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TAX CHALLENGES IN THE DIGITAL SECTOR

In my study for the TAXE 2 Committee of 2016, I had analysed direct and indirect tax challenges in the digital economy in light of the conclusions of the OECD's BEPS (Base Erosion and Profit Shifting) Project. While assessing the recent reforms in the area of taxation within the EU and third countries, the study discussed whether or not specific measures were needed for the digital sector and made policy recommendations for tax reforms to tackle tax avoidance and harmful competition.

As the digital goods are highly mobile and intangible, physical presence of a company in the market country is no longer needed. Moreover, some digital businesses heavily rely on network effects, user participation and user-generated content for their survival. New business models (described as subscription, access or advertisement models in my previous study) are not confined by national boundaries and can develop strategies to avoid tax payment in the jurisdiction where value is created.

As the business models are rapidly evolving with many digital companies having multiple business lines, the differentiation between multi-sided platforms and other digitalised businesses becomes challenging. In its report of 2018, the OECD refers to four business models: multi-sided platforms, resellers, vertically integrated firms and input suppliers. The value creation process is also going under a transformation and can be divided into three categories: value chain (brick-and mortar businesses), value network (multi-sided platforms) and value shop (cloud computing).

The OECD's 15 BEPS Actions

The OECD was effective at setting minimum standards with: Substantial activity requirement for preferential regimes (Action 5), measures to prevent treaty shopping (Action 6), improving transparency by Country-by-Country Reporting (Action 13) and ensuring greater certainty by effective dispute resolution (Action 14). The impact of BEPS measures can already be seen: IP regimes linking research and development expenditure to tax benefits with the new nexus approach, the use of cash-boxes under the new transfer pricing rules, the use of trade structures based on remote sales…. but some actions which are most relevant for digitalisation are rather at an embryo stage (Action 7, Action 8-10 and Action 3).

In the area of direct taxation, the implementation of some actions was rather slow as there is no consensus among different countries (e.g. Action 7 on Permanent Establishment). Nevertheless, some MNEs such as Amazon, eBay and Facebook started changing their trade structures based on remote sales models to local reseller models while reconsidering their transfer pricing positions and relocating valuable assets in jurisdictions where economic activities take place (On-shoring of assets).

Actions 8-10 dealing with intangibles, allocation of risks and transactions with third parties resulted in OECD Transfer Pricing Guidelines in 2016 but their effective implementation depends on domestic legislations. The good news is that the tax administrations are now

better equipped to address profit shifting by MNE groups, such as transfer pricing. They also use specific technologies, such as data recording technology, which permitted Hungary, for instance, to increase its VAT revenues by 15 percent.

Some progress could be seen in Action 3 (CFC rules).
The recent US tax reform of 2017 includes strengthened CFC rules (Action 3), with a new feature based on excess profit analysis: the tax on global intangible low-taxed income (GILTI). Similar arrangements have taken place in Japan and in the EU (ATAD), Colombia and Chile. The US implications of the use tax reform addressing CFC rules and hybrid mismatches shall be further discussed. Some believe that its implications would be far-fetched while others argue that it would not necessarily affect what MNEs do, as the US tax system already allowed for many exceptions in the past.

In the area of indirect taxes, the simplified compliance regime introduced by the EU in 2015 following the OECD recommendations resulted in an excess of EUR 3 billion.

Nevertheless, some issues relevant to the digital sector, which are beyond the scope of BEPS, such as data, nexus and characterisation, need to be addressed as quickly as possible.

In the absence of a consensus, some countries already started to introduce unilateral measures specific to the digital sector. (Israel's significant economic presence test, India's new nexus and equalisation levy, Italy's levy on digital transactions, Hungary's advertisement tax, France's tax on online and physical distribution of audio visual content, the United Kingdom's Diverted Profits Tax, the United States' Base erosion and anti-abuse tax…). There are a number of risks and adverse consequences arising from such measures: Adverse impact on investment, innovation, growth and welfare, potential economic incidence of taxation on consumers and businesses, possibility of over-taxation, possible difficulties in implementation, compliance and administration costs.

Such measures shall be designed carefully to be in accordance with the OECD and UN Model Tax Conventions, EU membership obligations (4 fundamental freedoms and state aid), WTO membership while targeting businesses constituting the highest risk, combining high levels of scale without mass and having business models intensively relying on user participation and network effects, such as Internet advertising and intermediation services.

The following existential question arises once more: Shall we adapt the international tax system to address broader challenges posed by the digital sector? While there is no consensus on this issue within the OECD, many countries agree that more attention shall be paid to the nexus rule and profit allocation rules.

Acknowledging that it is impossible to ring-fence the digital economy from the rest of the economy, some features of the digital sector such as gig and sharing economy, increase in peer to peer transactions, the development of technologies such as blockchain, growing data collection deserve our attention.

Tax Developments in the EU

The Commission's Directives of 21 March 2018 the aim at introducing an interim revenue tax which would be followed by a new Directive on digital Permanent Establishment in the long-term. The European Parliament had implicitly expressed its preference for a digital Permanent Establishment as well as for the CCCTB on 15 March.

The objective of the interim measure called Digital Service Tax would be taxing large digital companies at a rate of 3 percent. It is unclear why the long-term measure was not proposed under the umbrella of the CCCTB. At the same time, the CCCTB has its limits and may trigger a race to the bottom in the absence of a more holistic approach.

Member States remain divided over the proposal, largely because of the digital gap among them. For instance, Luxembourg, Ireland and the Netherlands are not in favour of the Commission proposal. It can be argued that such a measure could be over-protectionist risking alienating digital firms, which are important for the growth and technological advancement of the EU. In this case, a more global solution would be preferable.

- 'Tax Challenges in the Digital Economy', European Parliament Directorate-General for Internal Policies, Policy Department A. Economic and Scientific Policy. Economic and Monetary Affairs. Study for the TAXE 2 Committee.

- 'Tax Challenges Arising from Digitalisation-Interim Report 2019', OECD/G20 Base Erosion and Profit Shifting Project