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INDEPENDENT TAX CONSULTING



## Tax Consequences of the Digitalization of the Economy

# Agenda

- Taxation and the digitalization of the economy
  1. Defining the digital economy – From 'the digital economy' to the 'digitalization of the economy'.
  2. Overview of tax issues raised by the digitalization of the economy.
  3. International reform proposals and guiding policy principles.
  4. Consequences?

# Defining the Digital Economy

- From 'the digital economy' to the 'digitalization of the economy'
- Characteristics of digital business models:
  - Significant investments and the need for scalability.
  - Mobility with respect to intangibles, users and business functions.
  - Reliance on data.
  - Network effects (i.e. decisions by users may have a direct impact on the benefit received by other users).
- Examples of "highly digitalized businesses":
  - Online Retailer model (Amazon, Zalando, Alibaba).
  - Social media model (Facebook, Xing etc.).
  - Subscription model (Netflix, Spotify).
  - Collaborate platform model (AirBnb, Uber etc.).
- Digitalization goes way beyond.....
  - Cloud computing, 3D-printing, blockchain technology and crypto currencies, web-sales, virtual organizations etc.



# Tax challenges

- The rise of the internet tests many traditional tax principles.
- Tax legislation continue to focus primarily on the physical world and have yet to address many of the challenges posed by this new world.
- Are the current tax rules with respect to nexus sufficient?
- Data (valuation, nexus, profit allocation and qualification).
- Qualification of income related to digital business models.
- Does the digitalization increase the risk of BEPS?

# Tax challenges

- **Example: Google**
  - Business model: Internet advertisement and service provider.
  - Local Google entities provide support services to the local market, e.g. technical support, administration, promotion, marketing etc.
  - Customers conclude contracts with Google Ireland (subsidiary of Google US).
  - Local Google entities do not constitute agent PEs and are remunerated based on a cost plus service fee.
  - Challenged – without success – by several countries incl. France (Paris Administrative Tribunal 12 July 2017).
  - BEPS 7 – MLI Art. 12: Expanding the definition of an agent PE to also include activities leading to the conclusion of contracts.
    - Questionable whether the changes affects the Google model (see: <http://kluwertaxblog.com/2017/07/24/permanent-establishment-la-lutte-continue/?print=pdf>).

# Tax challenges

- The OECD, the EU MSs and a number of other countries agree that there is a problem!
- However, is there a burning platform.....?
- What is the impact of OECD's BEPS project and the US tax reforms and when can these effects be measured?



# International Reform Proposals

- OECD activities:
  - BEPS # 1 highlights possible solutions - however without recommendations:
    - Significant Economic Presence: SEP PE, Virtual PE, Digital PE etc.
    - Withholding tax on digital transactions.
    - Equalization levy.
  - Comprehensive draft for OECD report is expected in April 2018.

# International Reform Proposals

- EU activities:
  - Talinn Summit sept. 2017: COM(2017)547 final.
  - *“The underlying principle for corporate tax is that profits should be taxed where value is created. However, in a digitalized world, it is not always very clear what the value is, how to measure it, or where it is created?”*, p. 7.
  - Two key tax policy challenges are identified:
    - Where to tax? (nexus)
    - What to tax? (value creation)
- Expected that proposal is presented 21 March 2018 and apparently the OECD plans to deliver its report before this!



# International Reform Proposals

- EU activities (continued)
  - New international rules are necessary to determine where value is created and how it should be allocated for tax purposes:
    - PE definition: Alternative indicators for “significance presence”.
    - Transfer pricing: Requires alternative methods to allocate profits that better capture the value creation in new business models.
    - Anti-tax avoidance rules.
    - CCCTB – The Commission believes that the CCCTB provides for an EU framework for revised PE rules and for allocating profit of MNEs using the formula apportionment approach that should better reflect where value is created.
  - Short term alternative solutions:
    - Equalization tax on turnover of digitalized companies.
    - WHT on digital transactions.
    - Levy on revenues generated from the provision of digital services or advertising activity.

# International Reform Proposals

- EU activities (continued)
  - Leaked document from the Commission: *Income taxation is preferred over a levy on gross revenues.*
  - Comprehensive solution
    - Digital PE (new directive) and rules for allocation in CCCTB
      - Recommended solution: Intra EU and between third countries and an EU MSs. However not towards tax treaty states (including the US).
      - Scope:
        - Annual revenue exceeding EUR 10M in a MS,
        - Number of active users in a MS exceeding xxxx, OR
        - Number of online contracts concluded.
        - Allocation:
          - User engagement,
          - Data collected,
          - Number of users,
          - User generated content.
      - Recommended to include digital PE and allocation rules in tax treaties.

# International Reform Proposals

- EU activities (continued)
- Taxation and value creation:
  - Is there a difference between value creation in digital business models and other business models?
  - Market value:
    - Is value created by consumption compared to R&D, innovation and production?
      - Tax policy – at least *not* in line with the previous perception of value creation.
      - Isn't consumption taxed through the VAT-system?
  - Data:
    - Does the collection of data create value?
    - Does value comes from human innovation (significant people functions) or "data mining"?
    - Value is created when data is collected systematically, analyzed and used to incentivize user activity:
      - What data is collected?
      - Systems for the collection and storage of data.
      - Development of analytic tools.
      - Use of analytic results to take business decisions, which creates value.

# International Reform Proposals

- EU activities (continued)
  - Targeted solution:
    - Directive on levy on digital revenue.
    - “Interim measure”?
      - Unlikely - the only effective instrument on US entities.
  - “Revenues”:
    - Services supplied for consideration consisting in the valorization of user data – advertisement space or sale of user data (Facebook, Google AdWords, Twitter, Instagram, “free” Spotify).
    - Services supplied for consideration consisting in the making available of digital platforms/marketplaces to users (intermediation services) – (Airbnb, Uber etc.)
    - **Outside the scope:** supply of digital content/solutions for customers.
      - Media, streaming, online gaming, IT solutions, cloud services and fintech.

# International Reform Proposals

- EU activities (continued)
  - Targeted solution (continued)
    - Conditions:
      - Supply of digital services,
      - Exceeding the following threshold:
        - Global revenue exceeding 750M EUR,
        - Annual revenue from the supply of digital services exceeding 10-20M EUR.
    - Cross border and domestically.
    - Taxation where user value is created (Advertisement = where the advertisement is shown – “where the eyeballs are”) and where the users are residents and with respect to digital platforms = where the paying user is resident.
    - Rate: 1-5% - deductible in CIT.

# Consequences

- **Unilateral initiatives:**
  - UK DPT.
  - Australian MAAL.
  - Israel: Digital PE.
  - India: Equalization levy (6% on payments to foreign entities for advertisement services).
  - Italian web tax (3% on intangible digital products).
  - UK HMRC Position Paper (ready for action).
  
  - Which impact will these uncoordinated initiatives have?



# Consequences

- Impact on MNEs – moving target – but the tendency is clear!
- Follow the development and acknowledge that this will not only affect tech giants.
- Risks in different scenarios.
- Clarity on the importance of data in the business model.
- Preparing for several PEs and allocation challenges.
- Preparing for taxation based on value creation with focus on the collection and processing of data.
- Impact from more integrated value chains - more complex TP issues.
- Other: qualification of payments etc.



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