GARRIGUES

COMMENTARY
TAX

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A NEW TAX SYSTEM FOR THE DIGITAL ECONOMY IN THE EUROPEAN UNION

At its meeting held on December 5, 2017, the Economic and Financial Affairs Council of the European Union (ECOFIN) approved its conclusions on taxation of the digital economy in the EU. These conclusions are part of the broader objective of the Digital Single Market Strategy for Europe, and are aimed at guiding the legislative proposals which, in relation to taxation at least, the European Commission will have to put forward by early 2018. In this same context new VAT rules on e-commerce were approved.

The Digital Single Market (DSM) Strategy for Europe is one of the top political priorities of the European Commission, and seeks to achieve the approval of a stable framework in matters such as data transmission and digital content, audiovisual services, digitalization of the public sector, the creation of a first rate infrastructure and communications network (5G) across the EU, setting a common approach to cybersecurity and the fight against online crime, investment in training, education and R&D fit for the digital age, artificial intelligence and blockchain technology, among others.

In the field of taxation, the documents published by the Commission and the Council start out from the widely-held view that the traditional rules on distribution of taxing powers (based on tax residence or the existence of a permanent establishment), the very definition of permanent establishment, or the context offered by double-taxation treaties were only suitable in the so-called traditional economy, but are no longer fit for purpose in relation to the taxation of income in the digital economy.

In these context, it is sought to redefine those taxation rules to limit opportunities for base erosion, on the one hand, and on the other, to ensure that taxation is neutral (equivalent) regardless of the way of doing business of enterprises and their degree of digitalization. This makes it necessary to align effective taxation with value creation in accordance with the arm's length principle, having regard to the value chain in the digital economy and the zero relevance for these purposes of having a greater or lesser physical connection with a specific jurisdiction. It may be seen, therefore, that this initiative is clearly related to BEPS Action 1 (Addressing the Tax Challenges of the Digital Economy), to the operating models it defines, and to the potential proposals for reform indicated in that report.

To be more specific, and referring first to the Communication from the Commission dated September 21, 2017 (A Fair and Efficient Tax System in the European Union for the Digital Single Market COM (2017) 547 final), the legislative proposals which, in principle, the European Commission must put forward in 2018 should be built around the following principles/objectives:

1. The new taxation system needed for the digital economy is embedded in a general review of corporate income tax, which includes the various initiatives to tackle aggressive tax planning and the state aid proceedings against, among others, paradigmatic enterprises of the digital economy, such as Apple and Amazon.

2 Targeted enterprises: the Commission acknowledges that, to varying degrees, digitalization affects all businesses. Also that there is no single defining feature of new ways of doing business in the digital space, and therefore provides a nonfinite list of examples of those activities:

   a) Online platforms selling goods or connecting buyers and sellers in return for a transaction or placement fee. Examples: Amazon, Zalando or Alibaba.

   b) Social media relying on advertising revenues by delivering targeted marketing messages to consumers. Examples: Facebook, Xing or QZone.

c) Platforms charging a subscription fee for continued access to digital services (music or videos, for example). Examples: Spotify, Netflix or iQiyi.

d) Collaborative platforms connecting spare capacity and demand, and enabling users to have "access" to assets (without owning them) in exchange for a fee. Examples: Airbnb, Blablacar or Didi Chuxing.

3 Definition of an alternative taxation "nexus" by amending/broadening the concept of permanent establishment (PE), to ensure that taxes are paid in the states where businesses have a commercial presence (where they provide services digitally) despite having little or no physical presence.[1]

4. Definition of transfer pricing and profit attribution rules that are fit for the new digital business models, based on the identification and correct pricing of intangible assets, data and knowledge.

5. Reference, in the medium to long term, to the proposal for a common consolidated corporate tax base (CCCTB) as a suitable framework for achieving the foregoing objectives. This is because in the Commission's opinion the CCCTB provides sufficient room for maneuver to include a new definition of permanent establishment, and above all, to define the rules on profit attribution (tax base allocation) for the income generated by digital multinationals. According to the Commission, those rules on allocation of the CCCTB, currently based on assets, labor and sales, already better reflect where the value is created, but there is still room for them to be updated/enhanced further to capture digital activities fully.

6. Consideration, in the short term, of other potential solutions, that have already been presented internationally, such as:

a) Creating an "equalization" tax on all insufficiently taxed income generated through internet-based activities. It could either be implemented as a corporate income tax surcharge or a separate tax.

b) Charging a gross-basis final withholding tax on payments made to nonresident digital providers of goods or services.

c) Applying a special levy on revenues derived from all transactions concluded remotely (digital services or advertising activity) with in-country customers where a nonresident entity has a significant economic presence.

The Commission acknowledges in its Communication that before any of these measures can be implemented, their compatibility with the fundamental freedoms of the Treaty on the Functioning of the European Union, with State aid rules, with double-taxation treaties and with free trade agreements and WTO rules needs to be examined, although it appears to give priority to the adoption of immediate measures. The principal executive body of the EU wants these to be reflected in the OECD report to the G-20 finance ministers at their meeting in April 2018, at which it expects to make a significant contribution. At all events, independently of that global progress –which continues to be the preferred option -, the Commission will consider the adoption of its own measures in the legislative proposal which it should, in principle, adopt in spring 2018.

More recently, in December 2017 the ECOFIN welcomed the above conclusions reached by the Commission, although it underlined the need to continue with their implementation through the adoption of effective political and legislative decisions in the short and medium term, especially in the following areas **(Doc. 15175/17, FISC 320, ECOFIN 1064)**:

- Redefinition of the concept of permanent establishment, to include the so-called virtual permanent establishment, together with a review of the rules on transfer pricing and on attribution of profits to PEs, probably with similar factors to those referred to in BEPS Action 1 (based on revenues, digital presence and data consumed in the source state).
- Inclusion of specific intangibles, such as the information and data needed to operate in the digital business (users and consumer trends) among the factors considered to allocate the value and source of taxable profits.

[1] On December 12, 2017 Facebook made public its decision to allocate to the subsidiaries providing local sales support services the advertising revenues generated in those markets (formerly recorded by their head office in Dublin, Ireland).

- Implementation of immediate and temporary measures, such as the equalization tax mentioned by the Commission, which would enable the revenues from digital activities to be taxed in the source state. That tax would, in principle, remain outside the scope of international tax treaties. ECOFIN recalls that this initiative was expressly supported by the finance ministers from ten member states, including Germany, France, Italy and Spain.

It is also the opinion of the EU Council that the foregoing measures need to be addressed in a global context, and therefore urges the OECD to modify its Model Tax Convention and accompanying commentaries, as well as its Transfer Pricing Guidelines and Guidance on Attribution of Profits to Permanent Establishments. Specifically within the scope of the EU, it invites the Commission to put forward, in early 2018, a legislative initiative addressing those elements.

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