

Presidency Issues Note for the informal ECOFIN Tallinn, 16 September 2017

Discussion on corporate taxation challenges of the digital economy

Introduction

1. This document aims at outlining the challenges of the existing international tax rules raised by the digitalisation of the world economy. (1) It argues that deficiencies in these rules go beyond typical tax avoidance issues, (2) underlines the limits of possible "quick fixes" and (3) proposes the EU should push for a more comprehensive reform of international tax rules. Ministers will be invited to share their views and preferred ways forward on these issues, based on of the questions outlined at the end of this document.

Gap in the current international tax rules

2. Tax policy should be effective in reaching its objectives and neutral towards taxpayers. The notion of tax neutrality implies that all businesses, despite being local or international, small or large, innovative or keeping to their roots, should bear a similar tax burden. Most commonly, the effect of the lower tax liability of some businesses is attributed to tax avoidance and aggressive tax planning¹, which is already targeted by Base Erosion and Profit Shifting (BEPS) measures and corresponding initiatives at the EU level. However, taking a closer look at successfully advancing business models, at least part of the reasons behind their lower tax liability has to be attributed to the fact that international tax rules are outdated and cannot cope with the challenges of the digitalisation of the economy.
3. One of the main shortcomings of the current international tax rules is that the taxing right of a jurisdiction only arises when the business has a physical presence in that jurisdiction.² One feature of the digitalisation of the economy is that services can be provided digitally with minimal physical presence right from the start, even in the country of residence. It is for that reason that cross-border activities of digitalised businesses just fall into the gaps of international tax rules and remain untaxed in most jurisdictions where the business is digitally present and creating value.
4. The new ways of doing business allows the digital economy to enjoy a lower overall tax liability without being correspondingly targeted by BEPS measures or by any of the measures recently introduced in the EU (e.g. Anti-Tax Avoidance Directive - ATAD) or

¹ See for example:

Final Report – The Impact of Tax Planning on Forwardlooking Effective Tax Rates.

https://ec.europa.eu/taxation_customs/sites/taxation/files/taxation_paper_64.pdf

² This notion has recently gained wide public attention because of the French court case against Google. See for example:

<https://www.bloomberg.com/news/articles/2017-07-12/google-wins-french-court-fight-over-1-3-billion-tax-bill>





further measures being discussed at the moment (e.g. Common Consolidated Corporate Tax Base - CCCTB). This situation is a clear failure of the international tax rules that undermines the principle of tax neutrality, as the substantial difference in the tax burden occurs primarily because one company offers cross-border physical services and the other one digital services.

5. It needs to be highlighted that the scale of the described market distortion is growing rapidly since the share of digital economy in the global economy is expected to grow exponentially. This trend of growth is already clearly visible when we take a look at companies with the highest market value in the world. Ten years ago, they were ExxonMobile, General Electric, Microsoft, Citigroup, AT&T, Bank of America³ and now they are Apple, Alphabet, Microsoft, Amazon, Berkshire Hathaway, Facebook⁴. It cannot be argued anymore that the deficiency of international tax rules is a minor gap affecting only a limited number of companies. This deficiency has unintentionally turned into an unequal competitive advantage for the most successful and rapidly growing businesses.
6. It is therefore high time to reinforce the principle of the tax neutrality in international tax rules. Taking into account the globalisation of world economy, appropriate and timely action should be pushed forward by the OECD in order to avoid the necessity of unilateral measures. Taking into account the specificities of the EU, especially its highly integrated internal market, the EU should agree its preferred solution beforehand.

Possibilities for a “quick fix” outside current rules

7. One possible way to approach the gap in the current international tax rules is by using “quick fixes”. Where the problem lies in the non-taxation of internet advertisements, it is for instance feasible to introduce an online advertisement tax. Where the problem is created by non-taxation of video-streaming, it is possible to launch a tax equal to a more traditional levy on DVD-s. Where the tax revenues are not collected because large volumes of different digital services in that jurisdiction are rendered by non-residents, the introduction of a withholding tax or an equalisation levy on these transactions could be considered.
8. When considering the application of these kind of quick fixes, three aspects related to above-mentioned possibilities must be emphasised:
 - a. all these kind of taxes and fees are traditionally used in a moderate size and placed on certain services in addition to the corporate income tax on profits. Therefore, in

³ Forbes Global 2000 list 2007. https://www.forbes.com/lists/2007/18/biz_07forbes2000_The-Global-2000_MktVal.html

⁴ Forbes Global 2000 list 2017. <https://www.forbes.com/global2000/list/>





- common circumstances, these will not level the playing field for businesses if part of businesses is still not paying a fair share of taxes on its profits;
- b. if these kind of new taxes and fees are applied in a way that they would substitute taxes on profits, serious cases of unrelieved double or multiple taxation could arise⁵. There are no current international mechanisms for relieving the double taxation which may arise from the cumulative effect of applying, for example, corporate income tax and an equalization levy on the same transaction. Even the recently agreed Dispute Resolution Mechanism Directive will not apply in such cases;
 - c. it is common that a very successful digital service might still be looking for a source of income in its business model⁶. Also, it is not unusual that the source of income changes over time within the same business model⁷. Therefore, the revenue from the above-mentioned taxes and fees would be highly volatile and unsustainable as new business models arise, hence contradicting general recommendations on designing a solid and time-withstanding tax policy.
9. As a result, connecting the taxation of the digital economy with the source of income (e.g. online advertisements, digital services from non-residents) through “quick fixes” may not be a reliable solution in the long-run from a tax policy perspective. The most likely outcome of such approach would be under-, over- or non-taxation. The latter deriving from an expectation that after enacting new rules, the tax base would cease to exist although the digital presence and value created in the jurisdiction would remain the same: the businesses would for instance abandon the sources of income that led to taxation and reorient to non-taxed sources (e.g. substituting advertisement revenue with client fees).

Comprehensive approach building on the current rules

10. Another possible way to approach the gap in the current international tax rules is by building on and improving the current rules. The underlying principles of corporate income tax have withstood the test of time. General principles, like taxation of profits where the value is created, have worked for decades. These principles enable a level playing field for all businesses regardless of whether the business is selling knitwear at markets or airplanes to armed forces.
11. Therefore, the most promising way forward would be to amend the current international corporate tax rules to fill in the gap that enable the profits earned from businesses in the digitalised economy to escape fair taxation. This approach - amending existing rules rather

⁵ Withholding tax on certain payments may be an exception, provided that most of the Double Tax Conventions foresee some kind of relief for double taxation.

⁶ For example, Twitter is still lossmaking and looking for a valid source of income.

<https://www.theguardian.com/technology/2017/feb/09/twitter-loses-advertising-revenue-rise-users-shares>

⁷ For example, Youtube introduced a advertisement free version for paying users. <http://www.reuters.com/article/us-alphabet-youtube-subscription-idUSKCN0SF2KO20151021>





than reinventing the wheel - has been widely used on the global and EU levels for tackling other shortcomings of international tax rules. For example, the EU has recently adopted amendments to the Anti-Tax Avoidance Directive specifically addressing hybrid mismatches. The OECD has furthermore amended its Transfer Pricing Guidelines specifically to target Hard-to-Value Intangibles and Low Value-Added Services. As these examples confirm, specific challenges can be addressed by amending the current international tax rules and these amendments can be designed in a way that does not have spill-over effects for already well-regulated situations.

12. Suitable alterations for tackling the challenges of the digitalised economy within the current framework of international tax rules would entail modifying the concept of permanent establishment and enhancing the rules for attribution of profits to the newly modified permanent establishment reflecting the value created by it. Under this approach, even without physical presence, a business with significant digital presence would be deemed to have a (virtual) permanent establishment in a jurisdiction of operation and therefore be liable to its corporate tax regulations, including adapted attribution of profit rules.
13. Recent experience at the global and EU level have proven that it is possible to find compromises in a manageable timeframe to fix the shortcomings of international tax rules if we stick to the well-known and generally accepted principles of taxation. Under the proposed approach, the well-known and fairly well operating international taxation rules would remain intact. Therefore, it should not be more challenging to adapt the current international tax rules in a comprehensive way than to agree on a common quick fix outside of the current rules.

Conclusion

14. Every year that we spend analysing and discussing the ultimate best solution to the challenges of digital economy, businesses are suffering from unequal competition, countries are losing valuable tax revenues, and unilateral measures are undermining the Internal Market. Therefore, it is urgent to close the gap in international tax rules in order to ensure the fair taxation of profits from businesses in the digitalised economy.

Questions for discussion:

- **Could you share your ideas and experience on tackling the challenges of the digitalised economy from a national tax policy point of view?**
- **What are your views and preferred way forward in targeting these challenges on international level?**
- **Do you agree that, as a first step, the ECOFIN in December should agree a common position on the preferred way forward to give its input to the OECD to move quickly forward with a global solution?**

