisdiction. In addition, legal

uncertainty may arise due to other broader phenomena, such as the incorporation of [services](#), which increasingly rely on intangibles, into manufacturing.

Furthermore, highly digitalised businesses rely heavily on the use of data and user-generated content. This leads to a situation where it is difficult to determine to what extent the users, who allow platforms to use their data in exchange for free access, contribute to value creation. Some, including the EU, support the notion that taxes should be levied in the country where users are located, since they contribute to value creation and network effects. Indeed, businesses benefit greatly from data analysis, and user data are often sold to online advertisers. However, the value of data collected by a business would not generally figure on its [balance sheet](#) and therefore would not be taken into account when determining income liable for taxation.<sup>3</sup> Countries such as the USA refuse to take user-generated data into account for taxation purposes. The current lack of updated rules makes it very challenging to establish exactly how and where value is created, and there is no agreed uniform way of assessing the tax bases and the tax nexus for digitalised businesses.

In addition, the digital economy has increased the complexity of characterising income for tax purposes. The main issue is whether certain rather novel payments and transactions (for example, [infrastructure as a service](#) business models), should be treated as business profits or classified as royalties or technical services. Under current treaties, business profits would be subject to corporate tax on net income in a country if they could be attributed to a permanent establishment located therein. On the other hand, royalties and technical services may be subject to withholding tax in the country of the payer. Since the characterisation of income has become very difficult in the digital economy, it may, in effect, lead to taxation mismatches and loopholes.

To paint a more complete picture, it is worth mentioning that the constantly evolving digital economy poses a host of other tax challenges, which are beyond the scope of this briefing. For example, some online transactions made through platforms, particularly peer-to-peer transactions, may not reveal the identity of users and the payment amount, thereby facilitating tax fraud. Entirely different challenges are connected with shifts in working patterns and the taxable status of workers, due to the rise of 'gig' and [collaborative economies](#). Furthermore, a 2019 [study](#) for the European Parliament Special Committee on Financial Crimes, Tax Evasion and Tax Avoidance (TAX3) mentions that 'delivery channels and business models, such as service-oriented models using software or hardware, cloud computing, 3D printing, collaborative platforms and blockchain, pose legal uncertainty for both taxpayers and administrations, as they are hardly matched by existing rules. The sheer diversity of the digital businesses and digital businesses using multiple business lines are further tax challenges, which shall be addressed by robust measures that would last in face of rapid digital evolution'. Further issues arise with regards to indirect taxation, mainly value added tax (VAT). These issues concern import of low value parcels which are exempted from VAT and difficulties in enforcing VAT payments on services and intangibles, particularly those sold to private consumers. The EU adopted new [rules](#) on [VAT for cross-border goods trade](#) in November 2019, which partially address these issues. They simplify VAT rules, notably for online transactions, and remove VAT exemption for the low-value consignments.

## European Union and fair taxation of digital economy

The digital taxation issue has been discussed in the EU over the last few years,<sup>4</sup> as well as globally, with efforts carried out under the Group of Twenty (G20)/OECD [base erosion and profit sharing action plan](#) (known as BEPS). The EU position is that digital taxation needs to be addressed with an interim, temporary solution accompanied by a long-term, permanent fix. The reasons behind the proposals included a desire to mitigate the risk of fragmentation of the single market elevated by the emergence of unilateral national measures, as well as to anticipate measures on this issue which would help to shape global discussion under the BEPS. The European Commission proposed a package on [fair taxation of the digital economy](#) on 21 March 2018.

The [interim proposal](#) was for a Council directive which would tax revenues created by certain digital services that are currently untaxed, such as those generated by selling online advertising space, by digital intermediary activities between users (which facilitate the sale of goods and services), and by the sale of data generated by users. It would apply only to enterprises operating above two thresholds: with total annual worldwide revenues above €750 million, and total annual EU revenues exceeding €50 million. The Commission proposed a single rate of 3%, to be levied on gross revenues obtained from the provision of those digital services for which user value creation is crucial. It would apply to both non-resident and domestic firms and to domestic and cross-border transactions. Tax revenues would be allocated to each Member State proportionately to the number of users of the taxable service. The Commission intended for this tax to be temporary until the implementation of the comprehensive reform envisaged in the second proposal.

The [long-term solution](#) proposed was to be a Council directive determining 'where' and 'what' to tax in the digital economy. It defined a 'significant digital presence', which can be established even when there is no physical presence in the Member State's territory. Businesses would be liable for tax if they meet at least one of these criteria in a taxable year: annual revenue exceeding €7 million; over 100 000 users in a Member State; more than 3 000 business-to-business contracts for digital services concluded by the company. A proportionate share of profits would then be taxable in the Member State in which the business had a taxable digital presence. The rate would be equivalent to 'bricks and mortar' establishments. The tax would cover not only corporate taxpayers incorporated or established in the Union, but also those incorporated or established in a non-EU jurisdiction with which there is no double taxation treaty with the Member State in which a significant digital presence of the taxpayer is identified.

Taxation is subject to unanimous agreement in the Council of the European Union, with European Parliament involvement limited to giving a non-binding opinion under the consultation procedure. Parliament has generally supported fair taxation of the digital economy. It supported the Commission [proposal](#) on the common consolidated corporate [tax](#) base (CCCTB), which was designed to distribute the tax base among the Member States. As early as March 2018, Parliament voted to introduce the concept of [digital permanent establishment](#). Parliament thereby supported the proposal that companies which generate revenues in a Member State without having a physical presence, but have a digital permanent establishment, are treated for tax purposes in the same way as those with physical permanent establishments. The CCCTB proposal has, however, been blocked in the Council. Similarly, [Parliament](#) supported both short- and long-term solutions tabled by the Commission, widening their [scope and coverage](#) and backing integration of the concept of significant digital presence in the proposed Council directives on corporate taxation.<sup>5</sup> The Council however gave [preference](#) to working until the end of 2020 towards reaching a global solution at OECD level, and postponed work on these proposals.

## Digital taxes at Member State level

In the absence of immediate measures on digital taxation at EU or global level, some Member States have decided to continue with national initiatives. Others have announced plans to implement these taxes or to wait for international solutions. Many of the national taxes have features in common with the 2018 Commission proposal, such as the global threshold and the tax basis. The section below gives a brief overview of digital tax developments in the European Union.

### Hungary

An advertisement tax was introduced in 2014, on the turnover from broadcasting or publication of advertisements, with several progressive tax rates ranging from 0% to 50%. After a 2015 European Commission [investigation](#) found that this tax constituted State aid and was therefore incompatible with competition law, Hungary replaced these progressive rates with two rates: a 0% rate for the part of the taxable revenues below HUF100 million (approximately €312 000) and a 5.3% rate for the part of the taxable amount higher than the aforementioned threshold. Hungary then raised the

latter to 7.5 % for taxpayers with sales revenues from advertising exceeding HUF100 million. In 2017, the European Court of Justice (ECJ) annulled the Commission decision; however, Hungary suspended the tax temporarily by setting its rate to 0 % between 1 July 2019 and 31 December 2022. Interestingly, there is an ongoing case before the ECJ to determine whether Google has disregarded its obligation to register for advertising tax in Hungary. The Advocate-General argued that the fine for failing to register constitutes a [restriction](#) of the freedom to provide services. In a more general comment regarding digital taxes, she stated that the connection to the use of a country's language constitutes a sufficient territorial link for taxation.

## Slovakia

The Slovakian tax, which covers income obtained by digital platforms and websites for intermediating services in transport and accommodation, was introduced in 2017. Effective from 1 January 2018, this tax considered these businesses to have [permanent establishments](#) in Slovakia and therefore eligible to pay a 21 % corporate tax rate.

## France

On 24 July 2019, the French [Digital Services Tax](#) (DST) became law, applying from January 2019. The tax will apply to companies with global digital turnover of more than €750 million and digital turnover of more than €25 million in France. It covers targeted online advertising, the management and sale of user data for advertising and connecting users through digital platforms. It is applied at a 3 % rate on the gross revenues generated by those digital activities where French users play a major role in value creation. The government expects the tax to deliver €400 million in 2019, gradually increasing to €650 million in 2022. Introduction of this tax sparked tension with the USA (discussed below). If an agreement is reached at OECD level, this will replace the current DST.

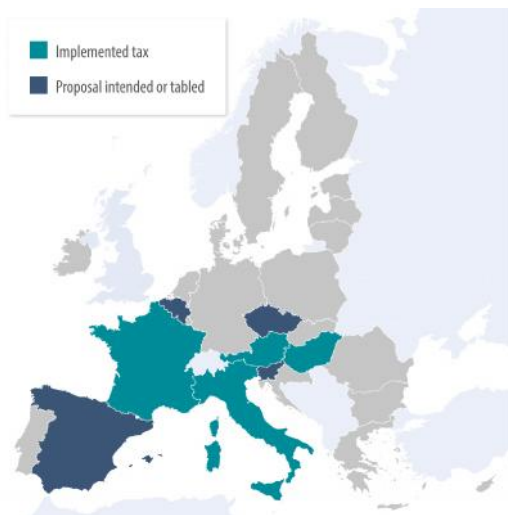
## Italy

The Italian [web tax](#), effective as of 1 January 2019, applies to digital business-to-business transactions and is due by residents and non-resident enterprises. It applies to companies providing more than 3 000 transactions annually at a rate of 3 %, levied on the service fees charged. Italy also introduced its own [DST](#) as of 1 January 2020, at a rate of 3 %. This tax covers companies with total worldwide revenues of €750 million and revenues of at least €5.5 million obtained from digital services provided in Italy. These services, which generate taxable revenues, include targeted advertising on a digital interface, linking users of multi-sided digital interfaces, and transmitting user data generated from the use of platforms. It will be repealed once an international solution is agreed.

## Austria

The Austrian [DST](#), adopted in 2019, is effective as of 1 January 2020. It applies to companies with global turnover of €750 million or more, and a national turnover of at least €25 million. Revenues from domestic online advertising services are liable for taxation when they are targeted at Austrian users. The tax rate has been set at 5 %.

Figure 1 – Digital taxation in the EU



Source: EPRS, Author's elaboration.

## Other countries

Changes of government in countries such as [Belgium](#) and [Spain](#) have made adoption of national initiatives uncertain. Currently, the [Czech Parliament](#) is considering a 7 % DST to apply in 2020, and the [Slovenian government](#) is preparing a draft proposal to be tabled by April 2020.

## The OECD proposals

Over the last few years, the OECD has intensified its work on the tax challenges posed by digitalisation, which resulted in proposals for a global solution being tabled in October 2019.<sup>6</sup> The new system, endorsed by the G20 finance ministers and leaders, is to be based on two pillars, which have been developed taking account of input from work carried out within the BEPS and the wider [inclusive framework](#), as well as from stakeholders.<sup>7</sup>

For the first pillar, the OECD proposed a '[unified approach](#)'. This focuses on the creation of new taxation rights and reviews the current profit allocation and business location-taxation nexus rules, since all three elements are interlinked. The proposal not only covers highly digital business models but also, more broadly, large consumer-facing businesses.<sup>8</sup> It creates a new 'tax nexus' model, which is predominantly based on sales instead of physical presence. This nexus would be established whenever a business has a sustained and significant involvement in the economy of a tax jurisdiction – such as through interaction and engagement with consumers. To avoid dependence on physical presence, it would be based on a revenue threshold in the market. It would also take activities, such as online advertising services directed at non-paying users located in jurisdictions different from those in which the corresponding revenues are booked, into account.

Once it is established that a country has a right to tax a non-resident company, the unified approach also proposes ways to determine the share of profits allocated to a given jurisdiction. These rules would go beyond the current 'arm's length' principle. The new profit allocation rule will be applicable to enterprises irrespective of whether they have a local marketing or distribution presence (either through permanent establishment or a subsidiary), or conduct commercial activities through unrelated distributors. Current transfer pricing rules would be complemented by a new model in areas where issues arising due to digitalisation are prominent. The OECD proposes using a three-tier mechanism. First, a jurisdiction would have a taxation right over a portion of a multinational enterprise's profits, deemed 'residual profit', which would be calculated after excluding profits generated by its routine functions.<sup>9</sup> Second, the proposal introduces a fixed remuneration for baseline marketing and distribution activities that are conducted in the given market jurisdiction. Third, in cases where in-country marketing and distribution functions exceed this baseline – possibly giving grounds to additional taxable profits – a binding and effective dispute resolution mechanism is proposed, to prevent double taxation and end disagreement between taxpayers and tax administrations.

The second pillar, also referred to as the '[global anti-base erosion proposal](#)' (GloBE), contains measures to mitigate risks stemming from the practices of profit-shifting to jurisdictions where the multinational enterprises may be subject to no, or very low, taxation. The GloBE proposal deviates from another current cornerstone rule, which is to tax income where value is created, by applying four new principles. They would only activate when various incomes are not already subject to taxation at least at a minimum rate or are not taxed at all. First, under an 'income inclusion' rule, the income of a foreign branch or a controlled entity would become taxable. Second, a 'switch-over rule' would allow a residence jurisdiction to replace the income exemption with a foreign tax credit. This is needed to tax the profits of foreign branches and subsidiaries attributable to a permanent establishment or derived from immovable property. Third, an 'undertaxed payments rule' would deny a deduction or impose a source-based taxation (such as a [withholding tax](#)) for a payment to a related party. Fourth, a 'subject to tax' rule, complementary to the previous principle, would subject a payment to withholding or other taxes at source. It would also change eligibility for any tax treaty benefits on certain items of income where the payment is not subject to a minimum tax rate. The

changes proposed would require modifications to domestic law as well as to tax treaties, such as those covering double taxation. The GloBE focus on ensuring that minimum tax rate dues are paid aims at reducing the incentive to engage in profit-shifting and sets a limit for tax competition among jurisdictions, thereby preventing a 'race to the bottom'.

## Way forward

The Council is monitoring developments at the OECD and has postponed work on EU taxes until the end of 2020. The von der Leyen Commission's position is firstly to commit to achieving a solution under the OECD/G20 framework. Should no consensus be reached by the end of 2020, the EU will prepare a new proposal for a fair European digital tax. During his 2019 hearing before the European Parliament, then Commissioner-designate for Economy [Paolo Gentiloni](#) said that 'If there is no consensus emerging ... in the third quarter of next year we will work on the European proposal'. In its January 2020 meeting the [Economic and Financial Affairs Council](#) agreed that an 'international solution on digital taxation was the best way forward, as it would prevent fragmentation and unilateral measures'.

While it is true that work under the G20/OECD agenda is progressing, taxing digital businesses remains a contentious issue worldwide, mainly because it implies a change: a genuine reallocation means that there will be winners and losers. Nonetheless, the G20/OECD work has delivered outcomes, and the shift to taxing all multinationals – without a special focus on digital businesses – has been welcomed by a large number of [stakeholders](#), since it grants many countries new taxation rights at the expense of big multinational companies and restricts the number of low tax jurisdictions. Moreover, taxation [experts](#) consider the less contentious GloBE proposal favourably.

However, in December 2019, the US position on the G20/OECD work shifted, as it preferred voluntary, rather than mandatory, digital taxes. This shift has increased doubts as to the possibility of finding an effective global solution. During the 2020 World Economic Forum in Davos, US representatives maintained that any international digital taxes must follow '[safe harbour](#)' rules; however, these rules would be reformulated to avoid declaring the taxes 'optional'. Many observers see this as a unilateral approach, without genuine support for finding a global solution.

In January 2020, the OECD/G20 Inclusive Framework on BEPS issued a [statement](#) underlining that many of its members are concerned about implementing pillar one on a 'safe harbour' basis, as this may lead to new difficulties, heighten uncertainty, and risk failing to meet overall policy objectives. Resolving this issue remains crucial to reaching consensus. During its next meeting, scheduled for July 2020, the Inclusive Framework will seek to reach agreement on all the controversial pillar one issues, while the deadline for a complete consensus based solution remains the end of 2020.

While tensions have been reduced, it remains to be seen whether efforts to reach a global consensus will succeed, as the situation continues to be rather fragile. In the case of a failure to reach a global solution, the most likely outcome is the implementation of a plethora of national solutions, which could aggravate the current situation.

### France and USA: trade tensions over digital tax

While many Member States have introduced DTS, plans to do the same in France have provoked a particularly strong reaction from the Trump administration. In December 2019, a US [investigation](#) concluded that the French DST was 'unreasonable, discriminatory, and burdens US commerce'. The US government then proposed the imposition of 100 % tariffs on up to US\$2.4 billion of French goods, such as champagne, cheese and handbags. The situation moved closer to a trade war between the USA and the EU, which signalled that the latter would support [France](#) should tariffs be imposed. Ultimately, a de-escalation seems to have occurred, at least temporarily, during the 2020 World Economic Forum in Davos, where both sides agreed to work on a [global solution](#), with the aim of reaching agreement by the end of 2020.

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[Secretariat proposal for a 'unified approach' under pillar one](#), OECD, October 2019.

## ENDNOTES

- <sup>1</sup> For taxation purposes, nexus can be defined as the tax liability of the taxpayer in a specific tax jurisdiction.
- <sup>2</sup> The charges could be, for example, for inputs, finished products, delivered services, or the use of intellectual property rights.
- <sup>3</sup> The [OECD](#) also raises the point that valuing data as an asset becomes even more complex due to legal questions about data ownership. Under most legislation, it is considered to be the property of the individual from whom it is derived.
- <sup>4</sup> This was evident in the outcome of the September 2017 [Digital Summit](#) in Tallinn, as well as in the [conclusions](#) of the European Council in October 2017, which called for the Commission to propose measures on digital taxation by early 2018. Member States then broadly agreed that the proposals should include both long-term and interim solutions, in December 2017.
- <sup>5</sup> These concerned both, the [common corporate tax base](#) proposal ([CCTB](#)) and the [common consolidated corporate tax base](#) proposal ([CCCTB](#)). On the digital services tax, Parliament proposed to lower the [threshold](#) above which companies would need to pay the tax from €50 million to €40 million and broaden the tax base. Considering the significant digital presence tax, Parliament also expanded its definition and added additional criterion determining such presence.
- <sup>6</sup> The OECD started its work with the publication of a 2015 report called [BEPS Action 1 - Addressing the Tax Challenges of the Digital Economy](#), which identified the main risks (nexus, data and characterisation) and presented policy options to mitigate them. This was followed in 2018, by an [interim report](#) that analysed the impact of digitalisation on business models and international tax systems, and in 2019, by a [policy note](#) in which it proposed a two-pillar approach. Consequently, a [public consultation](#) took place, and the OECD launched a [programme of work](#) to develop a consensus solution with detailed instructions on how to fix identified challenges by the end of 2020.
- <sup>7</sup> The proposals were developed within the [OECD/G20 Inclusive Framework on BEPS](#), comprising over 135 countries and jurisdictions that work together on the implementation of 15 measures to tackle tax avoidance, improve the coherence of international tax rules and to ensure a more transparent tax environment.
- <sup>8</sup> The OECD defines these as 'businesses that generate revenue from supplying consumer products or providing digital services that have a consumer facing element'. This means that some sectors like extractive industries and commodities would be excluded. .
- <sup>9</sup> A taxable, '[non-routine](#)' part of profits could be, for example, those obtained from the intangibles.

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