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Euro Tax Flash from KPMG's EU Tax Centre

EU Commission releases package on Fair and Effective Taxation of the Digital Economy

Digital Economy – EU Directive - Recommendations to amend Double Tax Treaties - Digital Services Tax – Digital Permanent Establishment – OECD: Interim Report

On March 21, 2018, the European Commission issued several proposals on a Fair and Effective Tax System in the EU for the Digital Single Market, including a Directive proposal on a Digital Services Tax, a Directive proposal on the introduction of a digital permanent establishment concept, and Recommendations to Member States to implement this concept in their double tax treaties. The release of the proposals comes less than a week after the publication by the OECD of its Interim Report on the "Tax Challenges Arising from Digitalisation" on March 16, 2018.

Background

Taxation of enterprises that use digital technology has been high on the political agenda of international fora in the past months and both initiatives should be seen in the broader context of the fight against base erosion and profit shifting (BEPS) and the perceived mismatch between taxation and value creation for digital activities.

While the OECD Interim Report on the "Tax Challenges Arising from Digitalisation" follows-up on the work delivered in 2015 under Action 1 of the BEPS Project, discussions on the taxation of the digital economy have intensified at the EU level since September 2017 (see ETF 335). On September 21, 2017, the European Commission issued a Communication (see ETF 338), which presented the critical challenges in taxing businesses that provide services digitally and proposed both long-term and short-term solutions. The Council's conclusions on "Responding to the challenges of taxation of profits of the digital economy" adopted by the ECOFIN in

December 2017 (see ETF 345) further aimed at defining a common EU approach to the issue, while highlighting the urgency of agreeing on a policy response at the global level.

EU Commission proposal

On March 21, 2018, the European Commission presented a series of measures aimed at ensuring a fair and efficient taxation of digital businesses operating within the EU. The package includes both interim measures, in the form of a 3% Digital Services Tax on revenues, and a long-term solution, introducing the concept of a digital permanent establishment.

Introduction of a Digital Services Tax

The proposal for a Directive on the common system of a digital services tax on revenues resulting from the provision of certain digital services intends to avoid potential disparities arising within the EU as a result of the implementation of unilateral initiatives by Member States and proposes a coordinated approach to tax revenues from certain digital services.

The new Digital Services Tax (DST) would apply as of January 1, 2020, and would be levied at the single rate of 3% on gross revenues:

- The DST would apply to certain digital services, including the supply of advertising space, the making available of marketplaces that facilitate transactions directly between users, and the transmission of collected user data, while the supply of digital content or payment services, as well as trading venue and regulated crowdfunding services, would be excluded.
- Businesses that cumulatively meet certain thresholds would be subject to the DST, i.e. entities with a total annual worldwide revenue above EUR 750 million and a total annual revenue stemming from digital services in the EU above EUR 50 million. If the entity is part of a consolidated group, thresholds should be assessed at the level of the group.
- The DST should be due in the Member States where the users are located. If the users are located in different Member States, the proposal also provides for the tax base to be attributed between Member States based on certain allocation keys.

The Directive also provides for cooperation between Member States in the form of a one-stop-shop mechanism, allowing taxpayers to have a single point of contact to fulfill all administrative obligations in relation to the new tax (i.e. identification, reporting, and payment). In addition, taxpayers should have the possibility to deduct the DST from their corporate income tax liability, so as to partially mitigate double taxation.

Introduction of a Digital Permanent Establishment

The proposal for a Directive laying down rules relating to the corporate taxation of a significant digital presence has a broader scope than the Digital Services Tax and is designed to introduce a taxable nexus for digital businesses operating within the EU, with no or only a limited physical presence. It also sets out principles to attribute profits to businesses having such “significant digital presence”:

- The Directive aims at taxing under the normal corporate income tax system of a Member State, profits generated by businesses providing certain digital services and having a "significant digital presence" within this Member State.
- The notion of "significant digital presence" builds on the existing permanent establishment concept and covers any digital platform such as a website or a mobile application that meets one of the following criteria: annual revenue from providing digital services in a given Member State exceeds EUR 7 million, the annual number of users of such services is above 100,000, or the annual number of online contracts concluded with users in a given Member State exceeds 3,000.
- The Directive would be applicable to EU taxpayers, as well as enterprises established in a non-EU jurisdiction with which there is no double tax treaty with the Member State where the taxpayer is identified as having a significant digital presence. However, it does not affect taxpayers established in a non-EU jurisdiction where there is a double tax treaty in force, unless such treaty includes a similar provision on digital presence.
- The proposed rules on profit allocation are mainly based on the current OECD framework applicable to permanent establishments and suggest the profit split as preferred method. Nevertheless, the Directive also details a list of economically significant activities that should be taken into account to reflect the fact that value is created where users are based and data is collected.

Finally, the measures proposed by the European Commission include Recommendations to the Member States to amend their double tax treaties with third countries, so that the above rules also apply to non-EU companies. The objective of the recommendations is to address situations involving non-EU jurisdictions without violating the Member States' existing treaties.

It is expected that once a Member State applies provisions to comply with the above concept of a digital permanent establishment with respect to a country, that Member State will also cease to apply the DST with respect to that country.

The proposals will now be submitted to the European Parliament for consultation and to the Council for adoption by unanimity.

OECD Interim report

Running parallel with the work performed at the EU level, discussions have been taking place in the OECD Inclusive Framework on similar issues. On March 16, 2018, the OECD published its interim report regarding taxation of the digital economy under the title "Tax Challenges Arising from Digitalisation". This was sooner than expected as the expected publication date was April 2018.

The OECD interim report, which is the result of a consensus reached between more than 110 member countries, presents an in-depth analysis of the different digitalized business models and how they create value. It describes a number of characteristics that are frequently observed in these businesses, such as a wide digital footprint with no or only a limited physical presence, heavy reliance on intangible assets and the importance of data and user participation. Considering how the changes associated with digitalization are increasingly affecting a growing number of businesses, the OECD reiterates its previous conclusions that it would be difficult or impossible to ring-fence the digital economy from the rest of the economy.

While the OECD recognizes that progress has been made in the implementation of the BEPS project, with some evidence that certain multinationals are already changing their tax arrangements, the report also underlines that the underlying issue of how the right to tax is allocated between jurisdictions, has not been addressed.

In this respect, and although members agreed that the two key factors of the existing tax framework, namely nexus and profit allocation rules, need to be reviewed in the light of digital businesses, the report also acknowledges that there are currently divergent views on how the issue should be approached.

As regards interim measures, the report clarifies that there is no consensus on the need for, or the benefit of, such measures and therefore does not recommend introducing any. However, it does provide some guidance for jurisdictions that are considering immediate action. Finally, the report briefly touches upon the impact of digitalization on tax policy and tax administration, in particular with respect to non-standard work, and the use of new technologies such as blockchain and crypto-currencies.

The report was presented to the G20 leaders on March 19-20, 2018, and an update should be provided by 2019, with the aim of working towards a consensus-based solution in 2020 with the self-proclaimed objective of finding a long-term solution for taxation of the digital economy.

EU Tax Centre comment

Both the Council and the European Commission have on numerous occasions expressed their preference for a coordinated tax policy response to the challenges raised by the digitalization of the economy at the global level. However, they have also pointed out the lack of consensus and the limited progress made at the OECD level in implementing a global standard to justify unilateral action at the EU level.

One of the main questions now is whether these proposals will be approved by all EU Member States, which requires unanimity. Some Member States have already expressed their concerns with respect to the DST. These concerns are for example, that the DST is a revenue tax, which means that the tax must be paid as well when the company is loss making. High and low margin companies pay the same level of tax as the tax is based on revenues. And finally, this DST will not be creditable against corporate income tax in the home country of the company, as normally only profit taxes can be taken into account as foreign tax credit. In this respect the possibility to deduct the DST as an expense should only partially mitigate the risk of double taxation.

The other major concern is how the United States will react to these proposals, as the European Commission estimates that around 120 to 150 companies will fall within the scope of the new rules, of which half is expected to be located in the United States and a third in the EU. During the G20 leaders meeting on March 19-20, 2017 in Buenos Aires, the United States have already expressed their concerns and could decide to introduce counter measures if the EU were to adopt these proposals.

Should you have any queries, please do not hesitate to contact KPMG's EU Tax Centre, or, as appropriate, your local KPMG tax advisor.

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