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The Broader Consequences of the EU Debate on Taxing the Digital Economy

By Gary D. Sprague, Esq.
Baker & McKenzie LLP
Palo Alto, California

Should companies outside the “ring-fenced” enclosure of taxpayers operating through those “highly digitalised business models”¹ which are at ground zero of the debate in the European Union (and elsewhere) over taxation of the digital economy care about the views developing in Tallinn, Paris, and Berlin? They should, because the international tax policy principles being proposed to support special measures to tax the “digital economy” have ramifications that could extend well beyond whatever group of companies or transactions may find themselves corralled within the ring fence.

Under the direction of the Estonian Presidency, the EU Council has established a remarkably ambitious agenda to design and possibly adopt special rules for the taxation of the digital economy within the EU. The Estonian Presidency set a mandate to address a variety of issues relating to the digitalization of enterprises, including supporting the free movement of data and widely available internet connectivity.² For the international tax community, however, attention is

¹ This term was used in the Request for Input issued by the OECD Task Force on the Digital Economy on September 22 to solicit public input on certain questions preparatory to the public consultation held on November 1. Presumably the reference is meant to distinguish particular companies or business models from the rest of the digitalized economy. OECD, *Request for Input on Work Regarding the Tax Challenges of the Digitalised Economy* (Sept. 22, 2017).

² Estonian Prime Minister Juri Ratas, *The Government Approved the Estonian Presidency Programme* (June 2017), <https://www.valitsus.ee/en/news/government-approved-estonian-presidency-programme>.

focused on the recent proposals to consider an EU-wide special measure to tax the “digital economy.” Two main proposals are under consideration: (i) a “digital presence PE” that would create local tax nexus even if the nonresident does not have sufficient physical presence in the source state to allow taxation under existing international tax law;³ and (ii) an “equalization levy” modeled on the Indian example which would impose a flat rate of tax on gross revenue derived through specified transactions.⁴ The Estonian Presidency note framing the issues justifies such special measures as follows:

“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. 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.”⁵

³ Essentially this would be the “significant economic presence” option as described in the 2015 BEPS Project Action 1 Final Report, but perhaps designed to have an impact on a more narrowly defined group of companies, given the change in terminology from “economic presence” to “digital presence.”

⁴ See Communication from the Commission to the European Parliament and the Council, “A Fair and Efficient Tax System in the European Union for the Digital Single Market,” at 9–10 (Sept. 21, 2017); “Presidency Issues Note for the informal ECOFIN Tallinn, 16 September 2017, Discussion on corporate taxation challenges of the digital economy,” ¶¶7, 12, available at https://www.eu2017.ee/sites/default/files/2017-09/Ecofin%20Informal_WS%20II_digital%20economy_15-16.Sept_.17.pdf.

⁵ “Presidency Issues Note for the informal ECOFIN Tallinn, 16

This paragraph is packed with assumptions and latent consequences for international tax policy. One can fairly assume that, despite the OECD's assertion that it is not possible to ring-fence the "digital economy," these proposals would be defined to apply only to certain targeted transactions or companies.

So should companies that do not consider themselves to be targets care about all this?

The answer is yes, for technical and policy reasons. This Commentary will highlight a few of these reasons.

We'll assume that one of the enterprises which would be corralled within the ring fence would be a digital services provider serving customers residing in a market jurisdiction through an enterprise not resident in that market jurisdiction. We can assume that the enterprise has achieved a certain level of market visibility, which would be due to its prior and ongoing investment in creative personnel and deployment of capital assets. The group's R&D personnel would be responsible for the technological innovations that created the service offering which has turned out to be attractive to purchasers or users in the market. Personnel outside the R&D group would have been responsible for the business innovation and risk taking that brought the service to the market, and other personnel would have made the decisions critical to attracting sufficient customers or users to support a viable business. Because the service is delivered through the internet, the company would need access to a sophisticated hardware infrastructure to deliver the service. If that infrastructure was built in house, the company would have incurred very substantial annual investments in capital equipment. As the number of users and customers grows, that investment would increase to support the connectivity demands of the business.

The first untested assumption in the statement quoted above is that the hypothetical digital services provider, which is described as having no physical presence in the market jurisdiction, nevertheless "creates value" in that state. The original OECD BEPS Action Plan set out as the goal of Actions 8–10 to "[a]ssure that transfer pricing outcomes are in line with value creation."⁶ Let's accept this statement as an accurate and appropriate international tax principle. During the debate on the digital economy, however, that expression has morphed into something other than a statement of transfer pricing principle. The most common political statement is that the

September 2017, Discussion on corporate taxation challenges of the digital economy," ¶3, available at https://www.eu2017.ee/sites/default/files/2017-09/Ecofin%20Informal_WS%20II_digital%20economy_15-16.Sept_.17.pdf.

⁶ Action Plan for Base Erosion and Profit Shifting, 20 (July 2013).

"profits" of companies "should be taxed where the value is created."⁷ On its face, that doesn't seem to depart much from the accepted guiding principle. These words, however, when used to justify the significant digital presence or equalization levy proposal, disguise an unstated assumption that is critical to the analysis, namely, that "value" is created in places other than the places where people functions are performed and capital is deployed as discussed in Actions 8–10. A somewhat looser statement is that companies should "pay taxes where they earn their profits."⁸ And the statement farthest from the starting point of a principled transfer pricing policy statement is that a state's taxing power should be exercised over value created within its territory by business conducted outside that country.⁹

The last formulation is the most transparent as to the intended policy direction of advocates for these special measures, as it is a clear statement that the fact of sales into a market should result in a certain portion of taxable income being allocable to that state as a matter of policy. This proposition was debated during the BEPS Project work on Actions 8–10 in the context of revising Chapter VI, dealing with Special Considerations for Intangibles. The conclusion was clear: "[f]eatures of a local market. . . are not intangibles."¹⁰ As for the other revisions to the Transfer Pricing Guidelines, they universally focused on the importance of actual people functions in determining how income should be allocated to owners and developers of intangibles, and to persons who assume and manage commercial risks.

The argument that the market *per se* deserves an allocation of taxable income is significant for non-digital companies because any acceptance of this proposition in the context of the digital economy means that, for the first time, the concept of an allocation of income to a market state solely by virtue of the fact of consumption for direct tax purposes will have been endorsed by leading participants in the development of international tax policy. There would seem to be no principled difference between how a consumer market creates value for digital services and

⁷ See Communication from the Commission to the European Parliament and the Council, *A Fair and Efficient Tax System in the European Union for the Digital Single Market*, at 7 (Sept. 21, 2017).

⁸ Joe Kirwin, *EU Countries Seek Legislative End-Around on Digital Tech Tax* (Oct. 2, 2017), available at <https://www.bna.com/eu-countries-seek-n73014470332/>.

⁹ Y. Brauner and P. Pistone, *Adapting Current International Taxation to New Business Models: Two Proposals for the European Union*, 71 Bull. Int'l Tax'n 12 (2017), Bulletin for International Taxation IBFD.

¹⁰ *OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations*, Ch. VI ¶6.9. (2017).

how a lucrative consumer market that is receptive to offers to sell luxury automobiles or high-priced consumer goods creates value for the automobile company or the fashion goods designer. If the principle is accepted for digital services, there will be less resistance to accepting it for other sectors.¹¹

The second major precedential point that should concern taxpayers outside the ring fence is that, in all cases, the proposals to determine the amount of tax which would be due under these proposals are redolent of formulary apportionment principles — in some cases expressly so. Even the proponents agree that under the arm's-length principle, it is not possible to attribute meaningful income to a virtual PE. After all, it is virtual. So to define the base to tax, there must be some income allocation based on non-arm's-length approaches. Factors that have been mentioned include revenue, users, and other measures of transactions with persons in the jurisdiction. It is telling that the proponents note that a longer term option to address the same challenges is formulary apportionment within Europe, including potentially creating an income pool just for the digital economy.¹²

The risk here for taxpayers outside the ring fence again is clear. There is no principled reason to apply formulary apportionment to one sector and not to others. Once formulary principles are applied to the digital economy, it weakens the case that the arm's-length principle should continue to be the otherwise uniformly applicable standard for allocating a tax base among jurisdictions.

The third is the concept of the ring fence itself. The income at the center of this discussion is not passive investment income; it is normal business profits of large, medium, and small enterprises. The OECD Model Convention and the U.S. Model Treaty do have special rules for particular circumstances, such as international transportation income and the income derived by entertainers and sportspersons. Those rules, however, essentially are source rules, that allocate income between sources when an enterprise does have actual business activity in both states. There is no case

¹¹ Readers may have noted the casual reference in the Estonian statement that the targeted enterprises may have “minimal physical presence right from the start, even in the country of residence.” This seems to represent a continuing blind spot in the eyes of some tax policy officials that the major digital enterprises employ tens of thousands of workers in various places around the world. This perception of the dematerialized enterprise existing only “in the cloud” is unfortunately persistent.

¹² Document from the Presidency in view of the Working Party on Tax Questions (Direct Taxation — CCTB), *Challenges of the digital economy for direct taxation — State of play and the way forward*, ¶¶40 et seq. (Oct. 11, 2017), available at, <http://www.politico.eu/wp-content/uploads/2017/10/Digital-tax.pdf>.

under those model treaties where normal business profits are subject to tax when the nonresident enterprise otherwise has no nexus with the state.¹³ Taxpayers not now inside the ring fence should consider whether the next ring fence might encircle them too.¹⁴

Finally, all taxpayers should be concerned by any broadly supported proposal that a generally applicable corporate tax be levied with the express intent that the tax not be subject to the existing double tax treaty entered into between the taxpayer's state of residence and the source state. Descriptions of the equalization levy option in particular are clear that the tax should be drafted so as to not be precluded by tax treaties.¹⁵

The purpose of the treaty network is to establish an agreed set of principles that divides taxation rights generally between countries of residence and source, when both have legitimate claims over the income as part of its tax base. The OECD Model has indeed changed over the years as views have changed as to where the nexus line should be drawn. The most recent example, of course, is the extensive changes to Article 5 as agreed in the Final Report under BEPS Action 7. Prior to that, the concept of a services PE was introduced into the OECD Commentary for those jurisdictions which choose to adopt it, along with useful interpretative materials. In these cases, however, the rules are universally applied to all taxpayers entitled to the benefits of the respective treaty. Any proposal to carve out from treaty coverage a tax aimed at a specific sector should cause concern even for the enterprises not now being targeted, as any precedent that treaties can be set aside in that way weakens the treaty network and could enable similar actions in the future.

There are good reasons Pandora should have kept her box firmly shut.

¹³ Some treaties include exceptions which allow taxation of consulting or technical services performed outside the source country, but those exceptions are not included in the U.S. or OECD Models.

¹⁴ It is ironic that the discussion over the possible EU tax is so transparent in the statement that there needs to be a “ring fence” to define the companies which would be subject to this tax, as the fundamental conclusion in the 2015 Final Report on Action 1, prepared by the Task Force on the Digital Economy, concluded that “it would be difficult, if not impossible, to ring-fence the digital economy from the rest of the economy.” See Action 1: 2015 Final Report, *Addressing the Tax Challenges of the Digital Economy* ¶115 (2015).

¹⁵ Descriptions are less clear as to exactly what the levy is meant to “equalize.” Taxation of nonresidents selling across borders compared to residents selling domestically? Taxation of the nonresident at source country rates instead of residence country rates? There has been little discussion as to whether the proposals under consideration would be effective in creating whatever equalization is intended.