

A Quantum Leap: European Commission Proposes New Rules for the Taxation of the Digitalised Economy

On 21 March 2018, the European Commission (EC) [set out](#) its proposals for a new framework of rules intended to ensure businesses operating in the digitalised economy are taxed “fairly and appropriately”.

Although the EC states its support for efforts to find global, multilateral, solutions to the problems posed by the digital economy, the delay in reaching an international consensus (punctuated by unilateral action initiated by some Member States to protect their individual tax base) has led to the EC’s decision to publish its detailed proposals.

There are many acknowledged problems and weaknesses in the current framework for the taxation of a globalised economy. The EC considers that a growing and evolving digitalised economy exploits those weaknesses resulting in a system that is both unfair and erodes Member States’ tax base.

To address those risks, and to secure a stable and competitive environment within which digital companies can thrive, the EC has tabled a package of four, surprisingly broad, initiatives:

- [Communication](#) on establishing a modern, fair and efficient taxation standard for the digital economy
- [Proposal for a Council Directive](#) laying down the rules for corporate taxation of a significant digital presence (and [Annex](#))
- [Commission Recommendation](#) relating to the corporate taxation of a significant digital presence
- [Proposal for a Council Directive](#) on the common system of a digital services tax on revenues resulting from the provisions of certain digital services

Although far from perfect, the EC proposals represent a quantum leap forward in efforts to resolve the tax problems posed by the digitalisation of the global economy.

Overview of the EC Proposals

In essence, the EC package is comprised of two main proposals:

- **A “long-term” solution:** defining and recognising a “virtual permanent establishment” – i.e. a significant taxable digital presence in a Member State
- **An “interim” solution:** imposing a 3% indirect tax on revenues deriving from certain digital activities

It is noteworthy that the EC proposals have been published a matter of days after the Organisation for Economic Co-operation and Development (OECD) released its own report: “[Tax Challenges Arising from Digitalisation – Interim Report 2018](#)”. That report restated the OECD’s commitment to finding a multilateral solution to address the problems posed by the digital economy, but fell short of outlining what that solution should be.

While the theoretical importance of the EC’s proposals can be assessed in light of the OECD’s continued efforts in this area and the unilateral action of various jurisdictions around the world, if implemented as proposed, the impact is likely to be felt far more widely than might have been originally anticipated. The proposals fundamentally reshape some of the core principles and assumptions that lie at the core of traditional tax policy.

The Long-term Solution in More Detail

The EC’s preferred solution is to **reform corporate tax rules** so that profits are registered and taxed where businesses have significant interaction with users through digital channels. In short, they want to **define and recognise a digital permanent establishment (DigiPE)** that will allow Member States to tax a company’s profits even if that company has **no physical presence** there.

A DigiPE will exist if it meets any one of three criteria, in a given year, in a European Union (EU) member state:

- It realises more than €7 million in revenue
- It has more than 100,000 “users”
- It creates more than 3,000 business contracts for digital services

For the new concept of DigiPE to work, a number of traditionally accepted rules and principles that underpin the tax policy will face major reform.

Identifying where “value” is created and how it is measured will need to be extended to recognise the role of “user participation” (including, for example, the use of user data, the interactions of the sharing economy and the subscription services delivering digital data). This, in turn, raises some critical (non-tax) questions about how “users” are identified, catalogued, characterised and tracked, as well as some pressing privacy issues around how data on “users” is collected, stored, used, shared and sold.

In addition, the long-term solution will require changes to traditionally accepted norms of how “value” is allocated between sovereign states, based on a greatly extended notion of what constitutes a taxable presence beyond physical “bricks and mortar”.

Finally, and possibly most challenging of all, the **EC proposals portend a move toward a destination-based (rather than source-based) system for taxation.**

In addition, the EC acknowledges a number of consequential changes will be needed to implement the new framework fully. Most obviously, Member States' Double Tax Treaties (DTT) with non-EU countries (including, most notably, the US) will need to be amended to ensure, in particular, both:

- The definition of "permanent establishment" is changed to incorporate situations where a company has a DigiPE in a Member State
- The rules on profit attribution are clarified so that they apply smoothly in scenarios involving a DigiPE

So fundamental to the operation of the global tax framework are these principles, none of the reformulations and amendments will be easily achieved.

The EC hopes to see the DigiPE form part of its Common Consolidated Corporate Tax Base (CCCTB) initiative. Irrespective of the challenges CCCTB itself faces, with **tax measures requiring the unanimous support** of all Member States, the road ahead is anything but smooth.

The Interim Solution in More Detail

Recognising this challenge, but at the same time stressing the increasingly urgent nature of the problem, the EC has also proposed an interim measure to "ensure that those activities which are currently not effectively taxed would begin to generate immediate revenues for *Member States*".

The interim measure is the **imposition of an indirect tax, levied at the rate of 3%, on revenues created from digital activities** where users play a major role in value creation. It is a **tax on digital services (DST)**. Although anticipated, and a feature of most, if not all, of the unilateral measures being considered around the world, the imposition of a tax on revenue, as opposed to profit, constitutes a **paradigm shift in tax theory**.

Imposing a tax on revenue, and not profit, has another short-term advantage. At a stroke, it resolves the DTT problems confronted by the DigiPE proposal because DTTs do not apply to revenue taxes. The DST has been designed to operate outside the traditional network of global DTTs. Just like the introduction of the Diverted Profits Tax in the UK, the implementation of a DST would signal a further weakening of DTTs as the core instrument of the global tax system.

The DST is intended to bring certain digital business activities, currently falling between the cracks in the global tax system, back within the scope of a Member State's tax net. Again, based on user-driven value creation, the tax will target, in particular, revenue created from businesses:

- Selling online advertising space
- Providing digital intermediary activities that allow users to interact with other users (and which can facilitate the sale of goods and services between them)

- Selling data generated from user-provided information (giving rise to those same difficult questions about the collection, tracking and privacy of "user" data outlined already)

Interestingly, and perhaps surprisingly, the proposed DST *would not* currently extend to some of the largest, and most commonly encountered, digital retail businesses on the internet. Those excluded from scope include digital stores that sell physical goods directly to customers and subscription-based businesses that sell digital data. To complicate matters further, equivalent, but non-subscription-based, data businesses *are* likely to be liable to the DST (under the advertising business model head).

The tax is to be collected in the Member State where the *users* are located (again, note the switch in taxing rights to the place of user consumption, to the destination, and away from the source).

In practice, the scope of the new tax is further limited (for now at least) so that it is only charged on companies with:

- Total annual **worldwide revenues of at least €750 million, and**
- Total annual **EU revenues of at least €50 million**

In reality, that limits the current impact of the proposal to approximately 150 or so of the world's largest, mostly US-based, digital businesses. Based on current estimates, the interim measure would raise approximately €5 billion per year, a relatively modest amount considering the size and value of the digitalised economy.

European Commissioner for Taxation Pierre Moscovici would like to see the **interim measure adopted** across the EU by the end of 2018. That is a highly ambitious goal, but one that, if nothing else, illustrates the EC's seriousness and sense of purpose in advancing these proposals.

Conclusions

The EC proposals represent a **significant development in adapting global tax rules to meet the challenges of the digitalised economy**. The EC has moved well beyond anything seen to date, from either the OECD or any individual country. In terms of the breadth of application, the depth of detail and the conviction of the delivery, this is undoubtedly the EC attempting to take the lead on the issue.

There are, however, **numerous difficulties**. Three immediate issues are worth noting.

First, there is, undoubtedly, almost universal acceptance that the problems posed by the digital economy can only be truly effectively addressed by a multilateral, global, response. It is not clear how, if they are adopted, the EC proposals will mirror those agreed (if they are agreed) on a global scale. The corollary is that the potential damage to the European Single Market, caused by the EU being a "first-mover", is equally indeterminate.

Second, there is no clarity on what, exactly, "interim" means when considering the interim proposal. The history of tax is littered with interim measures that have effectively become permanent features. Add to that the significant difficulties to be resolved before the long-term solution can be adopted, it is possible the interim existence of the DST will be considerably lengthy.

In addition, although currently limited to only the largest global companies, there can be no certainty that the DST will remain so limited in practical scope. Indeed, the pace of evolution of the digital economy suggests that it will (perhaps can) not.

Third, while almost certainly neither an “attack” on US companies nor a “protective” EU response to US tax reform, there is little doubt that companies based in the US would feel the greatest impact if the EC proposals are implemented. The timing of the EC proposals is politically highly sensitive. US Treasury Secretary Mnuchin has already issued a [statement](#) (albeit in response to the OECD report) opposing any proposal that singles out digital companies. The US is unlikely to be impressed by the EC deciding to press ahead with its proposals and the interim revenue tax, in particular. In a time when protectionist policies, the imposing of tariffs and talk of “trade wars” abounds, Washington’s reaction will need to be watched.

Companies will need to assess the potential impact of the EC’s proposals on their businesses. At the same time, following developments on both the multilateral and unilateral level will become increasingly important. The full extent of the application and impact of the EC’s proposals could be felt more widely than might initially have been thought, especially over time.

How We Can Help

The complex issue of taxing the digitalized economy is a priority for the current holder of the European Council’s Rotating Presidency, Bulgaria. Unanimous support from all EU Member States is required for either of the proposals to be implemented in the EU.

There is no certainty that such a challenging obstacle will be overcome, but the process following an EC proposal opens strong advocacy opportunities for the digital economy market players and other stakeholders. With a long history and **excellent track record of combining legal and public policy expertise**, we can help clients:

- Assess the threats posed to their business model by the new EC’s proposals for the taxation of the digital economy
- Take the appropriate course of action to minimize related risks and maximise potential opportunities arising out of the various proposals

Please do not hesitate to contact us for more information.

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