CLEARY GOTTLIEB

ALERT MEMORANDUM

The European Commission Is Attempting a Radical Change to How Digital Transactions Are Taxed Throughout the EU

October 20, 2017

On 21 September 2017, the European Commission issued a fact sheet outlining its plans to design and propose significant new international tax rules to be applied to all digital transactions and commerce.[1] The fact sheet first describes the difficulty of ensuring that companies operating within the EU digital single market are taxed appropriately and then sets out the Commission's long-term objectives and short-term alternative solutions.

- The Commission's proposals would radically change the well-established, universally-followed standard for tax nexus.
- The permanent establishment standard would be replaced with a "significant economic presence" test which would focus on where the marketing and consumption was occurring.
- If adopted, the Commission's proposals could significantly impact the tax compliance and economic burdens of companies selling digital products and services in the EU.

This Alert addresses what we know about the Commission's initiative and Cleary's insights on what the initiative might mean for multinationals with operations, customers or counterparties in the EU. We suggest that senior management and boards of directors closely monitor these developments.

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[1] "A Fair and Efficient Tax System in the European Union for the Digital Single Market", COM(2017) 547.

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I. The Goal: Create and Implement A Tax System Appropriate to the "Digital Single Market"

In May of 2015, the Commission adopted as a new strategic priority establishing a "Digital Single Market" in the EU to match the physical "Single Market". A Digital Single Market is described by the Commission as "one in which the free movement of goods, persons, services and capital is ensured and where individuals and businesses can seamlessly access and exercise online activities under conditions of fair competition, and a high level of consumer and personal data protection, irrespective of their nationality or place of residence".

The Commission explained that "achieving a Digital Single Market will ensure that Europe maintains its position as a world leader in the digital economy, helping European companies to grow globally (…). Fragmentation and barriers that do not exist in the physical Single Market are holding the EU back".[2]

The Digital Single Market strategy is progressing and the new initiative addresses what the Commission sees as the inadequacies of the existing tax systems to appropriately tax the digital commerce that is currently taking place and will, it hopes, expand in the Digital Single Market.

The Commission believes that the EU Member States' taxation systems are not able to appropriately tax profits derived from cross-border digital commerce. Under current law, profits can be taxed in a Member State only if the company maintains a presence in the Member State in the form of a "permanent establishment". However, in the Commission's view, digital distribution channels, automation and data processing make the permanent establishment concept obsolete.

The Commission refers to companies that can conclude and fulfill their contracts online, making use of a jurisdiction's infrastructure and legal structures, but escape being subject to profit taxation there. Intensifying this situation, profits can be shifted to an entity in the same group which is situated in a low-tax country. In addition, EU Member States compete by offering lower corporate tax rates accompanied by numerous incentives. For these reasons, the fact sheet asserts that digitalized businesses are subject to taxation at an average effective tax rate of only 9 %, less than half of the tax rate applicable to traditional "brick and mortar" businesses.

The Commission considers this situation unsustainable and unfair, and expects that, if this situation is not changed, there will be more tax avoidance and less tax revenue, a deepening of social injustice and a destabilization of the level playing field. The Commission disfavors uncoordinated separate responses by individual Member States, believing such measures could fragment the single market, increase tax uncertainty and potentially open up new tax loopholes.[3]

Accordingly, the goal of this initiative is to develop a single coordinated response that can be adopted and implemented internationally. The Commission hopes to coordinate its work with that of the OECD.[4]

II. Which Companies Will Be Impacted?

The short answer is: it is likely that all companies using digital distribution channels will be impacted.

The proposal would cover companies providing social networking, digital streaming or trading platform services, as well as companies supplying goods through the Digital Single Market.

[2] "A Digital Single Market Strategy for Europe", COM(2015) 192, P. 3.

[3] Recent examples of individual Member State action include: (1) The UK's adoption of a "diverted profit tax" in 2015. This penal tax of 25 % on the amount of profits diverted outside the UK aims to prevent multinationals artificially shifting UK generated profit overseas either through using entities or transactions lacking economic substance and/or arrangements designed to avoid creating a UK taxable presence; (2) the French tax authorities pursuing Google in court (unsuccessfully) for €1.12 billion in back taxes on the basis of the allegation that Google channeled its French profits to Ireland. Note also (3) Japan's introduction of a consumption tax on digital services provided to Japanese customers; (4) India's introduction of an "equalization levy" whereby 6 % of any payment for online advertising made to a non-resident is withheld by the Indian payor.

[4] OECD/G20 Base Erosion and Profit Shifting Project (BEPS), Addressing the Tax Challenges of the Digital Economy, Action 1: 2015 Final Report and upcoming OECDs Interim Report planned for April 2018

Differentiating digitalized businesses from "brick and mortar" businesses will be difficult, and controversial if the tax nexus test and tax computation rules differ.

III. Long-term and Short-term Solutions

The Commission identified two key priorities and long-term objectives (*see* 1. below).[5] The Commission will look closely at the OECD's interim report on the taxation of the digital economy to the G20, due in early 2018. If this OECD report does not satisfy the Commission, it will consider more immediate, supplementary and short-term measures (*see* 2. below).

1. Long-term priorities and objectives

a) Replace "permanent establishment" with "significant economic presence"

The first key priority is adapting the permanent establishment concept to the digital age. The minimum nexus for taxation would be "*significant economic presence*", which would be determined on the basis of indicators, *e. g.*, the level of revenue generated from digital transactions, the number of monthly users of a digital platform, the volume of data collected from users through a digital platform, a local payment option or a local domain name. The Commission's common consolidated corporate tax base ("CCCTB") would incorporate this concept and thus be made suitable to the Single Digital Market. This proposal appears to mean using the CCCTB to tax the digital economy effectually on a formula apportionment basis.

b) "Optimized" transfer pricing

The second key priority is ensuring that the *transfer pricing rules* prevent the shifting of digital profits to non-EU jurisdictions. The Commission explained that the rules need to enable effective challenges to inflated royalty fees paid for intellectual property held outside the EU.[6] Profits would not be able to be shifted to a non EU-state once they have been attached to a Member State under the significant economic presence text. The Commission believes that the formula apportionment approach based on assets, labor and sales already contained in the CCCTB provides a framework for allocating profits within the EU.

2. Short-term measures

The Commission discusses three alternative, short-term solutions to protect the direct and indirect tax bases of the Member States.

a) Equalization tax on turnover

The first approach is an equalization tax on all the untaxed or insufficiently taxed income resulting from internet-based business activities, including B2B and B2C transactions. The tax would either be creditable against the corporate income tax or a separate tax.

This idea was proposed by France with support from ten other Member States, but there is still very little detail about how this concept would work in practice.

If gross turnover constitutes the tax base and the tax is imposed at each level, there would be cascading of tax unless businesses could deduct input tax. By contrast, an income based approach would have to measure the untaxed or insufficiently taxed income, for example, by applying a hypothetical return on the digital company's turnover, gross receipts or other parameter. Since margins vary with different business models, a hypothetical return approach would need complex rules to implement it.[7]

[5] Report of the Commission Expert Group on Taxation of the Digital Economy dated May 28, 2014.

[6] Royalties on use of intangible property are often free of tax in the source country under many treaties and EU directives and that is why the corporate structures involving streams of royalties are generally exempt from tax in the source country.

[7] Press reports indicate that a tax rate between 2% and 5% on turnover is being discussed.

b) **Withholding tax on digital transactions**

A second proposal contains a *withholding tax* on certain payments for online orders on digital transactions or services. The final tax would be payable on gross amounts and be due when an EU resident orders goods or services provided by a non-EU resident online. The tax would not be integrated into an income-tax or VAT regime; it is designed as a standalone tax.

c) **Levy on revenue from digital services**

A third proposal is a *levy* on revenues generated from the provision of digital services or advertising activity. Unlike the withholding tax, the levy would not be applied to all transactions where an EU resident orders from a non-EU resident but only to those concluded remotely with EU residents where a non-EU resident has a significant economic presence. It could also be limited to transactions concluded through automated systems or be linked to data collected from residents.

IV. Legal Framework for Short-term Solutions

Any digital tax would have to be in line with fundamental principles of European law and existing international agreements. This raises a number of questions.

1. **Double Taxation?**

All short-term solutions pose challenges in this respect. Double taxation may arise when goods or services are subject to the digital tax and at the same time subject to (the existing) corporate income tax. Allowing taxpayers to credit the digital tax against their corporate income tax liability in EU Member States would address this issue. But it could suggest that the digital tax is an income tax, which would create tension under existing double treaties taxation (*see* 3.b) below). For digital companies that do not pay (sufficient) income tax in the EU it would be relevant whether they can credit the digital tax against their corporate income tax at home (*i.e.*, in the U.S.).

The equalization tax based on gross turnover should provide for a possibility to deduct input tax if the tax is imposed at each level. Otherwise supply chains would be subject to multiple taxation. This would raise the question whether the tax constitutes a tax on turnover within the meaning of the VAT rules (*see* 2.c) below).

2. **European Framework**

Any digital tax introduced EU-wide, in a group of Member States or in individual Member States would have to fit into the European legal framework.

a) **Unanimous decision**

At European level, harmonizing standards of tax law requires a unanimous decision by all Member States, Art. 113, 115 TFEU. The Commission's declared aim is to reach such unanimous decision. However, it is not certain whether this will succeed. Some Member States, especially Ireland and Luxemburg, have attracted digital companies through advantageous local tax regimes. An EU-wide digital tax would undermine that strategy.

b) **Enhanced cooperation and national measures**

It may be more promising if a group of Member States seeks to implement a short-term solution through *enhanced cooperation* in accordance with Art. 329 TFEU, 20 TEU. In this process, at least nine Member States could introduce a tax measure with effect only for their jurisdictions. The Council would have to authorize this procedure with the prior approval of the European Parliament. A qualified majority of Council votes representing at least 65 % of the EU population and 15 Member States is needed. Until now, enhanced cooperation was attempted only once for a tax law (namely, the creation of a financial transaction tax); this attempt has so far been unsuccessful.

Individual Member States could introduce a tax at the national level, provided it does not

conflict with European law. However, it is the declared aim of the Commission to prevent individual action by single Member States.

c) **VAT Directive**

Directive 2006/112/EC ("VAT Directive") would be relevant to the proposed equalization tax if it were considered a tax on turnover within the meaning of the VAT Directive. This is the case when taxpayers can deduct input tax (so called neutrality).

If the proposed digital tax would qualify as a tax on turnover within the meaning of the Directive, the Council's unanimous decision would be needed to allow Member States acting on their own or in enhanced cooperation. Consequently, the Commission may wish to design a digital tax to avoid application of the VAT Directive.

d) **European fundamental freedoms**

Every short-term solution would also have to respect European fundamental freedoms. In this context, the *freedom of capital movements* under Art. 63 TFEU should be less relevant, since it is only applicable if the transfer of money is made for investment purposes. With a few exceptions, this will generally not be the case in the targeted digital transactions. A digital tax would fall within the scope of Article 56 TFEU, which guarantees the *freedom to provide services*. This freedom is limited to EU residents and as long as the proposed measure would only apply to non-EU residents or would equally apply to all intra-EU transactions this freedom should not be infringed. But it would complicate the design of a tax through enhanced cooperation when digital companies resident in non-participating Member States would be disadvantaged.[8]

3. **Compatibility with International Commitments**

Possible short-term solutions must also comply with international rules. Potential conflicts with WTO regulations, free trade agreements[9] and double-taxation treaties may arise.

a) **GATT and GATS**

In many areas, a tax or levy on digital transactions falls within the scope of the WTO's GATT or GATS. Both treaties – signed by the EU – contain two types of prohibitions on discrimination: the *most-favored-nation principle*, which requires the equal treatment of all non-EU suppliers, and the *equal treatment of nationals*, which means that non-EU suppliers must be treated equally with EU suppliers. While under GATT the *equal treatment of nationals* is the general rule and therefore likely to be affected by a withholding tax on online sales of goods or by a levy on the revenues generated from such sales, with GATS the rule is only applicable if the services are part of a special commitment signed by the treaty party. Since the EU has not signed a GATS special commitment in e-commerce, electronic services or telecommunication, taxation of such services should only be subject to the *most-favored-nation principle*.

b) **Double Taxation Agreements**

The proposals must be compatible with the numerous double taxation agreements that exist between Member States and third countries. These double taxation agreements cover income taxes and identical or *substantially similar taxes*. The proposed digital tax would not be comparable to an income tax if it would be in the nature of a turnover tax. This may depend on the extent to which the proposed digital tax will be

[8] The same applies to the free movement of goods under Art. 28 TFEU.

[9] The free trade agreement with Canada also contains a provision in Art. 9.3 CETA requiring the application of a national equal treatment rule.

integrated into the existing income tax system.

It would be important that the digital tax is not covered by tax treaties since the purpose and design of the digital tax is to avoid the permanent establishment provision of tax treaties.

V. Effective Collection

It is open how a digital tax should be collected. The Commission recognizes that this point is critical to the practicability of possible solutions. The collection of tax from non-EU resident businesses may be difficult to achieve.

In B2B situations a tax or levy could be collected from businesses resident in the EU as the source country. Therefore a withholding tax is conceivable as a standalone final withholding tax or as a primary collection mechanism and enforcement tool to support non-residents to pay their net tax debt.

Collecting the tax or levy for B2C transactions would be more challenging. One idea might be to impose a withholding obligation on the payment processing intermediary. In this case, the intermediary must be able to identify whether the payments are subject to the tax or levy. Even if one could deal with data protection concerns, problems would arise when payments are processed through third-country intermediaries.

It may be more promising to build on the VAT mini-one-stop-shop ("MOSS") system. MOSS procedure can be used by companies with a taxable establishment within the EU to obviate the need to register for VAT in each Member State which otherwise would be necessary as goods and services ordered online are subject to VAT at the place where the customer resides (destination principle). The Commission plans to extend the MOSS procedure to goods and other services sold online. This may also be a starting point for the collection of an EU tax on the digital economy.

VI. Outlook

The Commission's approach will radically change national, EU and international tax law as it departs from the existing tax nexus (permanent establishment) definitions.

The Commission intends to specify its long-term goals as early as spring 2018. Following an assessment of the OECD report on the taxation of the digital economy in the G20 in April 2018, it plans to act on an international level. There is no defined time frame for the proposed short-term solutions, though. In this respect, developments over the next six months should be closely monitored.

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