Taxation in a digital world

– an update to the 2017 Report

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Executive summary

Main output

Our report "Unequal taxation in a digital world - a challenge for the Nordic media industry" ("2017 Report") - was published in May 2017. The 2017 Report outlined in detail the current tax framework, the hallmarks of digitized business models compared to more traditional business models, the development in digital technology and its impact on the economy, and the challenges resulting from the current tax framework's treatment of digitized business models. Furthermore, based on the different actions published by OECD under the BEPS project, respectively Action 1 addressing the digital economy, the 2017 Report outlined the work carried out by the OECD and others up until May 2017.

Since our 2017 Report was published, progress on finding solutions to the incremental taxation issues in the field of the digital economy has been both at the OECD/G20 and at the EU level. Simultaneously, an increasing amount of Member States have taken matters in their own hands by introducing, or planning to introduce, uncoordinated unilateral measures.

This report mainly provides a review of the work carried out by the OECD and the EU since May 2017, and the two solutions proposed by the European Commission ("the EC" or "the Commission"). After having reviewed the propositions and the different arguments presented by IF members, EU Member States and others, the main outputs from these sources is that that there seems to be an increased consensus to that measures should be taken in order to ensure fair taxation and a level playing field. Further work is, however, required to better understand how value is created in digitised business models, the accuracy of the propositions rendered by the Commission and for a consensus to be reached at the OECD and/or EU level.

Reviewing the available options presented by the Commission and the pro and contra arguments presented by Member States and others, we believe a global (comprehensive) solution at OECD level is preferable. The outspoken aim of reaching a fair and clear tax practice on digital services can possibly be achieved only by amending tax treaties to reflect the changes currently happening in the digital economy. A more detailed assessment on value creation is, however, needed to ascertain where value is in fact created, so as to achieve the aim of fair taxation practices.

Despite opposing arguments and concerns, the Commission recommends to introduce the DST as an interim solution. This presupposes, however, that the DST is replaced by a comprehensive solution at a later point and thus only acts as a temporary solution, and, preferably, is implemented as a coordinated measure. Should the EU not, within a reasonable time period, be able to reach the required unanimous vote for introducing the DST, it has been signalled by several countries that the DST will be considered introduced as a temporarily local measure. Because of the lack of international progress, UK has proposed to introduce DST from April 2020. The UK DST entails applying a 2% tax on the revenues generated directly or indirectly from specific activities where the UK believes that these activities indicate value being generated form the participation of UK users.

High level summary of the work carried out by the OECD/G20 and the Commission

OECD/G20

At OECD/G20 level, the work has thus far resulted in the report Tax Challenges Arising from Digitalisation - Interim Report 2018, published in March 2018 ("OECD 2018 Report"). In the report, the OECD stresses the importance of the BEPS project and that tax planning strategies are being addressed through the implementation of different BEPS actions. At the same time, the OECD admits that there is growing evidence that tax planning strategies are changing to align corporate structures with their economic activity. However, it also recognizes that there are features of digitisation and highly digitised businesses that create tensions in the international tax system and should be addressed at a global level.

The OECD 2018 Report is an interim report and does, as such, not provide any final suggestions or solutions. Instead, the report mainly explores the challenges of the digital economy, along with, to a certain extent, acknowledging that other factors, such as how to deal with sharing economies, the business tax functions, financial data, the people and systems, and the impact of technology on tax administrations, need further attention.

Further, the OECD 2018 Report also shows that while Inclusive Framework ("IF") Members seem to agree on what the prominent features of digital business models and root-cause of the challenges are, there is no consensus on their relevance and importance to the question of where value creation is located. The different views asserted by IF Members can be divided into the following three groups:[1]

- one group maintains that there is no need for any major change,
- a second group recognises a need for certain changes to the international tax framework to reflect the impact of digitalisation on business models and value creation and,
- a third group believes that fundamental change is required to reflect globalisation at large.

The OECD 2018 Report acknowledges these different viewpoints and does not argue in favour of or against any of the different viewpoints. Nor does the OECD 2018 Report state any discontent towards countries that believe there is a strong and imperative need to act quickly, and that consequently have introduced, or are considering to introduce, uncoordinated unilateral measures.[2] The OECD 2018 Report does, of course, support coordinated measures, and outlines a number of risks that the countries that supported unilateral measures agreed should be taken into consideration during their design and implementation.

Although the OECD 2018 Report does not present any final solutions or propositions, the 2018 Report is conceived as suggesting that focus should be on the comprehensive solution, i.e. a new concept of nexus that captures businesses with a "digital presence" and updating the principle for attribution of profit that takes into account the contribution of users to the value creation process. Specific options are, however, not mentioned.

The final outcome of the OECD/G20 work is all but certain. The OECD is, however, committed to spending the next two years looking for ways to bring the IF Members closer together on a compromise. As part of the next phase of their work, the OECD and the Inclusive Framework member states have agreed to undertake a coherent and concurrent review of the "nexus" and "profit allocation" rules - fundamental concepts relating, respectively, to the allocation of taxing rights between jurisdictions and the determination of the relevant share of multinational enterprises' profits subjected to taxation in a given jurisdiction. In exploring potential changes, the impacts of digitalisation on the economy, relating to the principles of aligning profits with underlying economic activities and value creation, will be considered. A progress update will be provided in 2019, and the final report is scheduled to be published in 2020.

EU:

At EU level, the work has resulted in the Commission's release of a digital tax package on March 21 2018. The digital tax package consists of a (non binding) Communication to the European Parliament and the Council of the EU, both providing background information and an explanation as to why the EC considers the digital economy to be undertaxed. The digital package culminates in two formal drafts: the Proposal for a Council Directive, which lays down rules relating to the corporate taxation of significant digital presences, and the Proposal for a Council Directive, which is on the common system of a digital service tax on revenues from the provision of certain digital services.

Similar to the OECD 2018 report, the EC digital tax package provides a broad background description and problem definition, presenting the background for today's challenges and the hallmarks of digital business models compared to more conventional business models.

Contrary to the OECD, the EC digital tax package contains proposals for two solutions: a comprehensive solution and an interim solution.

Comprehensive solution

The comprehensive solution proposes, in short,

1 PwC Tax Policy Bulletin of 9 April 2018 on "OECD and EC release disparate recommendations on tax and the digitalisation of the economy".

2 See p 26 et seq. of our 2017 Report and Chapter 6 of this Report for a summary of select unilateral measures.

changes to the definition of permanent establishments and principles for how profits should be allocated.

The proposed Directive lays down rules for establishing a taxable nexus for cases where there is a non-physical commercial presence of a digital business ("significant digital presence"). According to the proposed Directive, a digital platform constitutes a significant digital presence if one or more of the following criteria are met:

- the proportion of total revenues obtained in that tax period resulting from the supply of those digital services to users located in that Member State in that tax period exceeds EUR 7,000,000;
- the number of users of one or more of those digital services located in that Member State in that tax period exceeds 100,000;
- the number of business contracts for the supply of any such digital service concluded in that tax period by users located in that Member State exceeds 3,000.

The proposed Directive also sets out the principles for attributing profits to the significant digital presence. According to the proposed Directive, a functional analysis should be carried out. The economically significant activities performed by the significant digital presence through a digital platform, include, i.a., the following activities:

- the collection, storage, processing, analysis, deployment and sale of user-level data;
- the collection, storage, processing and display of user-generated content; (c) the sale of online advertising space;
- the making available of third-party created content on a digital marketplace;
- the supply of any digital service not listed in points (a) to (d).

On attribution of profit, the proposed Directive recommends that the profit split method is the default method in determining the attributable profits. Exceptions may apply to taxpayers able to demonstrate that there is an alternative method more appropriate in light of the results of the functional analysis.

According to the proposed Directive, the rules shall apply to all taxpayers subject to corporate tax in one or more Member States. The rules shall also apply to entities resident for tax purposes in a third country, in respect of their significant digital presence in a Member State.

The proposed Directive also lays down rules for when the Directive shall not apply: It shall not apply if an entity is resident for tax purposes in a non-EU jurisdiction that has a double tax treaty (DTT) in force with the Member State in which there is a significant digital presence unless i) that DTT includes similar provisions on a significant digital presence and the attribution of profits thereto to those of the draft Directive, and ii) those provisions are in force.

The EC proposes that the Directive should apply per 1 January 2020.

Interim Solution

The second proposed Directive entails introducing a

short term digital sales tax ("DST") at the EU level. In explaining the need for an interim, as well as a comprehensive, solution, the EC draws on current developments in the EU Member States, which, specifically, include that Member States increasingly are taking uncoordinated unilateral measures. Considering, additionally, that implementing the comprehensive solution itself will take time, as it requires re-negotiating treaties, an interim solution seems pressing.

According to the proposed Directive, the tax rate shall be 3 % on gross revenue (net of VAT and similar taxes) derived in the EU on the following services:[3]

- Advertising placed on a digital interface targeted at users of that interface;
- the making available to users of a multi-sided digital interface which allows users to find other users and to interact with them, and which may also facilitate the provision of underlying supplies of goods or services directly between users;
- the transmission of data collected about users and generated from users' activities on digital interfaces.

Exemptions do, however, apply to revenues resulting from the provision of any of the said services by an entity belonging to a consolidated group for financial accounting purposes to another entity in that same group. Moreover, if an entity belonging to a consolidated group for financial accounting purposes provides a service mentioned above and the revenues resulting from the provision of that service are obtained by another entity in the group, those revenues shall be deemed to have been obtained by the entity providing the service.

Furthermore, the DST applies to entities producing both a total annual revenue above EUR 750 million and total annual taxable digital revenues in the EU above EUR 50 million. Thus, in effect, SMEs and micro entities should be excluded from the scope of the DST, although they may be impacted indirectly.

With respect to the place of taxation of the DST, the proposed Directive suggests that the DST is levied based on the location of the users of the taxable service. A simplification mechanism in the form of a One-Stop-Shop is proposed established for taxable persons with DST liability in one or more Member States. According to the EC, it is also expected that Member States will allow businesses to deduct the DST paid as a cost from the corporate income tax base in their territory, in order to mitigate possible cases of double taxation where the same revenues are subject to corporate income tax and DST.

Finally, we note that each round of negotiations between EU Member States in the European Council's Committee on Economic and Monetary Affairs (ECOFIN) results in changes to the proposed Directive. In the November 2018 ECOFIN meeting it was clear that several Member States (including Finland and Sweden) could not agree to the proposals, despite amendments agreed by many Member States that would result in the tax not entering into force until January 2021 (and ceasing at the earlier of 31 December 2030 or EU implementation of an OECD-agreed solution).

In the December ECOFIN meeting, France and Germany proposed a significant scope reduction (such

3 See Commission Recommendation of 21 March 2018 p. 53 et seq., PwC Tax Policy Bulletin 9 April 2018, PwC EU Direct Tax Newsalert 21 March 2018.

that the DST would only apply to advertising revenues). France and Germany hope that such a proposal could be agreed before the European Parliament Elections in May 2019.

As envisaged, an abundance of discussions are ongoing between not only Member States, but also third countries, entities and organisations. Considering the current, prevailing climate, it can safely be assumed that it is highly uncertain whether a unanimous vote will or can be achieved on the full scope as presented in the Commission's proposals or on a reduced scope proposed by France and Germany. For a summary of selected arguments presented by Member States and others, we refer to chapter 6 of this report.

2

Introduction

Our previous report on Unequal taxation in a digital world - a challenge for the Nordic media industry ("2017 Report") - was published in May 2017. The 2017 Report provided a detailed description of the current tax framework, the hallmarks of digitized business models compared to more traditional business models, the development in digital technology and its impact on the economy, and the challenges resulting from the current tax framework's perceived failure to capture digitized business models. Furthermore, the 2017 Report outlined the work carried out by the OECD and others up until May 2017, the main legal sources of information being the different actions published by OECD under the BEPS project, respectively Action 1 addressing the digital economy.

We have now been asked to provide a summary and review of the work carried out by the OECD/G20 and the EU since May 2017. As such, this report will mainly address the OECD 2018 Report and the EC Digital Tax Package published in March 2018.

We will not outline in detail the core issues of the challenges that are currently debated in the OECD and the EU but refer to our 2017 Report for further details. However, in order provide context and to ease the read of this report, you will find below a high level summary of the background and problem definitions provided by the OECD and the EC in the OECD 2018 Report and the EC digital tax packaged (mainly the EC Recommendation of 21.3.2018 relating to the corporate taxation of a significant digital presence).

As agreed, the scope of this Report is furthermore limited to select corporate tax issues, i.e. we will not address the ongoing work connected to VAT in the EU or VAT related issues. Nor will challenges in relation to the application of personal income taxes be addressed. Finally, we will not address statistics, etc. but refer to our 2017 Report for the different statistics and figures showing the Nordic total advertising market revenues, expected outlook for the media industry and distribution of revenues between the media players (Nordic vs. global), etc.

3

Background and problem definition

Industrial economy and the digital economy - common challenges due to the globalization of the economy

Both the OECD 2018 Report and the EU digital tax package (respectively the EC Recommendation) address challenges resulting from the globalization and digitalization of the economy, and outline what the possible causes of these challenges may be. While the EC addresses both global issues and EU specific challenges, the OECD's main focus is the global economy and the actions following the BEPS project.

Existing tax rules are built on the principle that profits should be taxed where value is created. These rules were, however, mainly conceived in the early 20th century for traditional «brick and mortar» businesses, leading to rules that determine a country's taxing rights based on whether the business in question has a physical presence in that country. Consequently, non-tax residents were only liable to tax in a country provided their presence in that country amounted to a permanent establishment.

The EC believes that the current definition of permanent establishments and principles for profit attribution fail to encompass cross border digital business models, leading to a misalignment of the place where value is created, notably in the case of user contributions, and the allocation of taxing rights and ability to enforce taxation.[4]

Through the BEPS actions, the OECD addresses these larger issues from a global perspective in a number of specific areas. As shown below under the review of the BEPS 2018 Interim Report, Action 7 amends key provisions of the permanent establishment article in the Model Tax Convention. Under the new provisions, local subsidiaries that perform support functions, such as, supporting and facilitating sales on a cost plus basis, may be considered a permanent establishment. Furthermore, exceptions for certain functions like storage and delivery of goods are restricted. As such, businesses like online stores, where storage constitutes a core part of the business model, may be considered to have a permanent establishment. The OECD has been tasked with further assessing of the digital economy and the challenges arising from that.

Similar to the OECD, the EC is of the opinion that the solution must ultimately be a global solution as the issue is global and "there is a need to better harness globalisation with proper global governance and global rules."[5] Hence, the EC works closely with the OECD in order to support the development of a global comprehensive solution.

In addition to global concerns shared by the OECD and the EU, the EC Digital Tax Package focuses on the EU and the functionality of the single market. As an agreement on global solutions are not expected until 2020, the EC argues the need for quick and coordinated action at the EU level. According to the EC, only a common and coordinated EU action may tackle the existing problems as "the problems posed by the current tax framework are not particular to any specific Member State but constitute a common challenge for the EU as a whole."[6]

If coordinated actions are not taken as soon as possible, the EC argues there is a clear risk that further unilateral actions will be taken by Member States. In respect to the comprehensive solution, the EC argues that uncoordinated and unilateral actions may undermine the existing work at EU level on the wider corporate tax rules: only a coordinated action would be coherent with the efforts already made to subject taxpayers to a single set of corporate tax rules across the EU.[7]

Furthermore, the EC argues that coordinated interim actions are required while waiting for a comprehensive

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4 See chapter 2 of the EC Recommendation.
5 Communication from the Commission to the European Parliament and the Council p. 5.
6 Commission Recommendation p. 20.
7 Currently, the corporate tax framework is only to a limited extent harmonised at EU level. The EC has however adopted relevant proposals (CCTB and CCCTB) that aims at increased harmonization by subjecting taxpayers to a single rulebook of corporate tax legislation.

solution in order to mitigate the risk of interim unilateral actions either adopted, or planning to be adopted, by Member States. Such uncoordinated, unilateral measures, may create an increased risk of fragmentation of the Single Market and distortions of competition within the EU.[8]

The EC also argues, in short, that an "EU action would be more efficient and would minimize compliance cost" and that an EU action "would help steer the discussions at international level on the taxation of the digital economy in a more effective way than action at Member State level."[9]

8 Commission Recommendation p. 21.
9 Commission Recommendation p. 21.

4

OECD/G20 Base Erosion and Profit Shifting Project: Tax Challenges Arising from Digitalisation - Interim Report 2018

4.1. Introduction: tax and the global environment

4.1.1. The BEPS-project and actions taken to mitigate traditional tax planning within traditional sectors (PE-clause and Amazon, use of intermediaries) - a backdrop to why further actions are deemed required

As outlined in our 2017 Report, the BEPS Project, initiated in 2012, reinforced the international tax framework to avoid base erosion and profit shifting from jurisdictions where economic value is created to low-tax jurisdictions. The project resulted in a final report in 2015, containing 15 action points to address the issue. In the years following the report, over 110 jurisdictions implemented coordinated changes to tax treaties through a multilateral instrument ("MLI"), as well as changes to domestic tax law.

The BEPS project was built around three main pillars: reinforcing the coherence of corporate income tax rules at the international level, realigning taxation with the substance of the economic activities and improving transparency.

The action plan consists of 12 actions targeting different tax planning practices including, inter alia, hybrid mismatches, thin capitalisation, treaty shopping, artificial avoidance of permanent establishment status and transfer pricing. A few measures amount only to minimum standards, mandatory to all participating jurisdictions; however, most measures are either optional standards or common approaches and best practices (soft law).

Action 1 of the BEPS Action Plan calls for work to address the tax challenges of the digital economy.

In BEPS Action 1, the OECD concluded that it is impossible to ring-fence the digital economy from the rest of the economy, as it increasingly is becoming the economy itself. Therefore, the OECD seeks to address the relevant BEPS issues in the digital economy by applying a combination of:

- Action 3 (strengthening CFC rules),
- Action 7 (preventing the artificial avoidance of permanent establishment status) and
- Actions 8-10 (assuring that transfer pricing outcomes are in line with value creation)

were expected to tackle some of the tax issues related to the digital economy.

By widening the PE definition for dependent agents and an update of the specific activity exemptions in OECD Model Article 5 (4), BEPS Action 7 was, in particular, thought to prevent the artificial avoidance of PE status for digital global players.

Currently, a PE is triggered when an agent acting on behalf of a foreign enterprise habitually exercises authority to conclude contracts in the name of the enterprise, unless the agent is an independent agent acting in the ordinary course of its business. Since the current definition is limited to the formal conclusion of contracts, the OECD widened it to also include situations in which an agent habitually plays the principal role leading to the conclusion of contracts that are then routinely concluded without material modification by the enterprise.

Action 7 also recommended an update of the specific activity exemptions found in Article 5 (4) of the

OECD Model, according to which a PE is deemed not to exist where a place of business is used solely for activities listed in that paragraph (e.g., the use of facilities solely for the purpose of storage, display or delivery of goods, or for collecting information). The proposed amendment prevents the automatic application of these exemptions by restricting their application to activities of a "preparatory or auxiliary" character.

4.2. High level review of mandate, scope and purpose of the OECD 2018 Interim Report: a closer look at challenges arising in the era of digitalization.

In 2017, the IF extended the mandate of the Task Force on the Digital Economy (TFDE) to include an interim report on the digital economy in 2018 and a final report in 2020. In preparing for the interim report, stakeholders were requested to give their input in 2017. The task force received more than 50 submissions, and these were elaborated on in a public consultation in November 2017.

To provide a background to the taxing challenges posed by the digitalizing economy, the interim report provides an in-depth analysis of how value is created in various types of digitised business models. The initial analysis identified what, in the OECD's opinion, were characteristics prevalent in more highly digitalized businesses: cross-jurisdictional scale without mass; reliance on intangible assets, including UP; and data, user participation and their synergies with IP.

Different opinions persist between the participating jurisdictions on how these characteristics should shape and impact allocation of value creation for tax purposes. In particular, there is no consensus on whether user contribution contributes to value creation and thus should determine whether a specific country in any given case holds the taxing rights.

The report continues on to identify three concepts of value creation:

- value chain - inbound logistics, operations, outbound logistics, marketing and sales, service.
- value network - network promotion and contract management, service provisioning,
- and infrastructure operation.
- value shop - problem finding, problem solving, choices, and execution, control/ evaluation.

All of the values above may take place in highly digitalized businesses. However, no conclusions are drawn with respect to where value creation in general and specific business models takes place.

The report further reviews the progress of implementation of the BEPS package, specifically with respect to actions relevant to the digital economy, and the domestic measures taken by countries to address some of the broader tax challenges in the digital economy not addressed in the BEPS action. The report finds it likely that jurisdictions will continue to implement unilateral measures to address issues pertaining to the digital economy until a global consensus is reached.

4.3. Differences that necessitate other actions and measures to be taken to address challenges of the digital economy

The OECD report emphasises that the implemented BEPS actions and measures may not be effective in solving the broader tax challenges that arise as a result of digitisation. The reason is that many of the rules on taxation of cross-border activities were created and enacted in a time where such activities relied predominantly on tangible assets and intensive use of labour.[10]

The report identifies two sets of underlying rules that shape the framework of international tax. Firstly, the "nexus rule" determines which jurisdiction holds the right to tax non-resident entities. Secondly, profit allocation rules, based on the arm's length principle, determine the allocation of taxing rights between involved jurisdictions. Both these sets of rules are dependent on the requirement of physical presence.

Where amendments to the permanent establishment provisions are meant to ensure nexus in cross-border sales models, the supply of digital products and services would not have a taxable presence as no physical presence is required. With respect to determining nexus and allocating profits the report identifies three (overlapping) categories of challenges with the digital economy: nexus, data and characterisation.[11]

- Nexus: Digital technology and the increasing role of network effects reduce the need for physical presence to carry out business, thus reducing the effectiveness of existing nexus rules.
- Data: The increase in cross-border information use and gathering pose challenges in the allocation of value creation in products and services that are based on this data. The supply of (free) information from participation networks pose challenges in regard to whether this is characterised as a transaction for tax purposes.
- Characterisation: The characterisation of payments in connection with new digital products and means of delivery systems pose challenges and uncertainty.

In summary, challenges to the taxation of the digital economy can be attributed to several factors. Firstly, new business models have emerged to adopt to the digital economy, leading to new ways to create value. Secondly, businesses no longer rely on having a physical presence in the country they operate in. To achieve a common solution to these challenges, jurisdictions must also agree on a common understanding of where and how value creation happens and should be allocated.

At this stage, the OECD Report does not specifically outline options for designing a digital or virtual permanent establishment (PE). The threshold that must be met to trigger a PE (or other taxable presence) and the factors that should go into considering how to allocate profits from the taxable presence, will be a key concern for some stakeholders.

4.4. Review of the different solutions presented by the OECD/G20 in the Interim Report: interim measures, long term measures, nexus, legal challenges due to sovereignty, tax treaties and procedures for incorporation, etc.

The 2015 final report on the digital economy concluded that it would be difficult, if not impossible, to ring-fence the digital economy from the rest of the economy.[12] The interim report builds on this conclusion, but recognises that the 2015 BEPS package may not adequately address tax issues that some countries are concerned with related to nexus, data and characterisation.

A number of jurisdictions have implemented or are considering to implement interim measures to address these challenges in the wait for a consensus-based

10 https://www.oecd-ilibrary.org/docserver/9789264293083-en.pdf?expires=1539866967&id=id&accname=guest&checksum=E6E0D46878B4D9077D8D115B68DDA943
11 Ibid p. 169
12 https://www.oecd-ilibrary.org/docserver/9789264241046-en.pdf?expires=1539872912&id=id&accname=guest&checksum=497664CE86D28344A34DD828B3518B46 p. 11

common solution. However, these jurisdictions recognise the potential adverse effect of having a variety of different domestic interim measures. Therefore, a set of common guiding principles be published to minimise the differences between unilateral measures has been agreed by the countries that wish to implement them.

The report concludes that the issues raised by the digital economy are highly complex and technical questions, warranting continued monitoring towards the final Report in 2020. Moreover, further work is required to reach a consensus on the question of whether features of highly digitalized business models and digitalization should lead to changes in international tax law. As such, the report does not render any final proposal in respect of the issues considered in the report. The report does, however, set out general guidelines for taxing digital businesses as well an analysis of potentially adverse effects of doing such, in attempt to coordinate the unilateral actions either taken, or about to be taken, by various states.

The analysis of potential adverse effects lists the following:

- Impact on investment, innovation and growth,
- Impact on welfare (i.e. distortion of input and output in businesses),
- Potential economic incidence of taxation on customers and businesses,
- Possibility of over-taxation,
- Possible difficulties in implementing a tax as an interim measure, and
- Compliance and administrations costs.

To mitigate the potential adverse effects of interim measures, the following design considerations are provided:

- Compliance with international obligations
- Temporariness
- Targeting
- Minimising over-taxation
- Minimising impact on start-ups, business creation and small businesses more generally
- Minimising cost and complexity

4.5 Why the OECD/G20 did not render a final proposition and what the next steps are(follow-up report in 2020).

Although there seems to be an increasing consensus that actions must be taken, there is still no consensus on the need for measures targeting tax issues specifically pertaining to the digital economy, nor to how such actions should be designed . The OECD 2018 Interim Report identifies three groups of countries:

- one group that maintains that there is no need for

any major change,

- a second group that recognises a need for certain changes to the international tax framework to reflect the impact of digitalisation on business models and value creation and,
- a third group that believes that fundamental change is required to reflect globalisation at large.

The members of the Inclusive Framework acknowledge the dissenting opinions on the matter. However, there is agreement that they share a common interest in maintaining a single set of rules to promote economic efficiency and global welfare.

While IF members agree on the principal features of digital business models, there is no consensus on their relevance and importance to the location of value creation and the identity of the value.

In preparing for the final report scheduled to be completed in 2020, the task force will continue to analyse how prevalent characteristics of highly digitalized businesses affect how these businesses create value. Furthermore, the work towards the 2020 report will include exploring technical solutions to test the feasibility of alternative options regarding nexus and profit allocation, gathering input from a broader group of stakeholders and continuing to monitor the effects of the unilateral measures implemented by participants. The task force will release an update - interim report - on the work in 2019.

The task force will release its final proposal to address tax issues related to the digital economy, aiming to bridge the differences between members and achieve a common solution.

5

The EC Digital Tax package

5.1. Introduction

On 21 March 2018, the EC released its digital tax package. Along with explaining why the EC considers the digital economy to be undertaxed, the digital tax package also comprises two formal draft directives: the proposal for a Council Directive, which lays down rules for corporate taxation of significant digital presences, and the proposal for a Council Directive, which regards the common system of a digital service tax on revenues from the provision of certain digital services. Additionally, a recommendation on corporate taxation is made.

In the EC Recommendation, the EC gives a broad and detailed outline and review of the background to the issues by providing a problem definition and a review of the root causes (chapters 1-2). Furthermore, the EC presents arguments for why the EU should act and argues what the proposals aim to achieve (chapters 3-4), along with providing broad assessments of the available options for the comprehensive and interim solutions, the impacts of the respective solutions and reviews of the preferred comprehensive and interim solutions as put forward in the two proposals for council directives (chapters 5-9).

For a high level review of the root cause as explained and outlined by the EC in the Recommendation, including the specific arguments as to why the EC should act and the arguments for introducing both a comprehensive and interim solution (EC Recommendation chapters 1-4), reference is made to Chapter 3 of this report and to our 2017 Report.

In the following, the focus will be on what the EC considers to be available comprehensive and interim solutions, as well as the reviews of the preferred comprehensive and interim solutions (Chapter 5-9 in the EC Recommendation) as presented in the two draft Directives.

5.2. Objectives: What is to be achieved?

The presented initiative encompasses an interim, as well as comprehensive, solution. The EU Commission sets out general and specific objectives for both solutions. General objectives for both the interim and comprehensive solution include protecting the integrity of the single market by ensuring its proper functioning; making sure that public finances of Member States/ the EU are sustainable and that national tax bases are not eroded; ensuring that social fairness is preserved by creating a more efficient taxation framework that properly captures value creation, and outlining how to fight aggressive tax planning.

What the specific objectives are, depend on whether the interim or the comprehensive solution is in focus. The specific objective for the comprehensive solution is to create “a modern corporate tax framework which allows for the fair and efficient taxation of the digital economy.”[13] As the current rules were adopted in the 20th century, a period of time unfamiliar with the concept of digital economy, the main idea is to update the rules and create a framework that better reflects the new digital era that has emerged. For the interim solution, the specific objective is “to put forward measures that would target certain digital activities as a proxy

13 Commission staff working document, impact assessment, Accompanying the document, Proposal for a Council Directive laying down rules relating to the corporate taxation of a significant digital presence and Proposal for a Council Directive on the common system of a digital services tax on revenues resulting from the provision of certain digital services, 2018, pg. 23.

for the comprehensive solution"[14] and to avoid uncoordinated unilateral actions taken by Member States. Compared to the comprehensive solution, the interim solution should, in the opinion of the EC, be easier to implement and level the playing field until a long term solution is in place.[15]

5.3. What are the available comprehensive policy options

5.3.1 What is the baseline against which options are assessed?

In its impact assessment, the EU Commission outlines available policy options. Before outlining the available options, the EC outlines the background of the proposal, which, in short, is the significant benefits that digital transformation brings to society, and consequently, the taxation issues that arise. Moreover, the EC states that the dynamic baseline scenario "takes into account relevant initiatives at various levels (EU, OECD and Member States) and assesses whether they address the tax challenges posed by the digital economy."[16] In this assessment, the Commission refers to two aspects that are important: First, do the initiatives effectively address structural shortcomings of the current international tax system? Second, do they reduce specific tax avoidance opportunities that businesses of the digital economy can apply more easily than other companies?[17] The following paragraphs will shortly outline the initiatives already taken at the EU and OECD level.

At the EU level, relevant initiatives as of this date include the implementation of the Common (Consolidated) Corporate Tax Base (CCCTB), the Anti-Tax-Avoidance Directive and the EU finance ministers adopted package on VAT in e-commerce. Some of the challenges with these measures will be outlined below.

Issues with the CCCTB rules include that "companies not subject to mandatory application would remain subject to the standard profit allocation rules,"[18] and that for companies that do fall under the scope of the rules, the rules are not different from those already applying internationally. Additionally, the CCCTB rules do not provide solutions to "cases where sales by destination do not capture well the economic activity of the company (and neither do tangible assets or employment)".[19] On the other hand, the rules are deemed to mitigate the problems tied to profit shifting within the EU, although they do not address the artificial avoidance of permanent establishments. An issue with the legally binding anti-avoidance rules established at the EU level, is that they are not expected to deal broadly with the specific challenges of the digital economy. In fact, the CFC rules "only address situations where the ultimate parent company is a taxpayer in the EU."[20] And, although the EC in its Recommendation in 2016 on Tax Treaty issues endorsed the view that Member States implement the new provisions on permanent establishments, these are not legally binding, nor do they in-depth address the avoidance of permanent establishments by the digital economy.

At the OECD level, important work up until this date includes the final Action 1 report (OECD, 2015a) which discusses "the broader direct tax challenges raised by the digital economy,"[21] and the interim report on the implications of digitalization on taxation delivered in March 2018. The report outlines that "broader tax challenges for policy makers relate in particular to nexus, data, and characterisation for direct tax purposes."[22] Although it remains unclear what a comprehensive solution at the OECD level may be, the

14 Ibid. pg. 23.
15 Ibid. pg. 23.
16 Ibib. pg. 24.
17 Ibid. pg. 23.
18 Ibid. pg. 24.
19 Ibid. pg. 25.
20 Ibid. pg. 25.
21 Ibid. pg. 26.
22 Ibid. pg. 26.

solution may include revising the rules on nexus and profit allocation rules. On a final note, measures with the purpose of preventing tax treaty abuse have been widely implemented.

Although progress has been made at the OECD level, the revised permanent establishment rules continue to stipulate that businesses must have a physical presence in the country where they operate to be liable for taxes. Further, the EC considers that they mostly target abuse structures used by online retailers of physical goods.[23] As the current design of a permanent establishment does not, then, address the incremental taxation issues in the field of the digital economy to the EC's satisfaction, current work at the OECD does not offer solid guidance on possible solutions the EU should implement. At any rate, solutions offered by the OECD are either not binding or stipulated only in bilateral treaties or in the "Multilateral Instrument", which, in the Commission's opinion, leave important implementation gaps.[24]

5.3.2 What are the available comprehensive policy options?

To find an interim and comprehensive solution to the new taxation issues arising in the field of international taxation law, the EU Commission has looked into and evaluated several options. Many of these end up discarded. Below will follow a concise outline of the options that were looked into and evaluated as well as short explanations of why some of these were discarded.

The EU Commission has inserted the options into three categories: fundamental reforms, realignment within current international tax framework and design options for a digital permanent establishment. The outline below will follow this layout.

5.3.2.1. Options part of the fundamental reform

A first set of options that were looked into and evaluated but eventually discarded are the following: destination-based tax, unitary tax and residence tax base with destination tax base. These are all characterized as being part of a fundamental reform.

In short, the destination-based tax allocates "the right to tax exclusively to the jurisdiction where the good or service is consumed"[25]; the unitary tax entails that "worldwide consolidated profits are apportioned according to turnover generated in each jurisdiction"[26], and the residence tax base with destination tax rate, it is argued, means that "taxing rights and profit allocation rules remain as they are today, but the tax rate applied to the tax base in a jurisdiction is a weighted average of the tax rates of the countries where the turnover was generated"[27].

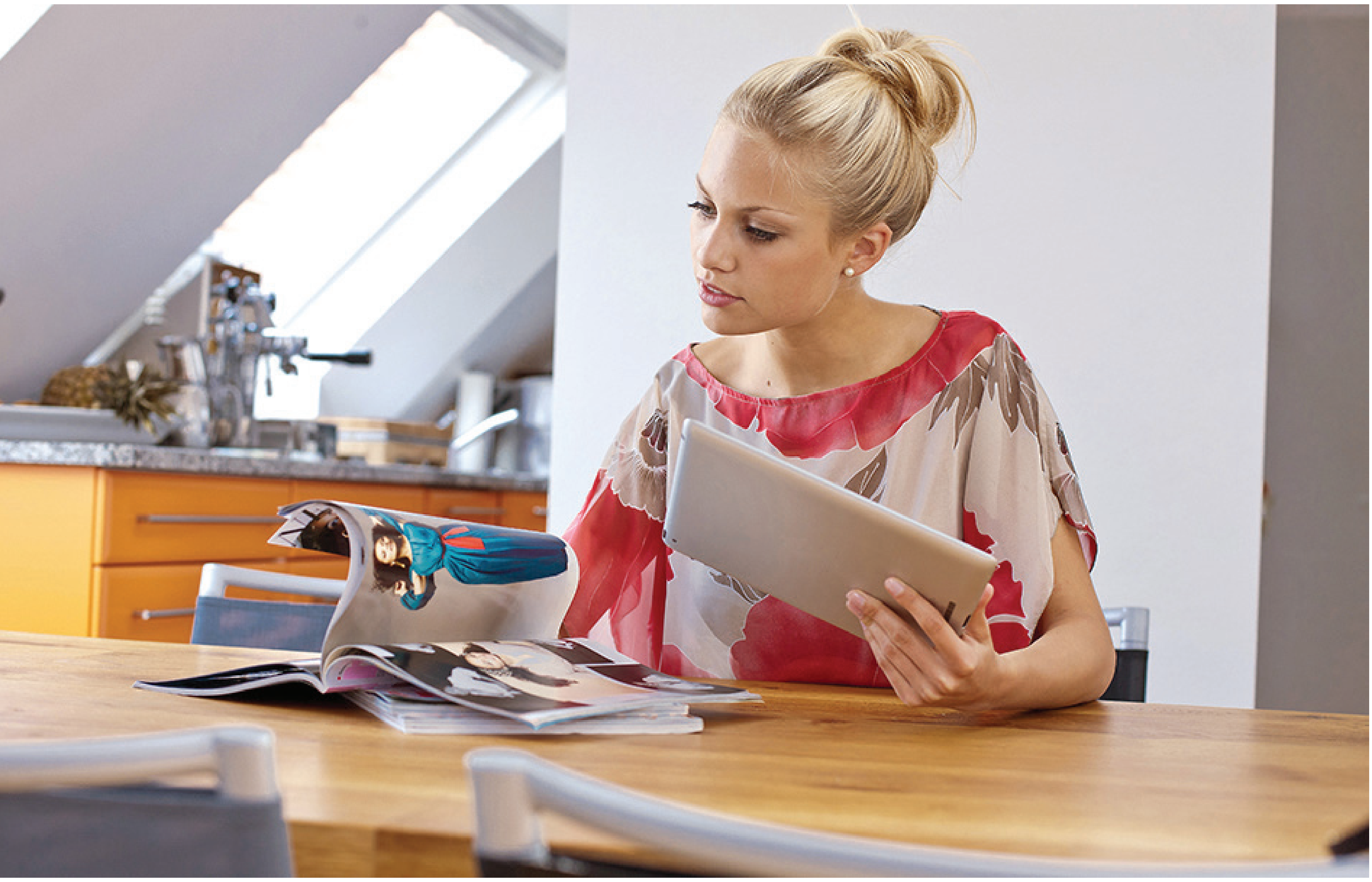
All options are thought to tackle root problems in taxing the digital economy, and in the EC's opinion, this is especially the case with the destination-based tax is. However, the implementation of the fundamental reform is deemed such an arduous task that, in sum, it is not a viable option.[28]

5.3.2.2. Options part of realignment within current international tax framework

Another set of options fall within the scope of the characterization realignment within current international tax framework (new permanent establishment and profit allocation rules): the intra-EU-narrow scope: Adjustments to the CCCTB rules; intra-EU-wide scope: Directive on new permanent establishment and profit allocation principles + adjustments to the CCCTB rules; the intra-EU-wide scope + mandatory application vis-a-vis third countries, and the intra-EU-wide scope + recommend application vis-a-vis third countries.

Being the only discarded option in this category, the intra-EU wide scope + mandatory application vis-a-vis third countries entails that the EU Member

23 Ibid. pg. 26.
24 Ibid. pg. 27.
25 Ibid. pg. 29.
26 Ibid. pg. 29.
27 Ibid. pg. 29.
28 Ibid. pg. 34.



States apply the new rules vis-a-vis third countries. Along with other reasons for why this option was discarded, cf. the Report page 35, the EC points out that the option would require the Member States to break their treaties with third countries.

Moving on to the other options that, to the contrary, were deemed viable, the intra-EU-narrow scope: Adjustments to the CCCTB involves a revision of permanent establishment rules and the apportionment formula in the CCCTB. Essentially, these rules entail that a "digital permanent establishment of an EU company would be triggered in a member State and be subject to corporate income tax on its digital activities once a set of conditions is met"[29]. To elaborate, the key condition appears to be that if the company reaches a certain level of digital activity, whether based on revenues from digital services, the number of active users of the digital service or the number of online contracts concluded, a permanent establishment in the applicable Member State is brought about.

The next option accepted as viable is the intra-EU-wide scope + recommend application vis-a-vis third countries. This option involves recommending EU States to revise their double tax treaties with third countries to reflect the new rules. As such, the option "would be addressed to Member States, but it could also influence the debate at international level on addressing the challenges of taxing the digital economy"[30].To implement these rules, the EC would, where this is of particular interest, seek a mandate to negotiate the revisions vis-a-vis third countries.

In sum, the intra-EU-narrow scope: Adjustments to the CCCTB and the intra-EU-wide scope + recommendation application vis-a-vis third countries and the intra-EU-wide scope + recommend application vis-a-vis third countries by the EC, are deemed to be viable options. The impacts of these options will shortly be outlined in 5.4. below.

29 Ibid. pg. 31.
30 Ibid. pg. 33.

5.4. The impacts of the intra-EU-narrow scope: Adjustments to the CCCTB rules; intra-EU-wide scope: Directive on new permanent establishment and profit allocation principles + adjustments to the CCCTB rules and the intra-EU-wide scope+ recommend application vis-a-vis third countries

5.4.1. The impacts of option 1: the intra-EU-narrow scope: Adjustments to the CCCTB rules

At the outset, the EC proposes that this option would apply to companies with a turnover above EUR 750 million, and, as such, not apply uniformly to all businesses. In further discussing the impact of these rules, the EC looks to the impact the rules have on the integrity of the market; sustainability of public finances; social fairness and the playing field among businesses; the fight against aggressive tax planning; economic impacts; administrative burden and compliance costs, and the coherence with other Commission policies and global tax agenda states. Below follows a summary of how the rules impact these factors.

As the rules would not, as stated, apply uniformly to all businesses, eliminating the risk for unilateral measures by the Member States, the integrity of the market would not be adequately safeguarded. Also, the EU Commission expresses that "introducing a solution that is contingent upon application of the CCCTB introduces new distortions in the single market"[31]. By example, the EU states that the situation could be that a company not applying the CCCTB rules pays taxes only in one Member State whereas the same company would pay taxes in all Member States if it applied the CCCTB rules. Introducing a solution that is conditioned on the application of the CCCTB would also make the decision on whether to apply the CCCTB rules more complicated than before.

Concerning the impact the rules would have on the sustainability of finances, the EC argues that no considerable tax increase at EU level is expected, although there "will likely be a certain amount of reallocation of tax revenue across Member States"[32]. Turning to how the rules level the playing field among businesses and contribute to social fairness, the EC argues that the CCCTB, along with effectively taxing digital activities, would level the playing field between digital and less digital companies adhering to the CCCTB rules. Moreover, the rules would, it is argued, level the playing field between EU companies operating domestically and EU companies operating remotely.[33]

The rules would also, according to the EC, contribute to fighting aggressive tax planning. Firstly, the rules would prevent tax avoidance through the artificial avoidance of permanent establishments, and secondly, cap the opportunities existing for aggressive tax planning. Further, regarding the economic impacts of the rules, the EC argues that since the rules will affect a small number of companies, the economic impact will be small. Second to last, the compliance costs and administrative burdens will, according to the EC, notably encompass the establishing of information items such as proxies to identify permanent establishments, but will be "limited" overall.[34] Finally, the EU argues that the proposed rules fit well within the "Commission's initiatives on fairer taxation".[35]

31 Ibid. pg. 36.
32 Ibid. pg. 37.
33 Ibid. pg. 37.
34 Ibid. pg. 39.
35 Ibid. pg. 39.

5.4.2. OPTION 2: Intra-EU-wide scope: Directive on new permanent establishment and profit allocation principles + adjustments to the CCCTB rules.

At the outset, the EC asserts that this option would, contrary to the intra-EU-narrow scope, not stipulate that companies have a turnover of more than EUR 750 million for the CCCTB rules to apply. In the EC's further assessment of the impact of the rules, the EC follows the same procedure as above, and discusses the rules in light of above-mentioned factors. The discussion is summarized shortly below.

Compared to the intra-EU-narrow scope, the rules will have a stronger impact on the integrity of the market, as they do not apply only to companies with a turnover above EUR 750 million. Regarding the effect of the rules on financial sustainability, the EC argues that they would "correct existing misalignment of taxation and value creation and contribute to a fairer distribution of tax revenue within the EU"[36]. Turning to how the rules affect social fairness and the playing field, the rules will, according to the EC, augment the perception of social fairness and, further, level the playing field by including all digital activities. The latter will also have the benefit of removing competitive distortions.[37]

In terms of how the rules contribute to the fight against aggressive tax planning, the EC argues that the rules will prevent companies from shifting profits to third countries. And concerning the economic impact of these rules, the rules will, due to their larger scope, have a relatively larger economic impact than the rules discussed in section 5.3.4. Finally, the EC assets that the rules will entail "only small increases [...] expected in the time spent on record keeping, on the preparation of tax computation and on dealing with the tax authorities"[38], and that the Directive will continue to push progress on taxation issues in the digital economy internationally.

5.4.3. OPTION 3: Realigning profit allocation rules with value creation intra-EU and recommendation to change rules vis-a-vis third countries

Orbis firm level data on affiliates of the set of 112 large digital companies shows that at least 75 % of them have at least one affiliate in the EU. The remaining 25 % are not accounted for in the data.[39] Consequently, the "immediate impact of an application also vis-a-vis third countries might be small"[40]. However, the Commission argues the rules would level the playing field between EU and third country companies. As the rules would also "avoid any disincentives to become a tax resident in the EU", the EC asserts that rules would provide for social fairness and have a positive impact on public finances.[41]

5.5. Design options for a digital permanent establishment

The last set of options have the purpose of detailing the new permanent establishment rules, and thus adhere to the category *design options for a digital permanent establishment.* This set of options outlines possible criteria central to finding a permanent establishment. The EC, thus, examines more closely what level and type of digital activity should be required for a permanent establishment to be triggered.

Regarding what *type* of digital activity should be required, the EC sets out two options: Option a1, which includes the online sale of goods, and option

36 Ibid. pg. 40.
37 Ibid. pg. 40.
38 Ibid. pg. 42.
39 Ibid. pg. 43.
40 Ibid. pg. 43.
41 Ibid. pg. 43.

a2, which excludes the online sale of goods.[42] The EC concludes that all types of digital activity should be included.[43]

Regarding what the threshold should be based on and how it should be applied, the EC sets out factors that it argues are central to determining the digital activity threshold: firstly, the threshold must account for the various types of business models; secondly, the threshold must not capture businesses barely able to pay compliance costs and other burdens tied to the rules, and thirdly, the threshold must ensure comparable treatment in different Member States, irrespective of their size.[44]

Turning specifically to what the threshold should be based on, the EC states that numerous alternatives have been recommended, the following three being the most often discussed: a threshold based on revenue earned from customers/users in the jurisdiction; a threshold based on the number of users (based on a concept of "monthly average users"), and the number of online contracts (agreements to terms of service).[45] Additionally, the EC evaluates how the threshold should be applied: in an alternative way (i.e. as soon as one of the thresholds is exceeded, the permanent establishment is triggered); in a cumulative way, or in combination with other thresholds, which can apply alternatively.[46]

The EC concludes that the thresholds should be applied alternatively. This, the EC argues, has the benefit of dealing "effectively with respect to the advertising business model that generates revenue not directly from its users but indirectly through sales to third parties"[47]. Concerning, then, how the threshold based on revenue should be set, the EC sets out that the "starting point for setting the revenue threshold are the estimated costs for operating an additional permanent establishment"[48]. And regarding how to set the threshold based on the number of users, the EC establishes that "data for the revenue per user is informative"[49]. In relation to how the threshold based on the number of online contracts (agreements to terms of service) should be set, the Commission recommends a high threshold if the "acceptance of 'terms of service' for the use of an online platform could be assimilated to the conclusion of a contract"[50]. A lower threshold should, on the other hand, be considered if the threshold is based on business-to-business contracts - for example cloud-computing services, which typically have relatively few "users"[51].

42 Ibid. pg. 33.
43 Ibid. pg. 50.
44 Ibid. pg. 45.
45 Ibid. pg. 45.
46 Ibid. pg. 33.
47 Ibid. pg. 45.
48 Ibid. pg. 46.
49 Ibid. pg. 46.
50 Ibid. pg. 47.
51 Ibid. pg. 47.

5.6. Impact on small and medium-sized enterprises

As Option 1 applies only to businesses with a turnover above EUR 750 million and Options 2 and 3 require that the threshold of digital activity to be met, small enterprises will not be directly affected by the new rules.

As companies that are active in at least two countries often will exceed the thresholds to be met for digital activity, some *medium-sized companies* may, on the other hand, be directly affected by the rules.[52]

5.7. How do the comprehensive options compare?

The EU Commission considers that all the options outlined in the above to some degree are effective in "achieving the various objectives set out for this initiative" (see section 4 in this paper). Regarding potential costs, Option 1 - not applying uniformly to all businesses - carries with it the risk that Member States will also take unilateral action. As this option, then, entails additional burdens, it is deemed to only moderately affect the above-mentioned objectives. Option 2 is deemed to be similarly effective. Although Option 3 is similar to Option 1 and Option 2, it is deemed to be the most effective "due to its stronger impact on a more level playing field and fight against tax planning"[53].

Pointing to a stakeholder consultation, the EU Commission sums up that the proposal for a "digital presence in the EU is the preferred approach for more than half of the respondents to the stakeholder consultation"[54]. In determining how to ensure that this preferred type of measure is proportionate, the EC argues that "including only digital services in the material scope (Option a2), and not the online sale of goods, accompanied by appropriate digital activity thresholds" is required.[55]

Preferred comprehensive solution

The EU Commission argues that the preferred comprehensive solution is implementing the Directive on digital permanent establishment and profit allocation rules, which should be included in the Common Consolidated Tax Base (CCCTB) negotiations.[56] In short, the Directive would "establish common rules [within the EU] for a digital permanent establishment and for allocating profits to digital activities of such permanent establishments"[57]. And as stated above, this will entail that once a digital activity threshold is met, a permanent establishment is brought about.

The Commission further asserts that "a significant part of the value of a business is created where the users are based and data is collected and processed, additional criteria specifically and exclusively targeted at these aspects would be added to profit allocation principles"[58]. And, lastly, the Commission adds that as before, Member States will continue to apply their "national corporate income tax rules with respect to the profits attributable to a digital permanent establishment in their jurisdiction"[59].

The preferred options also entails a recommendation to the Member States to implement digital permanent establishment and profit allocation rules in their double tax treaties.

52 Ibid. pg. 47.
53 Ibid. pg. 48.
54 Ibid. pg. 49.
55 Ibid. pg. 49.
56 Ibid. pg. 50.
57 Ibid. pg. 50.
58 Ibid. pg. 50.
59 Ibid. pg. 50.

5.8. Interim Solution

The general objective for the interim solution is the same as for the comprehensive solution, but the specific objective is different: The specific objective is to create a tax targeting business models that are easy to implement and improves the "level-playing field" and "fair taxation" in the interim period until the comprehensive solution is implemented[60].

5.8.1. What Is The Baseline Against Which The Interim Solution Is Assessed?

As the main purpose of the interim measure is to take action to meet the incremental taxation issues arising in the new digital economy era until a comprehensive solution is set, the interim solution will be "assessed against a scenario, in which the preferred comprehensive solution is not yet in place[...]". Additionally, particularly to prevent unilateral measures by Member States, the solution must be quick and easy to implement. As seen in table 6, several Member States have either already taken unilateral measures, or have concrete plans to do so.

5.8.2 What Are The Available Interim Options?

The EU Commission argues that available interim options must "reconcile with the current (international) tax framework".[61] Notably, the interim measure must fit in with important tax frameworks such as the "EU treaties, the rules implied by membership of the World Trade Organisation, and other international commitment, for example through the Inclusive Framework of the OECD multilateral, double tax treaties, and the EU rules for VAT".[62] Available interim options must also be fairly quick and easy to implement and should preferably be in line with earlier measures enacted to meet taxation challenges in the era of the digital economy.

Against this backdrop, the EU Commission finds that raising "VAT rates on digital services" and "tax[ing] profits" are not feasible options as they run counter to respectively the EU VAT framework and various double tax conventions."[63] Similarly, a tax on profits, although theoretically more efficient, is discarded on the grounds that it would interfere with "double tax conventions"[64]. Furthermore, the Commission rejects introducing a "transaction tax on those digital services that are remunerated by users through the provision of data is"[65] as its implementation would be too difficult.

In conclusion, the Commission argues that a revenue tax is the most viable option.

Below, the details of the revenue tax will be outlined.

Design options of a revenue tax on digital services

In its assessment paper, the EU Commission specifies the scope of the rules in light of the following: material scope; whether the rules depend on a threshold being met, and, if the answer is in the affirmative, what the level of the threshold should be; the tax rate; the tax revenue potential; the level of additional tax imposed on companies; how taxes will be allocated; relief of double taxation, and collection of taxes.

- material scope (which activities are covered)

Before defining the specific scope of the revenue tax

60 Ibid. pg. 53.
61 Ibid. pg. 55.
62 Ibid, pg. 55.
63 Ibid, pg. 56.
64 Ibid, pg. 56.
65 Ibid, pg. 56.

on digital services, the Commission states in general that the tax must "apply to resident and non-resident companies alike, as well as to domestic and cross-border transactions"[66]. Furthermore, solutions to double taxation issues must be drafted. Proposed solutions include allowing for deductions of the revenue tax against the corporate tax base. These are discussed below. Additionally, the Commission argues that not applying any interim solutions is unacceptable, because of the risks of distortions of the market due to unilateral measures by the Member States[67].

Turning to what the specific scope of the revenue tax should be, the Commission expresses that a "key principle to respect when addressing challenges in taxing the digital economy is the taxation of profits where the value is created, along with the aim to create simple rules"[68]. As the interim solution also needs to be easy and quick to implement, the EU Commission propsoes that the revenue tax will be based on user contribution. In short, user contribution involves several factors such as "technology (such as an algorithm), knowledge and user contribution."[69]

The Commission asserts that the concept of user contribution can be defined in three ways: in a broad sense, which entails taxing all business models as previously described; in a narrow sense, which means taxing only "business models where the user contribution plays a central role in the sense that the service would not exist if the user did not contribute to it"[70], and in a mixed sense which means "levying [...] tax on a broader scope than the narrow one by adding other services where user contribution is significant but maybe not essential"[71].

In determining which of the three approaches should apply, the Commission looks to which option they believe best prevents further fragmentations of the single market, improves fair taxation, is simple to implement and carries the lowest risk of taxing too heavily services that play a key role for the development of the digital single market. On this background, the Commission argeus that either the narrow scope or the (selective) mixed scope is the best option. As the narrow scope may have the best economic impact as it "notably [...] minimises additional distortions, while still having broadly the same revenue potential as the mixed scope"[72], however, the Commission seems to favor, overall, the narrow scope.

- application and level of a revenue threshold

At the outset, the Commission states that there are "good reasons to apply some form of revenue threshold"[73]. To name a few, "larger companies are more easily able to engage in aggressive tax planning [...]", and "a certain scale is necessary for companies to benefit from user contributions and network effects"[74]. And turning to whether the threshold should be based on all revenue or revenue only from relevant digital services, the Commission argues that as some companies, particularly smaller ones, may not record separately revenues from the services falling under the material scope of the new tax, "a threshold on general turnover would greatly limit the extra burden imposed on companies and provide important legal certainty"[75]. On the other hand, the Commission admits it may seem "unreasonable to impose a tax on a company above the general threshold, which has only minor relevant digital services in the EU"[76]. As both approaches have their own rationale, the Commission does not conclude on which approach is preferable. It argues, however, that some kind of threshold must be applied.

Regarding the threshold level, the Commission, in addition to defining a general turnover threshold, proposes a "complementary specific threshold set at EU level on the annual revenues from the provision of taxable digital services could further limit the application to the

66 Ibid, pg. 57.
67 Ibid. pg. 60.
68 Ibid. pg. 61.
69 Ibid. pg. 61.
70 Ibid. pg. 58.
71 Ibid. pg. 58.
72 Ibid, pg. 66.
73 Ibid. pg. 66.
74 Ibid pg. 66.
75 Ibid. pg. 66.
76 Ibid. pg. 67.

most significant cases”[77]. On this background, then, and, they argue, to ensure proportionality of the measure and to avoid “hurting the digitalisation of the economy and not be discriminatory against non-resident companies”[78], the tax would apply to businesses being above both of two thresholds: 1. “An annual worldwide total revenue above EUR 750 million, at the level of the multinational group to which the business belong, if applicable. 2. Revenue from the provision of digital services above a threshold of EUR 10-50 million”[79].

- tax rate, tax revenue potential and the level of additional tax imposed on companies

The Commission also discusses the tax rate and the tax revenue potential and the level of additional tax imposed on companies. The tax rate will be levied at a single rate. As to the tax revenue potential, the Commission states that both a “top-down and a bottom-up estimation of expected tax revenue conclude that the expected additional revenue collected from the tax would be rather moderate, but with significant growth potential over the next years”.[80] Regarding the level of additional tax imposed on companies, the Commission outlines that since “costs are not taken into account, the corresponding tax on profits implied by the tax on revenue, even at a low rate, could be substantial for individual companies”[81]. To illustrate, the Commission sets the following example: if a company that has EUR 100 of gross revenue and EUR 85 of (deductible) costs, it has a mark-up of 15 %. If it pays a tax on gross revenue of 2 %, it has to pay EUR 2 in revenue tax, which corresponds to a profit tax of 2/15 = 13 %. If a tax on revenues from digital services is deductible from the corporate tax base, the implied profit tax rate reduces to about 10 %[82]. Further, according to the Commission, the rate “should be decided taking into account both the amount of revenue generated form the tax and possible distortions from a business perspective”[83].

- allocation of taxes

According to the EC, two approaches can be made to the question of how taxes shall be allocated: tax can be collected based on user location and based on where payments have been made. Although allocating tax based on where payments are made would be the easiest solution both for companies and tax administrations[84], the Commission highlights that since the rationale for the interim solution is to “be a good and simple interim proxy to deal with the most extreme cases where users contribute a very significant share of the value”[85], allocating taxes based on user contribution is the best option. In specific cases, however, one can deviate from this approach, for instance in online advertising cases, where they argue it could be better to allocate taxes based on the number of times a user accesses a displayed advertisement.[86]

- relief of double taxation

In discussing methods for alleviating double taxation issues, the Commission finds that one should “[allow for] the deduction of the new tax as a business expense from the corporate tax base”[87]. This approach is preferred over crediting corporate tax against already paid the new tax or vice versa as stated above. Further, the Commission argues that there is “no risk of taxing the same service twice under the new tax”. If, however, revenue is associated to, for instance, an online advertising service and an online marketplace service, one would, according to the Commission, “take precedent over the other to ensure that the same revenue cannot be taxed twice”[88].

- collection of taxes

As enforcing withholding taxes on payments entails “technical and procedural difficulties” deemed to be “insurmountable”, the Commission instead invites the

77 Ibid. pg. 68.
78 Ibid. pg. 78.
79 Ibid. pg. 78.
80 Ibid. pg. 69.
81 Ibid. pg. 71.
82 Ibid. pg. 71.
83 Ibid. pg. 71.
84 Ibid. pg. 72.
85 Ibid. pg. 72.
86 Ibid. pg. 72.
87 Ibid. pg. 73
88 Ibid. pg. 73.

Member States to use a self-declaration system[89]. This system has, according to the Commission, several benefits: Along with being suitable for modest tax collections as will be the case in applying the interim solution, companies are also, in general, already familiar with this system.

- other economic impacts of tax on revenues from digital services

To start, the Commission argues that taxes on revenue is efficient under a number of circumstances. Firstly, a turnover tax is said to be "better than a profit tax in terms of social welfare"[90]. The reason for this, the EC argues, is that such a tax significantly reduces tax avoidance and erosion. Although a turnover tax may, however, result in a loss of production efficiency, this is "more than compensated for by the increase in revenue efficiency due to larger compliance"[91]. Further, since the tax would have a fairly narrow scope and because it affects business models with a large user base, the Commission believes cascading issues to be kept at a minimum[92]. And, despite limited evidence on "the pass-on effect of a new tax on turnover", economic theory and VAT experiences suggest "that there is no uniform answer for the variety of digital services considered"[93]. For online retail, however, evidence indicates that online purchasers react strongly to price increases, which the EC argues limits "the possibility for companies to pass additional tax on to consumer prices"[94].

- administrative burden and compliance costs

As businesses "must identify gross revenues from supplying digital services and relevant user statistics" and must declare and pay taxes to Member States assigned with the relevant taxing rights, the new rules require additional reporting requirements[95]. And, since the rules might "cover several different business models even for the same enterprises, taxpayers will have to further allocate internally revenues to various proxies (for example, number of active users and monetisation by user, local domain names, IP addresses, number of visits, number of clicks, number of ad displays, location of the accommodation, transport, entertainment services provisions"[96]. According to the Commission, it will not be an arduous task to collect relevant data to determine whether the business is in compliance with the new rules, nor are additional tax compliance costs expected to be large. For non-resident taxpayers the compliance costs and administrative burdens may, however, be slighter higher than for resident taxpayers. And as far as the burdens and compliance costs for national administrations goes, the "interim solution has initial set up costs limited to reporting adjustments, declaration and payment (in terms of both procedures and IT systems) and the corresponding staff and training costs"[97]. For tax administrations levying taxes on non-resident taxpayers, the tax collecting process may be cumbersome and thus costly, but according to the Commission, these can make use of the administrative tools available at the EU or OECD level[98].

- coherence and articulation with the comprehensive solution

The EU Commission argues again that the interim solution will be in line with the comprehensive approach, one of the most important guidelines in formulating the interim solution. Upon implementation of the comprehensive solution - the Directive on digital permanent establishment and profit allocation rules, adoption of the adapted CCCTB and Recommendation to revise double tax treaties, the interim solution would cease to exist[99].

89 Ibid. pg. 74.
90 Ibid. pg. 75.
91 Ibid. pg. 75.
92 Ibid. pg. 74.
93 Ibid. pg. 75.
94 Ibid. pg. 75.
95 Ibid. pg. 76.
96 Ibid. pg. 76.
97 Ibid. pg. 77.
98 Ibid. pg. 77.
99 Ibid. pg. 78.

5.8.3 Preferred Interim Option

Conclusion and description of the European Commission's preferred interim solution

Following the discussions above, the Commission concludes that "the preferred interim solution is a Directive on a common system of a tax on certain digital services". As stated, this measure carries a "narrow scope, levied on the gross revenues of a business resulting from the exploitation of digital activities characterised by user value creation, namely advertising revenue and revenue from services provided by online marketplaces/intermediaries"[100], and would ensure simplicity.

Regarding the threshold, the tax would apply to businesses being above both of two thresholds: "an annual worldwide total revenue above EUR 750 million, at the level of the multinational group to which business belong, if applicable, and revenue from the provision of digital services above a threshold of EUR 10-50 million"[101]. The single rate would amount to 1-3 %, and taxes would be deductible from the corporate tax base.

Moreover, taxing rights would be assigned according to user location. As mentioned above, the EC argues that this approach is better in line with the aim to match taxing rights with where value is created. Lastly, the EU Commission argues that the preferred option is consistent with the principle of proportionality and that it does not exceed what is necessary in order to ensure the proper functioning of the single market[102].

100 Ibid. pg. 78.
101 Ibid. pg. 78.
102 Ibid. pg. 80.

6

Progress made so far by the OECD and Commission – pros and cons presented by stakeholders

6.1. OECD level

Based on the progress that has been made at the OECD level, summarized above, it has been questioned whether it is likely that the recommended OECD BEPS measures, which aim to create "a modern corporate tax framework which allows for the fair and efficient taxation of the digital economy" by aiming to ensure location taxation (PE threshold), are sufficient to reach the goal of fair taxation and balanced allocation of taxing rights in the digital economy.

Questions have been raised whether the BEPS measures adequately address the emergence of new business models. In short, this is because contrary to how traditional business models operate, new business models, continuing to rise in number, do not require the same level of physical presence in any given country to successfully conduct business. Rather, it has been said that businesses increasingly operate remotely, not requiring physical offices or staff in the country they operate in and generate revenues (so-called "scales without mass").

The IF Members are committed to working together to reach a consensus-based solution by 2020 (an update on the progress is scheduled in 2019). Assuming this work does not culminate in specific actions, e.g. an expansion of the PE (digital nexus) and revised principles for attribution of profits to digital PE's, some believe that the implementation of unilateral measures is likely to increase.

A question that is currently debated to a great extent amongst IF Members and others and that deserves specific attention is where value in fact is created and who is responsible for it. Currently, a conclusion regarding these questions is not drawn. As of now, there are grounds to believe that it might be some time until the IF Members are able to agree on where value creation takes place and who is responsible for it, as answers to these questions will be vital in designing what tax rules apply. However, the IF Member States do, at the least, agree that agreeing on these questions is crucial to designing a framework that leads to a new international consensus on the allocation of taxation rights.

6.2 EU level

In the following paragraphs, we summarize the pros and cons of the interim and comprehensive solutions presented by different stakeholders. Pros and cons of the comprehensive solution will be summarized first in 6.2.1., and pros and cons of the interim solution will be set out in 6.2.2.

6.2.1. The comprehensive solution at the EU level

Pros presented by the EC of the comprehensive solution include that it is more in line with what is discussed at the OECD level. Furthermore, the EC points out that the solution is in line with current rules on taxation of profits of PE's and rules on avoidance of double taxation, possibly increasing the probability that the states reach a consensus on implementing it. Further, as for any coordinated solution, the comprehensive solution is more likely to put a stop to uncoordinated, unilateral measures taken at the state level, abating the effects this has on fragmenting and distorting the market.

The comprehensive solution entails that states need to re-negotiate treaties they have with third countries to enact the provisions. Questions like what the taxable nexus should be, where value is created and, in turn, what principles of attributing profits should be applied-, core questions on how the tax rules should be defined, must be solved.

To ensure that the comprehensive solution is workable stakeholders argue that more work is required to find and agree on the relevant nexus criteria, i.e. the relevance of the users and user contributions and which principles of profit attribution, other than the profit split method, should apply.

6.2.2. The interim solution at the EU level

First, since the current proposal allows for the DST to apply only to MNEs and entities above a certain size, EC is are scoping out SMEs and micro entities, and makes the solution an interim proxy to deal with the larger entities. In this context, EC says it is important that actions are taken quickly, as the introduction of unilateral measures at the Member State level do not, as of today, seem to be slowing down, cf. the table below for an overview of measures that are either already, or about to be, taken in the EU and third countries since our 2017 Report.

Country	Planned/ adopted/ implemented	Type of tax
Indirect taxes[103]		
In the European Union		
Hungary	Implemented (2014), amended (2015, 2017)	Tax on advertisement
UK	Planned (2019)	Withholding tax on revenues derived from intermediation and the provision of online advertising
Italy	Planned (2019)	Tax on digital business-to-business transactions of electronically supplied services
France	Implemented (2003), amended (2016)	Levy on access to content, including digital content by means of a video-on-demand / over-the-top online platform (for the cinematography fund)
Germany	Implemented (2004), amended (2010)	Levy on access to content, including digital content by means of a video-on-demand / over-the-top online platform (for the cinematography fund)
Romania	Implemented (2005), amended (2008)	Levy on access to content, including digital content by means of a video-on-demand / over-the-top online platform (for the cinematography fund)
Croatia	Implemented (2007)	Levy on access to content, including digital content by means of a video-on-demand online platform (for the cinematography fund)
Portugal	Implemented (2007)	Levy on access to content, including digital content by means of a video-on-demand online platform (for the cinematography fund)

103 VAT on digital services is not included here.

Belgium (certain regions)	Implemented (2009)	Levy on access to content, including digital content by means of a video-on-demand online platform (for the cinematography fund)
Czech Republic	Implemented (2012)	Levy on access to content, including digital content by means of a video-on-demand online platform (for the cinematography fund)
In third countries		
United States (certain states)	Implemented (2015-2016)	Levy on access to digital content and streaming services
India	Implemented (2016)	Levy on the provision of online advertisement services by non-residents
Canada (certain states)	Planned (2018)	Levy on access to digital content and streaming services
Brazil (certain states)	Planned (2018)	Levy on access to digital content and streaming services
Direct tax initiatives (anti-abuse and new approaches to define a significant economic presence for tax purposes)		
In the European Union		
UK	Implemented (2015)	Diverted profits tax
Italy	Adopted (2017), in force (2018)	Administrative procedure for large non-resident multinational enterprises
Slovakia	Adopted (2017), in force (2018)	Tax on income derived from intermediation through websites and online platforms
In third countries		
Israel	Implemented (2016)	The significant economic presence test for non-resident enterprises
Australia	Implemented (2017)	Diverted profits tax and additional anti-avoidance rule for large non-resident multinational enterprises
India	Planned (2018)	New concept of significant economic presence
United States	Adopted (2017), in force (2018)	The introduction of the concept of a 'base erosion anti-abuse tax' (BEAT) for large multinational enterprises

Source: European Commission analysis based on various sources, such as national legislations, replies to the Member State consultation or other government sources, websites of national film funds, European Film Agency Directors (EFADS) website, website of the International Bureau of Fiscal Documentation (IBFD - for most of the direct tax initiatives) and Thomson Reuters Tax & Accounting for the US BEAT measure.

Additionally, in the recently published 2018 Budget the UK stated that a Digital Service Tax ("UK DST") will be introduced from April 2020.[104] According to the 2018 Budget the UK DST applies a 2% tax on the revenues of specific digital business models where their revenues are linked the participation of UK users. The tax will apply to: search engines; social media platforms; and online marketplaces as the UK government considers that these business models derive significant value from the participation of their users. According to forecasts made by the UK Treasury, "the UK DST will raise £1.5 billion over four years and ensure digital businesses pay tax in the UK that reflects the value they derive from UK users".[105]

However, although the material scope of the interim solution appears to only target MNEs, the implementation of it may bring about a series of potential issues. The Finnish Finance Minister, Petteri Orpo, has, for instance, stated that the proposal "is not very good", the main point being that it would not collect much revenue (5 billion EURO). Consequently, the situation could be that Member States generate barely enough revenue from the DST tax to cover costs tied to the implementation of the rules.

The legality of the interim solution has been questioned in a confidential legal opinion from the EU

104 HM Treasury Budget 2018, Digital Service Tax.
105 Ibid.

Council by EU's lawyers. In the legal opinion, it is stated that the digital turnover tax would not constitute an "indirect tax" on companies, raising doubts about the correctness of the legal basis under which it has been proposed. The EU Commission, however, strongly disagrees with the position taken by the lawyers, stating it is "convinced" that the legal basis for introducing the measure is correct, and that the levy indeed constitutes a legitimate tax on companies. It has also been pointed out that further assessment of the legality of the solution is also necessary to ensure that it does not come in conflict with other international agreements and obligations, such as the WTO agreements.

EC is also aware of the challenge that the DST may create double taxation issues. This is because businesses, without effective credit mechanisms in place, are most likely already paying taxes - either within or outside of the EU. To deal with this risk of double taxation, the preamble (but not the legislative language) of the draft directive recommends that states of residence will allow for deductions of business expenses.

Stakeholders have also mentioned that the DST may be higher than the corporate tax under the comprehensive solution, possibly creating disincentives for Member States to enact the comprehensive solution. To ensure Member States do not reject the comprehensive solution once it is in place - opting instead to keep the interim solution in place-, equipping the solution with a "sunset clause", has been suggested by some Member States.

Some stakeholders have also argued that it remains unclear where value is created and who creates it. Pinpointing where value is created and who creates it is vital to ensuring that the comprehensive solution operates in line with its goal, but serves a larger purpose as well: Along with playing a central role in understanding how digital businesses operate, it will also play a vital role in evaluating whether and to what extent the DST is justifiable and represents a fair allocation of taxing rights. As such, answers to the questions of where value is created and who creates it go to the core of how the tax rules should be designed, and, consequently, are a key matter of dispute between the Member States. As answers to these questions to a large extent are left unanswered, the interim solution is clearly put to a test, and further work and assessment on these matters before the solution is implemented has been emphasized.

6.3 Going forward

Although it is uncertain if and when the DST will be agreed on, all of the discussions, debates and recommendations as to how to solve the taxation issues in the field of the digital economy do not leave the impression that work on making progress is in a standstill. Quite the contrary, the Inclusive Framework in the OECD will, as mentioned, continue to labour over reaching a consensus-based solution by 2020 (an interim report is scheduled to be released in 2019). And, despite the different positions taken by EU Member States, the EU is, as also mentioned, working to find a compromise by the end of the year of 2018. This may prove an arduous task as countries differ vastly in their views of whether the interim solution is viable, some preferring instead a global, comprehensive solution.

To exemplify the diverging views on the matter exhibited by some states, reference can first be made to a joint statement from the Finance Ministers from Sweden, Finland and Denmark. The Finance Ministers expressed the following:

“If we in the EU unilaterally apply a digital services tax on gross income, including to non-EU firms, the tax will be difficult to enforce and there is a substantial risk that it will complicate international cooperation in the tax area. (...) The Nordic countries will continue to participate actively and constructively in such work, and we would support an acceleration of the OECD discussions on this topic, so that we can find a consensus-based solution rapidly”.

And, Eric Robert, Adviser of BEPS, Taxation and the Digital Economy, states that numerous OECD countries are opposed to a short-term solution:

“Regarding unilateral actions and more precisely the proposal made by the EU regarding the Digital Services Tax, I think here clearly when you look at the Interim Report which was released this year, there is no consensus within our membership on the merit, or the need, for immediate and unilateral action. I would add to that, that, speaking from the point of view of the OECD, or the Inclusive Framework, it is in our DNA to try to strive for consensus-based, multilateral solutions. So, we have a natural suspicion towards unilateral, uncoordinated action”.

Further, there is a clear difference between countries quintessentially supporting the interim solutions and countries that do not. Countries typically adhering to the former group include larger countries, as larger countries, presumably, would generate higher levels of revenue from the DST compared to smaller countries, such as the Nordics. Consequently, leaders of these countries have strongly voiced the opinion that the interim solution be implemented: The French Finance Minister Bruno Le Maire has, for instance, recently offered to facilitate a compromise by offering to add a “sunset clause” to the European Union tax. Under his proposal, the DST would be replaced immediately by the comprehensive solution once it is in place.

On the opposing side of the debate is the U.S., which only very recently strongly discouraged that the DST be implemented. In a letter dated October 2018 from the US Senate Finance Committee to the president of the European Commission President, Jean-Claude Juncker, and the president of the European Council President, Donald Tusk, it asked that the tax be abandoned. The letter reads:

“The EU DST proposal has been designed to discriminate against U.S. companies and undermine the international tax treaty system creating a significant new transatlantic trade barrier that runs counter to the newly launched US and EU dialogue to reduce such barriers. Therefore, we urge the EU to abandon this proposal, urge the member states to delay unilateral action and instead refocus efforts on reaching consensus with other leading economies within the OECD on any new digital taxation models”.

In light of wording of the letter, it could be assumed that the US will impose countermeasures in a case where the DST is implemented. Such possible countermeasures carry the risk of negatively impacting trading and growth in the EU, and particularly for exporting Member States.

On a final note, the DST requires a unanimous vote by Member States to be adopted. As we have mentioned in the above, although there appears to be an increased consensus to the solution, Member States still differ vastly in their views, leaving it highly uncertain whether the DST will reach the required unanimous vote.

6.4 Conclusion

As the digital evolution will have a profound effect on the economy and business life as a whole, many argue that actions are required in order to update and modernize the tax framework so that it better reflects how business is carried out in the modern world of digital economy.

Considering the ongoing discussions at both OECD/G20 and EU level and the propositions rendered by the Commission, in line with what seems to be the majority opinion among Member States action is possible at the EU level. However, it is most important that any solution is agreed at a global level to be truly effective. Further work, however, is required to review, understand and agree on the nexus principles, where value is created and the relevance of the user contributions. The principle of attribution also, in our opinion, should undergo further assessment, particularly because the application of a profit split method on digital business models, as suggested by the EC, may be challenging.