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Taxation of the Digital Economy – An EU Perspective

The EU High Level Expert Group on Taxation of the Digital Economy, one of the experts of which was the author, gave its Report on 28 May 2014. This article comments on the characteristics of the digital economy and the Report's conclusions in respect of value added taxes and corporate income taxes.

1. The EU High Level Expert Group on Taxation of the Digital Economy

The task of the EU High Level Expert Group on Taxation of the Digital Economy is:[1]

> [...] to identify improvements in the current way of taxing the digital economy in the European Union, weighing both the benefits and risks of various approaches.
>
> Its focus will be on identifying the key problems with taxing the digital economy from an EU perspective, and presenting a range of possible solutions. The Commission will then develop any necessary EU initiatives to improve the tax framework for the digital sector in Europe, which has the potential to contribute significantly to growth and innovation in the EU.

The task relates to taxes of all kinds, although taxes related to business activities, in a broad sense, such as consumption taxes, as well as corporate income taxes, are most important. Its Report was published on 28 May 2014.[2]

This article concentrates on the characteristics of the digital economy (section 2.) and the Report's conclusions in respect of value added taxes (section 3.) and corporate income taxes (section 4.). General matters related to base erosion and profit shifting (BEPS) are only briefly referred to if they are of direct importance to the digital economy.

2. The Digital Economy

2.1. Characteristics of the digital economy

The whole economy is becoming digital. The effects of new general purpose technologies (GPT) in the fields of information and communication have "implications beyond the Information and Communication Technology (ICT) sector, impacting all sectors of the economy and society: retail, transport, financial services, manufacturing, education, healthcare, media etc".[3]

There is no special division of the economy that may be named *digital*. The economy is digital. Every sector within European business is or will become digital, at least to a certain extent. Digitalization relates to manufacturing industries, as well as to IT and other service activities. This ongoing development underlines the impossibility of establishing a firm borderline between the digital world and other fields. It is possible to characterize the digital economy through a set of key features: mobility, network effects and use of data, but not to define what constitutes the digital economy. The digital economy includes e-commerce suppliers and developers of apps to mobile or other devices, as well as suppliers of goods such as cars, trucks and refrigerators, with embedded software.

The conclusion is simply that there should be no special taxation of the digital economy and no special tax provisions for digital businesses. There should be no form of ring-fencing around the digital economy. This is valid for consumption taxation, as well as corporate income taxation. The Report underlines, in its executive summary, that "there should not be a special tax regime for digital companies. Rather the general rules should be applied or adapted so that 'digital' companies are treated in the same way as others".[4]

2.2. National attempts to introduce special taxation of the digital economy

Despite the impossibility of defining a digital sector distinct from other business activities, France and Italy have proposed and, to a certain degree, legislated, and later repealed, laws on general or specific digital taxation. Despite emphasizing that "the digital economy is everywhere" a French Ministerial Report[5] proposed that France:[6]

> [...] create a tax on the use of data obtained through regular and systematic monitoring of users' activity in the country. Collecting data obtained through regular and systematic monitoring of users is the only taxable event that ensures the neutrality of the tax with regard to business models, technologies and business location strategies.

In the author's view this is a remarkable statement. Such a tax is, in the author's opinion, not neutral in respect of

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1. *See* European Commission, MEMO/13/1042, Taxing the Digital Economy: The Commission has appointed the members of the expert group (25 Nov. 2013). The group was chaired by Vítor Gaspar, former Finance Minister of Portugal. Bjorn Westberg was one of the six experts chosen from across Europe.
2. *See* Report of the Commission Expert Group on Taxation of the Digital Economy, available at http://ec.europa.eu/taxation_customs/resources/documents/taxation/gen_info/good_governance_matters/digital/report_digital_economy.pdf (accessed 6 August 2014) (hereinafter the Report).
3. *See* the Report, *supra* n. 2, at p. 11.
4. *See* the Report, *supra* n. 2, at p. 5; *see also* p. 47.
5. *See* Ministère de l'economie et des Finances and Ministère du Redressement Productif, *Task Force on Taxation of the Digital Economy* (January 2013). In spite of the fact that it is a public report it is often quoted as a report of Pierre Collin & Nicolas Colin, the rapporteurs (hereinafter the French Report).
6. Id., at p. 4.

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the country and context in which the service is offered. Besides, this perspective does not consider the speed of technological development of hardware and software.

Italian attempts to tax advertising services and sponsored links within the framework of the VAT regime have failed.[7,8] In principle, similar objections to those raised against the Italian law apply to the French law.

The Report is clear. It states: "The Group believes that there is no convincing argument why the collection of data via electronic means in a country should in itself create a taxable presence in that country".[9] The background to certain national attempts to tax such activities is that several enterprises "have been extremely successful in rapidly generating significant revenues from the collection, processing and marketing of free individual data".[10] If such activities are successful from a business perspective, they will result in taxable profits. If the basis of a market economy is not respected, however, the tax burden will be completely arbitrary and will act as an obstacle to business development.

3. VAT Policy Options

3.1. Special provisions related to the digital economy

The EU VAT Directive (2006/112)[11] has a number of special provisions on digital transactions. The most general one is article 98.2(2), which provides that reduced VAT rates must not apply to electronically supplied services. As there are many electronic services that are interchangeable with other supplies of goods and services, the different rates may be in conflict with the basic EU principle of neutrality. This provision should, in the author's opinion, be abolished, which would permit all Member States to equalize the rates for electronic books, etc. with printed materials. Some states, such as France and Luxemburg, have, in conflict with this provision, already introduced the same reduced rate for electronic books that is applicable to printed versions. The importance of abolishing this provision extends beyond electronic books, for example, the issue also arises in respect of electronic versions of cultural events.

3.2. The OECD perspective

There is, in the author's opinion, a need for complete treaty provisions covering consumption taxes, i.e. provisions that are as comprehensive as those existing with regard to taxation of income and capital, preferably integrated into the existing OECD Model (2014),[12] including the Commentary on the OECD Model (2014).[13] Although there might be other instruments in the form of regulations or directives on transactions between Member States, the digital world has no borderline relative to third countries. In addition, consumption taxes should, in a treaty context, be treated parallel to income and capital taxes.

The development of clauses or specific treaties related to the exchange of information in recent years could be essential to consumption taxation and, in particular, digital transactions. As digital suppliers may move to countries with no or a very low rate of consumption taxation, strong treaties in this respect are a precondition for compliance. Such agreements should also be complemented by collection agreements. Supplementary collection, after all efforts have been exhausted in the state where the taxes are due, is not sufficient. Collection by the state where the supplier has his primary establishment could provide an efficient tool in respect of taxes on electronic supplies in a broad sense in the countries where the consumption takes place or is deemed to take place. Such agreements could be essential enforcement mechanisms within the European Union when the destination principle is applied.

3.3. The EU perspective

If the European Union is to take a leadership role in respect of the digital economy, a broad range of VAT initiatives should be undertaken with haste. Legal certainty, however, must be observed, which necessitates a time-consuming process for the introduction of new or amended tax laws.

A genuine single market requires the same treatment in respect of VAT rates and other VAT provisions independent of the place of establishment of the supplier and the purchaser, as long as the transaction takes place within the European Union. Such a market requires the origin principle to be operative, pursuant to which the place of establishment of the supplier is determinative. As the perspective has changed from an EU to a Member State basis, however, the destination principle should apply to all types of supplies, independent of whether goods or digital or other services are at issue. Once this occurs, the framework conditions should be fully in line with the 1998 OECD Ottawa decisions, the main principle of which is consequent taxation in the state of consumption.

The principle of neutrality in respect of VAT has frequently been emphasized by the ECJ and applies to almost all provisions. It should be observed, in the context of consumption taxation of the digital economy, that the principle of neutrality is essential to fair competition between suppliers of different types, independent of whether they are supplying goods or services or a mix thereof, and independent of the country of establishment and the country from which the supply takes place or is deemed to take place.

In order to achieve neutrality within this meaning certain actions should be undertaken:

7. *See* L. Quaratino, *New Provisions Regarding the Taxation of the Digital Economy*, 54 Eur. Taxn. 5, pp. 211-217 (2014), Journals IBFD.
8. The Italian provisions have been partially repealed by IT: Law 68 of 2 May 2014, the Official Gazette No. 102 of 5 May 2014.
9. *See* the Report, *supra* n. 2, at p. 7.
10. *See* the Report, *supra* n. 2, at p. 25.
11. EU VAT Directive (2006): Council Directive 2006/112/EC of 28 November 2006 on the common system of value added tax, OJ L347 (2006), EU Law IBFD.
12. *OECD Model Tax Convention on Income and on Capital* (15 July 2014), Models IBFD.
13. *OECD Model Tax Convention on Income and on Capital: Commentary* (15 July 2014), Models IBFD.

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- The destination principle should be applied for supplies to taxable, as well as non-taxable, persons. The resultant application of the reverse charge mechanism for trade between taxable persons domestically, as well as between Member States, and for transactions with third countries, will both simplify the process and allow for more possibilities to avoid abuse. This is an essential step in particular with regard to SMEs. It has been argued that the reverse charge mechanism, with its zero-rating of supplies to taxable persons, would lead to an uncontrollable situation. The author disagrees on the basis that digital means can be used to avoid this potential problem. As an example, when a person wants to book a train or flight ticket or a movie or theatre ticket, the customer is typically identified by means of a credit or debit card. Once basic data is verified, the purchase is authorized. This procedure is possibly more complicated than providing a VAT number and other relevant data related to a taxable person and obtaining authorization for a supply net of VAT, if the receiver is included in the list of taxable persons provided by the tax authorities. The information regarding the transactions will automatically be available to the authority in charge and will enable auditing.
- VAT rates should be the same for competing products or services on the same market. In the single market there ought to be a single standard VAT rate applicable to all kinds of supplies. However, the consequent application of the destination principle would facilitate differentiation between the Member States. With regard to the digital economy, no reduced rates would be allowed either for electronic services[14] or for any supply of goods competing with a digital supply, for example, books or other printed matter. It is the author's view that a generally applicable standard rate with no or limited exceptions is necessary, in particular given the increasingly frequent use of embedded systems. The main reason for not accepting reduced rates for electronic services is the immensity of such services and the combination of goods and services.
- Extended options for one-stop shops for supplies to non-taxable persons should be introduced. The mini one-stop shop (MOSS) procedure applicable from 1 January 2015 is an essential step forward in the process. It should be extended, however, to cover all B2C cross-border supplies of goods and services. A single one-stop shop (SOSS) covering all cross-border supplies of goods and services should be introduced due to the rapid and broad-based development of digital services and increased difficulties in drawing a sharp distinction between different services and between goods and services.
- The MOSS should also be extended to cover, in principle, all data for a complete VAT return, mainly by enabling deductions for input VAT related to supplies in a certain Member State. This would facilitate the process and reduce the financial burden, in particular for SMEs.
- Fair competition between supplies of services related to embedded systems is essential. The VAT treatment should be the same independent of whether a particular software is delivered as an embedded system in goods, for example, trucks or cars or household equipment, or sold separately. It should be noted that it is possible that the goods will be purchased in one Member State but the software, from another Member State or a third country, will later be added.
- The increased interactivity between seller and purchaser and sometimes between different suppliers related to a specific purchase underlines the need for standard rates, as well as standards in respect of a number of other VAT provisions. Services of this kind can easily be supplied at a distance with, for example, an Australian architect engaged in building projects within the European Union or vice versa. The services might be provided by a legal person registered in a sunny island, but managed from another place.
- There is a need to facilitate the administrative burden in respect of the fulfillment of VAT obligations, in particular for SMEs. The digital development means an increase in cross-border business for sales, as well as purchases. This underlines the urgent need for a more complete introduction of extended one-stop shop applications.
- There is a need to quickly eliminate double or non-taxation of cross-border supplies of digital services. The different treatment of supplies of apps in different Member States is only one example. Changes at the OECD level are essential but not sufficient and take too long to transpire. In order to combat abuse and enable fair competition there is a need for extended EU provisions related to exchange of information and the collection of taxes by other Member States on a regular basis, not only when they are due.

The digital media development has been swift and broad. This emphasizes the need for EU initiatives related to a number of obstacles as outlined in this article.

4. Corporate Tax Policy Options

In the Expert Group, the view was taken that "there should not be a special tax regime for digital companies. Rather the general rules should be applied or adapted so that 'digital' companies are treated in the same way as others. These general rules must impose taxation based on real economic activities [...]".[15]

In the author's view, the critical aspect of the Report in respect of corporate income taxation is related to the long-term policy options. The text refers to:[16]

14. In accordance with the VAT Directive (2006/112), article 98.2.

15. *See* the Report, *supra* n. 2, at p. 41.
16. Id. at p. 50.

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> […] more radical changes to the corporation tax system [which] have been proposed in academic literature. Some of these focus on a "destination based" corporation tax. This would be similar to a VAT in that its key feature would be that exports would be zero-rated and imports would be taxed. It would differ from a VAT in that wage costs would continue to be deductible, and the tax would continue to be levied on an accounting basis, rather than using the invoice-credit method. It has been claimed that a version of such a destination-based corporation tax based on cash flow (with immediate expensing of capital expenditure but no relief for interest payments and therefore even more similar to VAT) would be neutral with respect to corporate location, investment, financing and transfer pricing decisions, thus addressing some fundamental concerns of international tax competition between countries.

The report adds that "[t]hese conclusions are not uncontested" and states in a footnote that "[c]areful consideration of international redistribution of tax revenues would be necessary. Moreover, possible empirically significant effects on resource allocation, including trade and cross-border investment would have to be considered".

A corporate tax on cash flow instead of on profit determined on an accrual basis would fundamentally change the current tax system and allocate the tax base to destination countries instead of source countries. This would require a thorough analysis of the economic effects and specific design of the tax in order to agree on the new allocation of the tax base and tax revenue among countries. It has been emphasized herein that all of the revenue from VAT already accrues to the place of consumption. To add corporate income tax, wholly or partly, to such markets would raise major concerns, since it would entail a substantial redistribution of revenue between Member States and a risk of a radical restructuring of cross-border business investments. Despite ongoing research on how such a tax would be implemented, much more information would have to be gathered before a policy position could be agreed on.

As stated in the Report, the long-term conclusions are not uncontested. In the author's view, the statement that such a destination-based corporate income tax "would be neutral with respect to corporate location, investment, financing and transfer pricing decisions" is simply not true. It is misleading. If, one were to forget about the community, business realities, present localization of investments, etc., then it would be true that under the very specific conditions presented under certain academic models there would be no distortions.

It has been argued that a cash flow tax applicable on a destination basis, "would not create distortions to any margins of business decisions, namely choice between discrete options, choice of scale of investment, choice of form of income, and choice of source of finance".[17] The author has no objection to this, as long as the conclusions do not extend beyond this. A destination-based corporate income tax has been explored in detail by Auerbach and Devereux (2013).[18] It is argued "that the destination based tax does not create distortions to any margins of decision (at least in the model), but falls on residents of the destination country".[19] The author has no objections to such restrictions on the model. For public decision-making purposes, however, it is necessary to precisely define the concepts – all the concepts and their consequences! When the Report states that destination-based corporate income tax "would be neutral with respect to corporate location, investment, financing and transfer pricing decisions" it is on shaky ground. If the present source-based tax were to become destination based, the state revenue would also be transferred from one country to another. For the enterprise, this may necessitate a change in localization of future investments from one country to another in order to qualify for full deductions of wages and other business costs.

In the author's view, the arguments for a destination-based corporate income tax depart from the task of the Expert Group, as such a proposal does not provide a solution to the problems articulated by the G-20 countries and the OECD under the BEPS project. "[W]hat creates tax policy concerns is that, due to gaps in the interaction of different tax systems, and in some cases because of the application of bilateral tax treaties, income from cross-border activities may go untaxed anywhere, or be only unduly lowly taxed".[20] Instead, the Expert Group proposal in this respect would only lead to a significant shift of revenue between states with well established and functioning tax systems. The losers would be small countries and countries with a strong export business, independent of whether or not engaging in traditional export of goods from, for example, the manufacturing industry or the export of services in the form of apps or other forms of e-commerce. The outcome would be even worse in respect of minor markets with a strong export sector. The winners would be big markets and states with a small export business.

Such a destination-based corporate income tax is likely not only to negatively impact state revenue for a great number of countries but also the future of the enterprises concerned, as it will probably lead to a preference for future investments in countries with big markets in respect of the goods or services supplied by the enterprise. To argue that such a destination-based corporate income tax "would be neutral with respect to corporate location, investment, financing and transfer pricing decisions" is misleading.

In the author's view, the future corporate income tax should be based on where the headquarters and the PEs are located, where the real business activities are carried out, where research takes place and where the risks are allocated. Some minimum form of physical presence and permanence should be required in any source country aspiring to reap tax benefits.

17. *See* M. Devereux & R. de la Feria, *Designing and implementing a Destination Based Corporate Tax*, p. 8 (April 2014).
18. *See* A.J. Auerbach & M. P. Devereux, *Consumption and Cash-flow Taxes in an International Setting*, National Bureau of Economic Research (October 2013).
19. *See* M.P. Devereux, *Issues in the Design of Taxes on Corporate Profit*, Oxford University Centre for Business Taxation, WP 12/15, April 2012.
20. *See* OECD, *Action Plan on Base Erosion and Profit Shifting* p. 10 (2013), International Organizations' Documentation IBFD.

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