SULLIVAN & CROMWELL LLP

March 27, 2018

Digital Economy Taxation

OECD Publishes Report on Taxation of the Digital Economy; European Commission Publishes Draft Directives

SUMMARY

While the OECD has published a report on the taxation of the digital economy, noting that there is no consensus on what changes, if any, should be made, the European Commission has published two draft directives.

The first sets out a "digital services tax" levied on businesses of sufficient size at a rate of 3% on their gross revenues from on-line advertising, sales of user data or provision of digital platforms enabling user interaction. This is intended as a temporary measure until wide agreement can be reached on a comprehensive proposal for digital tax reform.

The second is the Commission's comprehensive proposal for reform. It would introduce the concept of "significant digital presence" for corporate income tax purposes. A member state would be able to tax a company on profits treated as made through a significant digital presence, even if it had no physical presence in that member state.

The digital services tax may be implemented by individual member states even if no EU-wide directive is adopted. The digital services tax as proposed raises a number of issues, such as:

- how it will interact with corporate income tax systems and tax treaties;
- what is and is not taxed; and
- how and where users are counted in calculating it.

BACKGROUND

The past five years have seen an increasing international focus on the taxation of digital business. When the OECD began its Base Erosion and Profit Shifting (BEPS) Project in 2013, it recognised that it was

possible to do business with customers over the internet without paying taxes on profits in that jurisdiction – and that that was being questioned. Action 1 in its Action Plan on Base Erosion and Profit Shifting of July 2013 was, therefore, to "Address the tax challenges of the digital economy". The Action Plan noted several issues specific to the digital economy:

- unparalleled reliance on intangible assets;
- massive use of data (notably personal data);
- multi-sided business models capturing value from externalities generated by free products; and
- difficulty in determining the jurisdiction in which value creation occurs.

The OECD established a task force to look at these issues. It did note, however, that if changes to business models affected where functions were carried out and profits were taxed, that did not necessarily indicate that the existing rules were flawed. Moreover, the focus of the OECD's efforts – operating as it was by consensus – was on artificial structures used by multinationals to pay less tax. The focus was not on changing the standards incorporated in international treaties on which jurisdictions should have taxing rights over income in general, or how those rules allocated rights to tax income from cross-border digital services in particular.

This approach was reflected in the October 2015 Action 1 Final Report. This listed several measures taken as part of other BEPS actions, such as:

- modifying the definition of "permanent establishment"[1] in the OECD model tax treaty so that, for example, the warehouse of an online seller might now be sufficient to create a taxable presence; and
- revising transfer pricing guidance to clarify that performing the important functions and controlling economically significant risks was more important than mere legal ownership of an intangible asset when deciding how to attribute the income derived from that intangible.

The report also recommended provisions that would allow states levying valued added or goods and services taxes to tax transactions involving consumers in their jurisdictions. The task force had, however, considered and rejected three other options for increasing the tax borne by digital businesses:

- a new nexus in the form of a significant economic presence, sometimes referred to as a "digital PE", which would be sufficient to allow the host state to impose corporate income tax on a non-resident with such a presence;
- a withholding tax on certain types of digital transactions; and
- an equalisation levy, possibly in the form of an excise tax, to be borne by non-resident businesses with a significant economic presence in the customer jurisdiction, and possibly by domestic businesses as well.

[1] A "permanent establishment" or "PE" is a presence of an enterprise in a foreign state which is sufficiently significant that the foreign state is allowed to tax the profits it generates.

One of the difficulties for proponents of these measures is ensuring that they comply with international commitments: existing tax treaties do not generally contemplate taxation of digital PEs and limit the ability of a jurisdiction to discriminate against businesses from the other contracting jurisdiction. Similarly, EU treaties forbid discrimination against undertakings from other member states unless it can be justified by objective factors and is proportionate. Although EU treaties are unlikely to change, it is possible to amend tax treaties: but this takes time and consensus.

Some states, including some EU member states, most notably France, remained of the view that certain forms of digital business were undertaxed and pushed for action at the OECD and EU levels.

OECD REPORT

The OECD task force has continued to work on the tax challenges of digitalisation under a mandate from the G20. It has now published an interim report on the "Tax Challenges Arising from Digitalisation" in March 2018. The report illustrates the division of opinion among states participating in the OECD Inclusive Framework on BEPS:

- there is no consensus on whether the international tax system should be adapted to the digitalisation of the economy; and
- among the participants who agree in principle that it should be adapted, there is no consensus as to the form which reform should take.

The report notes also that some states advocating reform (again, not all) believe that their inability to levy tax on transactions with customers in their jurisdiction is a sufficiently urgent problem that, pending some form of widespread consensus on reform, they need to put interim measures in place. The report does not express a view on whether interim measures are appropriate, but sets out criteria by which any such measures should be judged.

The report recommends further work and discussion with a view to reaching some level of consensus by 2020.

EU PROPOSALS

Introduction

In September 2017 France, Germany, Spain and Italy, joined by six other member states, wrote to the European Commission asking it to explore new ways of taxing digital companies. The UK added its voice to calls for change and published a position paper in December expressing support for new measures.

Other member states, such as Ireland, Luxembourg, Malta and the Netherlands, are sceptical of digital tax reform. Their hostility is partly linked to the ways in which reform would undermine their status as competitive tax jurisdictions. But they have also expressed the concern, shared by a number of other

member states (for example, Sweden and Denmark) that the EU should not take unilateral action but continue to attempt to build international consensus through the OECD.

On March 21 the Commission published its own proposals.

The Commission notes that unilateral digital tax measures are already in place or are planned in 10 member states. These measures take different forms in different member states: Italy has introduced an excise-style levy on digital transactions, Slovakia a form of digital permanent establishment, and Hungary a tax on the advertising revenues of resident and non-resident companies.

Concerned that this lack of coordination risks further fragmenting the Single Market and distorting competition, the Commission has proposed two draft directives. The first is an interim tax on digital services. The second – which the Commission introduces as the comprehensive permanent solution – would treat a foreign business providing digital services to users located in an EU member state as having a permanent establishment in that state (and so falling within that member state's charge to corporate income tax). Coupled with this is a recommendation that member states amend their tax treaties with non-members to allow them to tax digital service PEs.

Interim Measure – Digital Services Tax

The Commission's digital services tax is a 3% levy on the revenues generated from the provision of certain digital services by businesses meeting the draft directive's threshold criteria. A business will meet the threshold criteria if it has global revenues of over €750m, and revenues which are taxable under the draft directive of over €50m. Taxable revenues are defined as revenues generated from:

- services in which value is principally generated through user data from users located in the EU, either through the sale of the data or its monetisation via targeted advertising; and
- the supply of digital platforms that facilitate interaction between users located in the EU (which may include exchanging goods and services by way of the platform).

The Commission estimates that the tax could generate up to €5 billion a year, and that between 120 to 150 companies could be affected by the rules, of which roughly half would be American and one-third European. Each member state would be entitled to the proportion of taxable revenues generated by a business from the supply of digital services to users in that member state.

The draft Directive contains a number of important exclusions, which the Commission identifies as digital businesses in which the user does not play a central role in generating value. Accordingly, the following services do not give rise to taxable revenues:

- the provision of digital content to users;
- services provided between entities within a consolidated group; and
- the provision by trading venues, systematic internalisers or crowdfunding service providers of financial intermediation services which are regulated under EU law.

The location of users would be identified by reference to their IP addresses, or "if more accurate, any other method of geolocation".

Comprehensive Solution – Taxation of Significant Digital Presence

This proposal is not for a new tax, but to widen the scope of national corporate income tax rules:

- first, by extending the concept of permanent establishment to encompass a "significant digital presence"; and
- second, by treating it as carrying out certain functions for the purposes of calculating what profits should be attributed and taxed in the "host" state.

Under the draft Directive, a business would have a significant digital presence in a member state if it fulfils any one of the following three criteria:

- its revenues from the provision of digital services to users located in that member state exceed €7m per tax year;
- it has more than 100,000 users located in that member state who access its digital services per tax year; or
- it creates over 3,000 business contracts for digital services with business users located in that member state in a tax year.

If a business met one of these criteria, it would be deemed to have a permanent establishment and become chargeable to corporation tax in the relevant member state. Like the interim tax, this proposal excludes a variety of services. Services not to be treated as "digital services" for the purposes of the draft Directive include the supply of goods ordered over the internet, television broadcasting services and advertising services "in particular as in newspapers, on posters and on television".

This Directive would apply only to cross-border digital activities within the EU and to businesses operating in a member state which does not have a double taxation treaty with the jurisdiction in which the business is established. The Commission has accordingly coupled this proposal with a recommendation that member states renegotiate their existing double taxation treaties to include provisions which replicate those in the draft Directive.

REACTION

The reactions of EU member states to the proposals have been broadly in line with the division of opinion described above.

France, Germany, Italy, Spain and the UK published a joint statement on March 21, saying that they "continue [to] support the EU's ongoing work and hope it provides an impulse for the discussions at the G20/OECD level, while at the same time providing a basis for co-ordinated EU action to effectively align the taxation of highly digitalised business profits with the place where value is created". On the other hand, reports suggest that the German government is concerned that introducing these measures at a

time of considerable tension with the Trump administration will make it more difficult to engage with the US over its threatened trade tariffs. While there is no indication that Germany would actively oppose reform, it has been suggested that Germany will not join France in aggressively pushing the proposals.

Leo Varadkar, the Irish Prime Minister, described the proposals as “ill-judged”, and made clear that he intended to oppose them at the meetings of the EU Council held through the course of the week of 19 March. Because the proposal provides that member states should permit companies that are resident in a member state to deduct the digital service tax from their taxable profits, Ireland could suffer a material reduction in tax revenue.

The response from other member states has been at best tepid, suggesting that they are yet to be convinced that an interim measure is as urgent as the Commission has made out.

The US administration is against both interim and long-term changes to the taxation of digital businesses. Treasury Secretary Steven Mnuchin commented when the OECD published its report that “imposing new and redundant tax burdens would inhibit growth and ultimately harm workers and consumers.” This is in line with previous statements from senior US Treasury officials that digital businesses are not currently sufficiently different from traditional businesses as to warrant changes to tax rules.

COMMENT

Prospects

So far as the “significant digital presence” proposal is concerned, the Commission itself acknowledged in its explanatory notes to the draft directive that any comprehensive digital tax reform should be multilateral and requires a degree of international consensus which has not yet been forthcoming. The Commission describes the draft directive on significant digital presence as being “intended to contribute to the ongoing work at OECD level” in the hope that it “will serve as an example to influence the international discussions on a global solution”. And, of course, the Commission has proposed an interim tax as a stop-gap measure (and its provisions are rather more detailed than the proposed comprehensive solution). It therefore seems likely that the Commission views its proposed comprehensive solution as a means of sparking debate, rather than as a measure it expects to be implemented in the short to medium term.

As for the interim digital services tax, the hostility of Ireland and the scepticism from other member states mean that its proponents – who must obtain unanimous support for the measure if it is to be implemented on an EU-wide basis – face an uphill battle.

What seems considerably more likely is that one or more member states, most obviously France, will introduce their own digital services tax more or less closely tracking the proposal from the Commission. (The French government is said to have worked closely with the EU Commissioner for Taxation, Pierre Moscovici, on the Commission’s proposals.)

Other Comments

Bearing these points in mind, our remaining comments are focused on the proposed digital services tax. Generally speaking, the introduction of a novel and untested tax creates uncertainty. Even though the new tax is at first glance simple in principle (being a flat tax on revenues), it raises a number of unexpected and unanswered questions.

Would the digital services tax breach tax treaties?

Any state imposing a digital services tax would need to consider whether it has given up the right to levy it on some non-residents under tax treaties with their home jurisdictions. The relevant treaty here will be the treaty with the jurisdiction where the operating entity (rather than the parent) is based. For example, for the many US multinationals which operate in Europe through Irish or Luxembourg subsidiaries, the relevant treaty will be the Irish or Luxembourg treaty with the jurisdiction imposing the tax, not the US treaty.

The Commission appears to have taken the view that introducing the digital services tax will not put member states in breach of their treaties. It has not addressed the question explicitly in the materials it has published, although its discussion of whether the directive could provide for payments of digital services tax to be credited against corporate income tax notes that this could “compromise the legal nature of the tax and impact double tax conventions”.

Would foreign tax authorities give credit for the digital services tax?

This will depend on the domestic law of the taxpaying company’s state of residence, and possibly also on the terms of any treaty with the state imposing the tax. Whether the digital services tax is viewed as a tax on income or something more akin to an excise tax may affect whether the taxpayer’s state of residence will grant credit for it. If the residence state sees it as an excise tax, it may only be deductible from revenue, rather than creditable against home state tax. If, however, the residence state views it as a tax on income, it may give credit – unless it therefore sees the tax as levied in breach of a treaty with the state imposing it. There may be other conditions to meet, for example that the income is treated as arising in the jurisdiction imposing the tax: this could also be a point of contention.

US-parented multinationals with non-US subsidiaries that are liable for the digital services tax will also need to consider whether the digital services tax will be creditable against the US company’s obligation to pay tax on “subpart F income” and “global intangible low-taxed income” earned by “controlled foreign corporations”. In general, the United States only treats foreign taxes as creditable if those taxes are (i) net-basis income taxes or (ii) imposed “in lieu of” a net-basis income tax. Courts and the IRS have, however, concluded on occasion that withholding and other taxes imposed on gross income fall within one of these definitions if:

- they are structured to reach net income; or

- they are viewed as similar to the withholding tax the United States imposes on “fixed or determinable, annual or periodical income” that is not effectively connected with a US trade or business.

What is the scope of the tax?

The scope of the tax gives rise to some anomalies.

- A company selling digital content directly to consumers will not be subject to the new tax, so an online business selling recorded music as downloadable files will be competing on equal terms with a business selling physical records and CDs. By contrast, online advertisements which finance digital content will fall within the scope of the tax. As a result, companies which provide streaming services or subscription-based online newspapers would not be caught by the tax, whereas the same services when funded by online advertising are captured. The reasons for this discriminatory treatment are not made clear in the proposal.
- The tax also discriminates between companies which sell products through a digital interface, which are not subject to the new tax, and companies which operate a digital interface on which third parties’ products are sold (such as digital marketplaces), which are subject to it.
- Nor is it necessarily clear whether a trading platform should be viewed as a digital platform facilitating interaction between users located in the EU, and therefore subject to the new tax. Even though the proposal provides for exemptions in respect of certain financial services, the exemptions are restricted to a small number of activities. These include cash payment services, trading platforms on EU regulated exchanges, regulated crowdfunding services and regulated peer-to-peer lending. Third-country trading venues and non-regulated trading platforms, such as betting exchanges and cryptocurrency exchanges, on the other hand, may fall within the scope of the tax.

How would the tax be calculated and shared among member states?

A member state would be entitled to digital services tax in proportion to the number of users located in that member state. This allocation model does not take into account the effective revenues generated by users in each member state. For example, if a company has the same number of users in two different member states, both member states will be entitled to the same share of tax revenues, even if the company generated more revenue in one of the two (for example, because of higher fees charged in one of the two states). Here again the simplistic approach of the proposal leads to arbitrary consequences.

Moreover, the proposal defines a “user” as “any individual or business”, and provides that the location of users would be identified by reference to their IP addresses, or “if more accurate, any other method of geolocation”. Among other issues –

- If an individual is accessing a digital service on a device owned by a business, who counts as the user? This could be significant: if the user is the individual, a member state would be able to count each user accessing digital services on behalf of the business towards its share of taxable revenues.
- Further, because the user’s location is determined using the user’s device’s IP address, a single individual will count as multiple users if he accesses digital services on different devices.

Besides, in order to determine the user's location, extensive data is to be gathered and kept by the taxpayers, which would raise significant privacy concerns.

Would the digital services tax result in multiple taxation?

Taxes on gross revenue may be more economically distortive than taxes on profit. The 3% tax on gross revenue would apply indifferently to companies that have very different business models. For example, some digital companies have very low profit margins, or are loss-making.

To prevent double taxation, the proposal provides that member states should enable companies that are resident in a member state to deduct the tax from their taxable profits.

The potential for multiple taxation can be magnified where several supplies in the chain are subject to the tax, without credit for tax paid at earlier stages: "cascading". The Commission argues that this should be of relatively minor concern: "because digital services tax would have a fairly narrow scope and because it affects business models with a large user base [in other words, it is more likely to catch B2C than B2B transactions], it is relatively unlikely that several relevant transactions are taxed in a row". The Commission also notes that intra-group transactions have been excluded. It does acknowledge, however, that further safeguards may need to be put in place for advertising.

Would the digital services tax be a temporary measure?

The draft Directive contains no sunset provision. It is intended to be levied for as long as it takes to agree a comprehensive solution to the taxation of the digital economy. Given the lack of international consensus on what such a solution should look like (or whether it is necessary), it seems likely that the "interim" digital services tax, if implemented, could be around for quite some time.

* * *

Copyright © Sullivan & Cromwell LLP 2018

ABOUT SULLIVAN & CROMWELL LLP

Sullivan & Cromwell LLP is a global law firm that advises on major domestic and cross-border M&A, finance, corporate and real estate transactions, significant litigation and corporate investigations, and complex restructuring, regulatory, tax and estate planning matters. Founded in 1879, Sullivan & Cromwell LLP has more than 875 lawyers on four continents, with four offices in the United States, including its headquarters in New York, four offices in Europe, two in Australia and three in Asia.

CONTACTING SULLIVAN & CROMWELL LLP

This publication is provided by Sullivan & Cromwell LLP as a service to clients and colleagues. The information contained in this publication should not be construed as legal advice. Questions regarding the matters discussed in this publication may be directed to any of our lawyers listed below, or to any other Sullivan & Cromwell LLP lawyer with whom you have consulted in the past on similar matters. If you have not received this publication directly from us, you may obtain a copy of any past or future publications by sending an e-mail to SCPublications@sullcrom.com.

CONTACTS

London			
	S. Eric Wang	+44 20 7959 8411	wangs@sullcrom.com
	Andrew Thomson	+44 20 7959 8501	thomsona@sullcrom.com
	Michael Orchowski	+44 20 7959 8504	orchowskim@sullcrom.com
	Emma Hardwick	+44 20 7959 8401	hardwicke@sullcrom.com
New York			
	S. Eric Wang	+1 212 558 3328	wangs@sullcrom.com
Paris			
	Gauthier Blanluet	+33 1 7304 6810	blanluetg@sullcrom.com
	Nicolas de Boynes	+33 1 7304 6806	deboynesn@sullcrom.com
	Marie-Aimée Delaisi	+33 1 7304 5832	delaisima@sullcrom.com
	Alexis Madec	+33 1 7304 5834	madeca@sullcrom.com
	Jérôme Rueda	+33 1 7304 5806	ruedaj@sullcrom.com