N O V E

DIGITAL TAX PACKAGE

MONDAY 26 MARCH 2018

BACKGROUND

CONTEXT

On Wednesday 21 March, the European Commission (EC) released a package of measures to establish a digital tax in the European Union (EU). The package contains two directives, one providing a "comprehensive solution" amending EU corporate tax law to better account for significant digital presence across the Single Market[1], the other an interim "targeted solution" proposing a Digital Services Tax (DST) on the revenues of large internet companies and platforms[2]. Accompanying the two legislative proposals is a 161-page impact assessment, a Recommendation advising the EU's 28 countries on how to amend their double taxation treaties with third countries in light of the new proposals, and a Communication explaining the rationale for the measures.

ANALYSIS

The digital tax package could have far-reaching consequences for internet platforms and, if taken with the plans to harmonise the EU's corporate tax base through the Common Consolidated Corporate Tax Base (CCCTB), could re-cast the EU's tax system to better reflect a digitalised economy.

While the EC hopes that the proposals will be adopted before May 2019 (i.e. before the European elections), it appears already that Member States are divided on the need for a new tax. Smaller Member States, for example, argue it will either cause damage to their banking systems (Ireland, Luxembourg, Netherlands and Cyprus) or not benefit them at all because the threshold for the companies concerned is too high (Czech Republic, Slovakia). The need for unanimous support to enact tax reform and growing opposition to the plans for a DST could lead to only a partial agreement in favour of soft law measures, such as rules on "Significant Digital Presence". Progress on the discussions will be known in late April, following the meeting of Finance Ministers on the issue in Sofia, at which time the OECD will release its own policy recommendations for measures at international level.

This note outlines the main points contained in the EC's proposals as well as reactions from major stakeholders released so far. The note includes three Annexes, providing information on how this package complements existing proposals (Annex I), a list of activities included in the scope of the Directive on Significant Digital Presence (Annex II), and a table overviewing the positions of Member States on the DST (Annex III).

NEW PROPOSALS

DIRECTIVE ON RULES FOR SIGNIFICANT DIGITAL PRESENCE ("COMPREHENSIVE SOLUTION")

In its 20-page proposed directive, the EC outlines criteria to help tax authorities identify the taxable digital presence of a company or platform.

According to the EC, rapid digitalisation has enabled companies to provide cross-border services without any significant presence on the territory of the country concerned, leading to massively under-taxed activities. The

[1] Directive 2018/0072 "laying down rules relating to the corporate taxation of a significant digital presence".
[2] Directive 2018/0073 "on the common system of a digital services tax on revenues resulting from the provision of certain digital services".

new rules focus on the users or followers of the given platform and **allow governments to determine the organisation's digital footprint through three user-based criteria:**

i. the company's reliance on a large user base
ii. the nature of user engagement, and
iii. the value created by the users.

By combining the three factors (revenue, number of users, and number of contracts), the directive acknowledges some companies may have a large number of online followers but generate very little revenue, and vice-versa, that a company with a small-user base could generate a high amount of revenue, for example through e-commerce or online marketplace activities.

Taxing digital activity remains complicated. Almost all businesses in the Single Market are more-or-less digitalised. Moreover, **the directive's definition of a digital service (Article 3) remains broad**, i.e. one that is "delivered over the internet or an electronic network and the nature of which renders their supply essentially automated, involving minimal human intervention", which **corresponds to the definition of 'electronically supplied services' used in the Directive laying out the EU's common VAT system[3]**.

To render the proposal more targeted, the proposal sets out **thresholds complementing the three user-based criteria** to ensure the digital presence is "significant" and does not burden start-ups or SMEs. For the company's digital presence to be taxable it must fulfil just **one of the following criteria**:

- Annual revenues exceeding **€7m** in one Member State;
- Over **100,000 users** in a Member State in a taxable year;
- Over **3,000 business contracts** for digital services are created between the company and business users in a taxable year.

The proposal also lays down general principles tackling rules on profit allocation to better identify and value intangible assets, such as user data or advanced data analytics models. **The current framework for attributing profits is the authorised OECD approach (AOA), which the EC argues is outdated, relying too heavily on principles of permanent establishment to tax the company based on the location of its European Headquarters rather than a significant digital presence**. To change this, the EC's guidelines propose that the attribution of profits account for the development, enhancement, maintenance, protection and exploration of intangible assets whenever a platform or company is engaging in economically significant activity through its digital presence[4].

The directive's timeline for adoption is set as 31 December 2019, by which time Member States must have taken the necessary measures to be fully compliant with the provisions.

This proposal is the EC's preferred option, more flexible to apply throughout the Single Market than the second proposal establishing a Digital Services Tax (DST). The EC also hopes to integrate this proposal into the scope of the Common Consolidated Corporate Tax Base (CCCTB), which also contains new rules to profit sharing and allocation[5].

DIRECTIVE ESTABLISHING A DIGITAL SERVICES TAX (TARGETED SOLUTION)

The second proposal is longer (37 pages) and proposes a targeted tax on digital services, a Digital Services Tax (DST), as an interim measure that would generate immediate returns for Member States and, most importantly for the EC, should dissuade Member States like France from adopting their own measures creating diverging tax policies in the Single Market[6]. The DST will **affect an estimated 120-150 large tech companies, of which half are American and a third are European[7]**.

Services falling within the scope (Article 3) of the DST are those where the participation of a user in a digital activity constitutes an "essential input" for the business, in other words, activities that would

[3] Directive 2006/112/EC. For the full list of services covered by Article 3, see attached Annex below.
[4] The OECD is also working on a new profit allocation system, through actions 8 to 10 of the Base Erosion Profit Shifting (BEPS) Framework on Transfer Pricing, covering intangible risks & capital high-risks.
[5] The European Parliament adopted its report on the CCCTB on March 15 2018, but progress is likely to slow as the text reaches the Council. Opposition is expected in the Council from Ireland, Luxembourg, Austria, Hungary, the UK and possibly the Czech Republic.
[6] Some EU countries have already introduced measures for a direct tax targeting digital activity, including in the UK (diverted profits tax in 2015), Italy (administrative procedure for large non-resident companies) and Slovakia (tax on income derived from intermediation through websites and platforms). Outside the EU, examples include Israel, Australia and India. See Impact Assessment, page 55.
[7] Press conference of Pierre Moscovici, Commissioner for Economic and Financial Affairs, 21 March 2018.

not exist without the role played by user-value creation. Within this scope, the directive would apply to two types of digital services:

- **Services that value user-data by making available advertisement space (like Google AdWords) on a digital interface, or the sale of such user-data by social media companies and search engines;**
- **Digital marketplaces or platforms, which the EC defines as "multi-sided digital interfaces" that act as intermediation services allowing users to supply goods and services directly amongst themselves (Airbnb, Uber).**

The directive makes a distinction between the supply of digital content through a digital interface, and the open availability of multi-sided digital interfaces providing intermediary services. **As a result, any service provided to users through a digital interface consisting in the supply of digital content such as video, audio, or text, either owned or not by the supplier, with or without the rights to distribute, are not regarded as intermediation services and therefore excluded from the scope.**

Not included in the scope are: electronically supplied media, streaming, online gaming, IT solutions, but also cloud computing services, which do not depend on user-value based business models, and fintech services that facilitate the granting of loans or crowdfunding service providers. In the last two cases, the value lies not with user but in the ability of such entities to bring together buyers and sellers of financial products under specific conditions.

For companies with taxable revenues, the directive sets a **single rate of 3%** across the EU as long as the company has **global revenues exceeding €750m** and **annual EU revenues** of at least **€50m**[8].

The place of taxation (Article 5) would be determined in the Member State based on where the users are located, following the logic that it is the user's involvement in the digital activities generating the value. The users would be located by their IP address and the revenues would be collected through a One-Stop-Shop (OSS) mechanism (Articles 9-11) so that the company or platform would have a single contact point in the Member State to fulfil all its DST obligations (identification, submission and payment).

While business models as Airbnb, Facebook, Google or Uber are explicitly mentioned in the framework of the targeted solution, there was **no explicit reference to platforms or marketplaces such as Amazon or Alibaba**. Back in September 2017, the Estonian Presidency of the Council criticised these measures as being a "quick fix", for several reasons: the fees collected are usually moderate; income sources for digital companies are volatile and liable to change over time; and because it creates a risk of double taxation. There is currently no international mechanism for relieving the double taxation that could arise from the cumulative effect of applying both corporate income tax and an equalisation levy on the same transaction[9].

The targeted solution is planned to be introduced on a temporary basis until a comprehensive solution is introduced. However, once the interim measure is in place, it is not clear whether Member States would abolish it after the permanent solution comes into force.

RECOMMENDATION ON DOUBLE TAX CONVENTIONS

Alongside the two directives, the EC published a Recommendation containing guidelines on how Member States can adapt their Double Tax Treaties with third countries to the new digital taxation proposals. Double Tax Treaties are bilateral agreements aimed at acknowledging the differences in the tax systems of two trading countries to ensure companies do not pay tax for the same activity twice.

The Recommendation states the Member States should make the following changes to their Double Tax Treaties:

- **Change the definition of "permanent establishment"** to account for situation where a company has a significant digital presence in given country/jurisdiction;

[8] Previous draft versions by the EC foresaw a lower threshold for the application of the tax, ranging between 10m and 20m instead of 50m, and a 1% to 5% tax rate instead of a single tax rate of 3%. Other changes to wording in the final version includes: "multi-sided digital platform" instead of "online platforms and marketplaces".

[9] ECOFIN, September 2017, Estonian Presidency note for the informal ECOFIN Tallinn meeting, 'discussion on corporate taxation challenges of the digital economy'.

- **Include rules for how profits should be attributed to a significant digital presence.**

The Recommendation has been addressed to the governments of Member States who will now have to inform the EC of the measures taken to comply.

NEXT STEPS

April – throughout 2018 and early 2019: examination of the EC proposals in the European Parliament and Council of the EU (Working Party on Tax Questions and High Level Working Party on Tax Questions).

April 2018: OECD report on digital taxation due, outlining the OECD's progress on its tax agenda (BEPS Framework) and presenting recommendations for action at international level. A draft version of the report was released on 16 March revealing the current lack of consensus for short-term measures to tax the digital economy.

27 April 2018: informal meeting of economic and financial affairs ministers (ECOFIN) in Sofia.

June 2018: next scheduled date for European Council to discuss the issue of digital taxation.

May 2019: preferred EC timeline for adoption of the directives.

STAKEHOLDER REACTIONS

Reactions are still in process of appearing, but initial feedback on the EC plan for a digital tax raised concern and caution from industry and division among many Member States.

INDUSTRY

Industry representatives from big tech firms met Commissioner Moscovici on Wednesday 7 March to discuss their concerns about the Digital Services Tax. The companies included: **booking.com**, **Google**, **TransferWise**, **BlaBlaCar**, **Spotify**, **Amazon**, **Netflix**, **Apple** and **Uber**. Trade organizations **DIGITALEUROPE** and **France Digitale** also attended the meeting. The main points raised included the risks that a short-term measure would unfairly target start-ups and stifle innovation. While many industry representatives agreed about the general need for updating Europe's taxation system, they argued the method had to be refined.

No public statements or reactions yet from DIGITALEUROPE, EDIMA (the association representing online platforms whose members include Google, Amazon, Apple, Twitter and Facebook), AppAlliance, BSA - The Software Alliance (whose members include IBM, Apple, Microsoft, Oracle, SAS), nor from individual companies like Google and Facebook.

Publicly, the President of the European association of retail, wholesale, and other trading companies **EuroCommerce** welcomed the EC's initiative to seek more harmonisation of the EU's digital tax, while calling for a caution on any taxes that could burden European businesses. In internal communications to its members, EuroCommerce highlighted the uncertainty around the DST's impact on eCommerce platforms, while for the directive on digital presence, found it lacks a clear definition of digital services, as currently it could unnecessarily include a vast array of eCommerce services.

NGOS

No reactions yet from digital-focused NGOs like European Digital Rights (EDRi) or La Quadrature du Net. Oxfam welcomed the proposals.

MEMBER STATES

Divisions between France and Germany

Calls for a DST are led by France's Finance Minister Bruno Le Maire, who had reportedly enlisted the backing of 19 other Member States. However, scepticism is growing among several countries, notably Germany, who is said to back the digital tax "for now" to "accommodate" France". **According to reports by POLITICO,**

Germany favours a "global solution" led by the OECD, one that would head off the risk of a "tax war" with the Trump administration that could damage Germany's car exports. Sceptical countries are hardening their resistance, forming a group that includes some **Nordics and Baltics states**, **Ireland and the Netherlands** that oppose a temporary EU tax on digital firms (See Annex II for full list of public positions of 28 Member States).

Outcome of Council meeting held on Thursday 22 March, Brussels

Following a European Council meeting on March 22, **a majority of EU leaders stated their preference for a global option, implemented through the OECD**, and several capitals feared a tax would worsen their US relations if it led to retaliatory tariffs on European exports. Leaders did acknowledge that a global agreement was difficult in the short term and that "something had to be done". But several remain critical, strongly questioning the EC's tax proposal as being a workable solution, notably the Irish Prime Minister Leo Varadkar, who called the EC's proposal "flawed on a number of accounts" especially on whether the tax is based on the location of the company, the user or something in between.

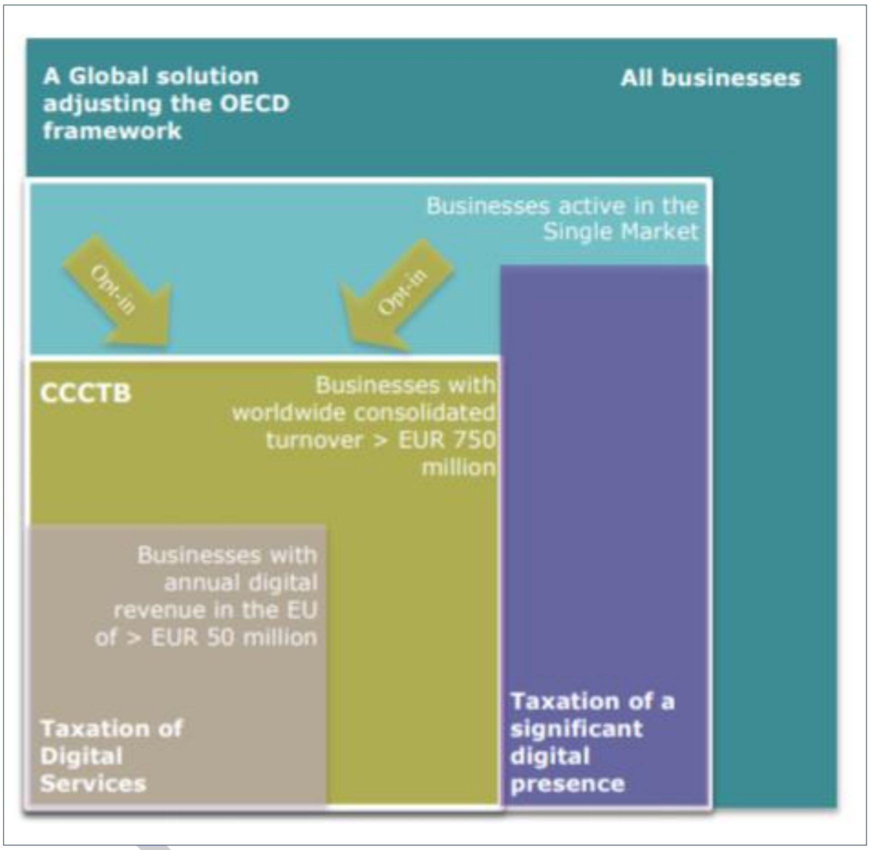
While Poland came out early in support of a revenue tax, some Central and Eastern European states (Czech Republic and Slovakia) are concerned the DST proposals will disproportionately favour large European Member States if the thresholds on the size of the digital company's presence are set too high. The Bulgarian Presidency of the Council is apparently keen to prioritise the concerns of smaller Member States, but many countries remains largely sceptical, with Slovakian PM stating that the EU will not have a stable solution "for a long time to come".

EU Leaders will reconvene to discuss the DST in **June** once their finance ministers have scrutinised the proposals at an informal meeting in Sofia in **late April**.

Annex I. Build-blocks of Digital Tax

The below image from the EC's Communication for Fair Taxation in the Digital Economy shows how the various digital tax proposals fit together [10]. A large proportion of businesses active in the Single Market (light blue), will be covered either by the rules on significant digital presence (purple) or will opt-in to the Common Corporate Consolidated Tax (yellow) while all the largest internet companies will be liable for the Digital Services Tax (light brown). Meanwhile, all businesses will eventually be subject to a global solution adjusting the OECD's framework (turquoise).

The EC's over-arching vision for digital tax



[10] European Commission, March 21 2018, Communication "Time to establish a modern, fair, and efficient taxation standard for the digital economy", p. 9.

Annex II. List of Services not covered by proposed rules on Significant Digital Presence (Annex of Proposal 1)

Extracted from the Annex of the proposed directive laying down rules relating to the corporate taxation of a significant digital presence, the below list of services **are** deemed to be digital services as referred to in Article 3(5) final sentence:

a) website hosting and webpage hosting,
b) automated, online and distance maintenance of programmes,
c) remote systems administration,
d) online data warehousing where specific data is stored and retrieved electronically,
e) online supply of on-demand disc space,
f) accessing or downloading software (including procurement/accountancy programmes and anti-virus software) plus updates,
g) software to block banner adverts showing, otherwise known as Bannerblockers,
h) download drivers, such as software that interfaces computers with peripheral equipment (such as printers),
i) online automated installation of filters on websites,
j) online automated installation of firewalls,
k) accessing or downloading desktop themes,
l) accessing or downloading photographic or pictorial images or screensavers,
m) the digitised content of books and other electronic publications,
n) subscription to online newspapers and journals,
o) weblogs and website statistics,
p) online news, traffic information and weather reports,
q) online information generated automatically by software from specific data input by the customer, such as legal and financial data, (in particular such data as continually updated stock market data, in real time),
r) the provision of advertising space including banner ads on a website/web page,
s) use of search engines and Internet directories,
t) accessing or downloading of music on to computers and mobile phones,
u) accessing or downloading of jingles, excerpts, ringtones, or other sounds,
v) accessing or downloading of films,
w) downloading of games on to computers and mobile phones,
x) accessing automated online games which are dependent on the Internet, or other similar electronic networks, where players are geographically remote from one another,
y) automated distance teaching dependent on the Internet or similar electronic network to function and the supply of which requires limited or no human intervention, including virtual classrooms, except where the internet or similar electronic network is used as a tool simply for communication between the teacher and student,
z) workbooks completed by pupils online and marked automatically, without human intervention.

Extracted from the Annex of the proposal on Significant Digital Presence, the below list of services **are not** deemed to be digital services as referred to in Article 3(5) final sentence:

a) radio and television broadcasting services,
b) telecommunications services,
c) goods, where the order and processing is done electronically,
d) CD-ROMs, floppy disks and similar tangible media,
e) printed matter, such as books, newsletters, newspapers or journals,
f) CDs and audio cassettes,
g) video cassettes and DVDs,
h) games on a CD-ROM,
i) services of professionals such as lawyers and financial consultants, who advise clients by e-mail,
j) teaching services, where the course content is delivered by a teacher over the internet or an electronic network (namely via a remote link),
k) offline physical repair services of computer equipment,
l) offline data warehousing services,
m) advertising services, in particular as in newspapers, on posters and on television,
n) telephone helpdesk services,
o) teaching services purely involving correspondence courses, such as postal courses,

p) conventional auctioneers' services reliant on direct human intervention, irrespective of how bids are made,
q) telephone services with a video component, otherwise known as videophone services,
r) access to the Internet and World Wide Web,
s) telephone services provided through the internet.

Annex III. Positions of 28 Member State on the Digital Services Tax (as of March 23 2018)

Country	Position
Austria	One of the ten initial countries backing the DST in the joint political statement coordinated by France on Sep 15-16 2017
Bulgaria	One of the ten initial countries backing the DST in the joint political statement coordinated by France on Sep 15-16 2017
France	Leading Member State behind proposals for a DST. Secured support from at least 10 Member States in favour of the EC's proposal and on Wednesday 21 March led a statement in favour of a DST signed by Italy's G5 (France, Italy, Spain, Germany and the United Kingdom)
Greece	One of the ten initial countries backing the DST in the joint political statement coordinated by France on Sep 15-16 2017.
Italy	One of the ten initial countries backing the DST in the joint political statement coordinated by France on Sep 15-16 2017. Jointly signed a G5 statement with France, Spain, Germany, and UK in favour of the tax
Poland	Early supporter of the tax. Argued in February 2018 that a digital tax could be a way of "compensating for the pay-in from the UK" after Brexit (PM Mateusz Morawiecki)
Portugal	One of the ten initial countries backing the DST in the joint political statement coordinated by France on Sep 15-16 2017
Romania	One of the ten initial countries backing the DST in the joint political statement coordinated by France on Sep 15-16 2017
Slovenia	One of the ten initial countries backing the DST in the joint political statement coordinated by France on Sep 15-16 2017
Spain	One of the ten initial countries backing the DST in the joint political statement coordinated by France on Sep 15-16 2017. Signed France's G5 statement
United Kingdom	Broadly in favour of a digital tax. Signed France's G5 statement. May legislate separately on the matter after Brexit. Following a consultation and publication of a report on the matter by the UK Treasury (Nov 2017), Treasury Minister Mel Stride told the BBC back in Feb that a digital tax on revenues was the government's "preferred option" to tax the tech sector
Germany	One of the ten initial countries backing the DST in the joint political statement coordinated by France on Sep 15-16 2017. However, Germany's position is apparently softening. Finance Minister Olaf Scholz is said to be concerned about the impact on German exports if the US takes retaliatory measures and more generally favours an international approach reached through the OECD
Sweden	Initially receptive to France's initiative but increasingly sceptical about the EC's current DST proposal

Cyprus	Leading country against the DST proposals
Czech Republic	Concerned about scope of the DST disproportionately favouring large Member States
Denmark	Reportedly sceptical about the DST proposal. Danish Finance Minister Kristian Jensen has warned about the impact on European competitiveness, claiming such a tax could lead to European consumers choosing cheaper Chinese and American products
Estonia	Released critical position paper of a digital tax on revenues back in September 2017 when the country held the rotating presidency of the Council of the EU
Finland	Critical of the DST. In favour of an approach agreed at international level via the OECD. (source: FT)
Ireland	Leading country against the DST. Irish government ready to block digital tax, arguing for the need to preserve the competitive edge of its banking sector, a strategic national interest. (Source: Sunday Times)
Lithuania	Critical of the DST. In favour of an approach agreed at international level via the OECD. (source: FT)
Luxembourg	Leading country against the DST. Argues with the Irish that it would unfairly damage the Luxembourgish banking sector, strategic national interest
Malta	Critical of the DST. Maltese government argues a digital tax would damage the EU's competitiveness and incite internet companies to move their activities elsewhere. (source: Times of Malta)
Netherlands	Critical of the DST. In favour of an approach agreed at international level via the OECD. (source: FT)
Slovakia	Concerned about scope of the DST disproportionately favouring large Member State
Croatia	No public position yet released on the DST
Hungary	No public position yet released on the DST
Latvia	No public position yet released on the DST