Digital Tax Q&A
1 May 2018

Why is digital tax in the news?

A quick background

The scale of international tax reform in the past five years has been vast.

- 15 OECD actions on base erosion and profit shifting (BEPS),
- 2 EU Anti-Tax Avoidance Directives,
- US tax reform; and
- A raft of global tax transparency measures such as the Common Reporting Standard and the Foreign Account Tax Compliance Act.

However, one key challenge remains - how best to tax a global economy that is becoming increasingly digitalised. Over the past 12 months, the OECD, EU and national governments have been intensely focused on this issue.

BEPS Action 1 was designed to address the BEPS challenges of the digital economy and concluded:

> "Because the digital economy is increasingly becoming the economy itself, it would be difficult, if not impossible, to ring-fence the digital economy from the rest of the economy for tax purposes".

The other 14 BEPS Actions[1] were intended to address the BEPS risks in the digital economy but, to ensure this happened, the OECD undertook to review the issue of the digital economy again by 2020.

This weekend, reports say that the OECD is ready to speed up its work for a global overhaul of digital taxation, possibly advancing to next year the adoption of a blueprint on the issue that is currently due in 2020.[2]

The challenges of taxing the digital economy have now gone beyond BEPS concerns. Some countries take the view that they should be entitled to more tax from digital companies than they are able to collect under the current tax system. They believe that global corporation tax rules need to be changed to reflect an increasingly digitised economy. Currently, companies selling into a market are only taxed in that market if they have a physical presence there and that is often unnecessary for digital business models. Political pressure is growing internationally for reform.

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[1] For example, broadening of the PE (permanent establishment) definition, tightening of transfer pricing rules.
[2] https://mobile.reuters.com/article/amp/idUSL8N1S5062

What happened on digital tax this weekend?

An informal ECOFIN happened on 28 April 2018 in Sofia, Bulgaria where the group discussed the European Commission's recent proposal on digital taxation. Prior to the weekend, the Asia-Europe Meeting Finance Ministers' Meeting (ASEM FinMM) took place on 26 April 2018 in Sofia, Bulgaria where digital taxation also appeared on the agenda.

Reports from the recent informal meeting of Ecofin[3] indicate growing concerns and opposition to the EU interim measure, with preferences being strongly expressed for a long-term global solution. Concerns are emerging from both small and larger EU Member States according to the reports.

Ángel Gurría, Secretary General of the OECD, who attended the ECOFIN meeting, said work for global reform, which would include the United States, Japan and China, was already under way and cautioned against adopting measures that could be inconsistent with a long-term solution[4].

Reports from the Asia-Europe Meeting Finance Ministers' Meeting (ASEM FinMM) last week [5] highlight that China, the world's second largest economy with 19% of the world's population, also supports a global approach to digital tax[6] and opposes the EU interim measure.

What have the EU and the OECD announced this Spring?

Two major announcements on digital taxation by the EU and the OECD in March.

1. **Friday, 16 March** - The OECD released their interim report on *Tax Challenges Arising from Digitalisation*[7] on Friday, 16 March. They presented it to the March G20 meeting of Finance Ministers in Buenos Aires on 20 March. (See highlights on page 6).

2. **Wednesday, 21 March** - The EU Commission published their digital tax proposals on 21 March, in advance of the EU Council meeting the same week.

Where did the EU proposals stem from?

The EU became very focused on digital taxation from autumn 2017 onwards. It was a priority of the Estonian presidency in the second half of 2017 and the Bulgarian presidency now intends to progress the agenda in 2018.

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[3] Informal Ecofin, Sofia, Bulgaria, 28 April 2018.

[4] Interview with Ángel Gurría, Secretary General of the OECD, Bulgarian Presidency of the Council of the European Union, 28 April 2018: https://vimeo.com/266991157.

[5] Asia-Europe Meeting Finance Ministers' Meeting (ASEM FinMM), 26 April 2018.

[6] *Sunday Business Post*, 29 April 2018.

[7] OECD (2018), *Tax Challenges Arising from Digitalisation – Interim Report 2018: Inclusive Framework on BEPS*, OECD Publishing, Paris. http://dx.doi.org/10.1787/9789264293083-en. The OECD issued a Brief on Friday, 16 March which summarises the key findings of the interim report.

In 2017, the French Tax Authorities lost a high-profile "permanent establishment" tax case. Following this decision, France, Germany, Spain and Italy issued a Political Statement calling for the Commission to explore:

> "a so-called "equalisation tax" on the turnover generated in Europe by the digital companies".

The letter was subsequently signed by six other Member States.

The Commission was quick to respond, with a Communication on 21 September 2017 titled "Fair and Efficient Tax System in the European Union for the Digital Single Market". It set out options for taxing the digital economy within the framework of their plans for a CCCTB (Common Consolidated Corporate Tax Base).

A Public Consultation on digital tax was launched on 26 October 2017, following the Communication and the Institute responded on 20 December 2017, completing the Consultation Questionnaire and submitting a Position Paper to the Commission.

The issue was high on the agenda at the ECOFIN meeting on 5 December 2017 and the Conclusions of ECOFIN recognised the importance of working towards an internationally agreed solution at the OECD. The EU:

> "REITERATES … its commitment to principles of international taxation and UNDERLINES the importance of the examination of value creation and profit generation processes by the digital economy, currently being carried out by the OECD, with the aim to design adequate policy response."

What is the EU Commission proposing?

The EU Commission has released two legislative proposals which will:

1. **Impose an interim Digital Services Tax** on certain revenue from digital activities in the EU – *the temporary (interim) solution*

AND

2. **Reform corporate tax rules** so that profits are registered and taxed where businesses have significant interaction with users through digital channels – *the comprehensive solution*.

1. The EU temporary (interim) solution

This measure involves the introduction of a new interim **Digital Services Tax,** targeted at larger digital companies that generate revenue by supplying digital services within the EU.

Digital services are defined to include three types of services:

a. Digital advertising targeted at users of a digital interface;
b. The transmission of data collected about users of a digital interface; and
c. Intermediation services, such as providing an online marketplace where buyers and sellers can transact.

The Digital Services Tax will be:

- A tax imposed on the gross EU digital turnover of large multinationals with total worldwide revenue exceeding €750m **and** EU digital revenues of €50 million.
- At a rate of 3%.
- Applied to both EU companies and non-EU companies until such time as the comprehensive EU solution is agreed and/or double taxation treaties with non-EU countries are negotiated which contain a digital PE clause.

However, there is a view that any temporary tax measures can be difficult to reverse once they have become established, thus raising concerns that the temporary solution may become a permanent tax on the digital companies affected.

The text of the Digital Services Tax Directive does not include any 'sunset clause' or provision for its automatic cessation.

What sort of a tax is this new temporary solution?

The temporary Digital Services Tax falls **outside** normal corporation tax principles – it is **not a tax on profits** but a **tax on turnover**.

It has some similarities with a Value Added Tax but the normal credit that businesses can obtain for VAT would not be available.

It seems likely that the tax would be calculated based on the number of digital users in each EU Member State. However, there will be many political and administrative challenges to carving up taxing rights in this way, on the basis of geographical apportionment.

Are there any legal issues with the interim tax?

Some commentators[8] have suggested that the EU proposal may not be consistent with WTO obligations, even though the Commission believes that its temporary solution does not breach any double tax treaties with third countries or WTO rules.

2. What is the long-term solution being proposed by the EU?

The EU's long-term comprehensive solution is to reform corporate tax rules, so that EU Member States would be able to tax profits that are generated in their territory, even if a company does not have a physical presence within the country.

Under the proposal, a digital platform would be deemed to have a taxable "digital presence" or a virtual permanent establishment in an EU Member State if it satisfies **one** of the following criteria:

- A threshold of €7m or more in annual revenues from digital services in a Member State;
- More than 100,000 users in a Member State in a tax year;
- Over 3,000 business contracts for digital services between the company and business users in a tax year.

[8] Mr Philip Baker QC, commenting on the Digital Services Tax at the CFE Tax Advisers Europe Forum on Fair Taxation of the Digital Economy, Brussels, 19 April 2018.

The new rules also would affect how profits are allocated to Member States to better reflect how companies can create value online. For example, depending on where the user is based at the time of consumption.

This measure could eventually be integrated into the scope of the Common Consolidated Corporate Tax Base (CCCTB).

How will Ireland be impacted by the EU proposals?

The main concern is that the EU is proposing to act unilaterally, before there has been a global agreement on the best way to tax the digital economy, as proposed by the OECD in their interim report. This could undermine the road to international consensus that the OECD is trying to navigate with Governments, businesses and other stakeholders globally.

Anything other than global agreement will lead to double taxation, incoherence and complexity and potentially trade agreement challenges.

The Commission has recommended that Member States allow companies a corporate tax deduction for the Digital Services Tax paid to other Member States, although the Directive (as proposed) does not legally require this. While the companies may not get a euro for euro tax credit against corporation tax paid, this could nonetheless reduce the corporate tax receipts for that Exchequer.

At a Press Conference with Donald Tusk (European Council President) on 8 March 2018, Taoiseach Leo Varadkar, set out the Government's position on digital tax:

> *"We're committed to Tax Reform at a global level. And we're therefore very supportive of the OECD BEPS Process. This will avoid retaliation. We don't want to see any Trade Wars or any Tax Wars. And will also ensure that we don't inadvertently hand advantages to Europe's competitors."*

What has the OECD been doing in recent months?

A quick background

The OECD Digital Task Force has been working intensely with digital businesses over the past year to get a better understanding of all the current business models with a view to achieving a long term permanent solution to the issue that is based on global consensus.

The sheer diversity of digital business models makes this work very challenging. It is also difficult to find one single measure that will be effective for the whole digital economy – which is also evolving by the day.

Ángel Gurría (OECD Secretary General) explained the OECD's objectives, while in Dublin on 8 March 2018:

> *"We're not talking about taxing a company or a few companies. We're talking about how you tax an increasingly digitalised economy in the world*."

Addressing the Joint Committee on Finance, Public Expenditure and Reform, and Taoiseach on 8 March, Mr Gurria also stated:

"The substance is that this matter is too important to be urgent. One does not need to come up with some short-term solutions if they are not well thought out or consensus based and they do not take a longer-term approach. We must not do anything today that will make it difficult to have a long-term solution."

"No, we do not support the short-term solution or approach that would consider turnover only because that is only one part of the problem, would leave out many of the activities and would be very uneven in its application. This may be a reflex or an intuitive way to address the issue but intuition and reflexes do not offer good guidance"

The OECD also engaged in a public consultation (launched October 2017) which the Institute responded to on 13 October and held a public meeting with the main digital stakeholders in Silicon Valley on 1 November 2017.

What did the OECD say in their interim report released on 16 March?

The OECD released their interim report on *Tax Challenges Arising from Digitalisation*[9] on Friday, 16 March. The key points to note in the interim report are:

- The interim report was **agreed by more than 110 countries**.
- The OECD stressed the importance of a comprehensive, long-term solution – "together" globally.
- The report does **not recommend** the introduction of **interim measures** because there is no consensus on the merits of, or the need for interim measures.
- Members agreed to work towards a **consensus-based solution by 2020** by undertaking a coherent and concurrent review of two fundamental tax concepts - "nexus" and "profit allocation rules."
    - > "Nexus" refers to a country's right to tax a company's profits based on the business having a taxable presence or business activities link/connection with that country.
    - > "Profit allocation rules" relate to how much ("the share") of a multinational's profits should be taxed in a given country.
- A number of countries are opposed to an interim measure because they believe that it will give rise to risks and adverse consequences irrespective of any limits that may be imposed on the design of such a measure. They do not agree that features of the digital economy such as "scale and mass", a heavy reliance on intangible assets or "user contribution" provide a basis for imposing an interim measure.
- The countries who are in favour of an interim measure acknowledge these challenges but believe they do not outweigh the need to ensure tax is paid in their country on certain e-services supplied in their country and that they can mitigate some of the adverse consequences through the design of the measure.

[9] OECD (2018), *Tax Challenges Arising from Digitalisation – Interim Report 2018: Inclusive Framework on BEPS*, OECD Publishing, Paris. http://dx.doi.org/10.1787/9789264293083-en

- Countries that are in favour of the **introduction of interim measures** recognise the need to take the following **six design considerations** into account:

    1. Be compliant with a country's international obligations
    2. Be temporary
    3. Be targeted
    4. Minimise over-taxation
    5. Minimise impact on start-ups, business creation and small business more generally
    6. Minimise cost and complexity

The OECD Digital Task Force will hold its next meeting in July 2018. An update on this work will be provided to the G20 in 2019, as members work towards a consensus-based solution by 2020.

However, Ángel Gurría (OECD Secretary General) who was attending the EU meeting in Bulgaria over the weekend, said the OECD was ready to speed up its work for a global overhaul of digital taxation, possibly advancing to next year the adoption of a blueprint on the issue that is currently due in 2020.[10]

BEPS is working

The OECD said there is evidence to indicate that the **implementation of the OECD/G20 BEPS measures are having an impact on the behaviour of multinationals**, which are changing their business structures to better align them with their real economic activity. Monitoring the impact of the BEPS measures and US tax reform will be an important part of the work of the OECD Digital Task Force going forward.

The US position in the digital tax debate

US Treasury Secretary, Steven Mnuchin reacting to the publication of the OECD interim report on Friday, 16 March stated:

> *"The US firmly opposes proposals by any country to single out digital companies. Some of these companies are among the greatest contributors to US job creation and economic growth. Imposing new and redundant tax burdens would inhibit growth and ultimately harm workers and consumers. I fully support international cooperation to address broader tax challenges arising from the modern economy and to put the international tax system on a more sustainable footing."*

Chip Harter, Deputy Assistant Secretary (International Tax Affairs) at the US Department of the Treasury set out the US position concerning proposals to tax the digital economy at a Tax Council Policy Institute conference in Washington, 15-16 February. He stated that the US is open to discussions as to whether benchmarks concerning permanent establishment and profit attribution should be revised on a broader basis, but not as part of a special regime which is specific only for digital business. Harter said that the US does not believe digital business is so inherently different such that it warrants separate treatment by way of the creation of a special tax regime.

[10] https://mobile.reuters.com/article/amp/idUSL8N1S5062