EU Digital Services Tax: A Populist and Flawed Proposal

Kluwer International Tax Blog
March 16, 2018

Johannes Becker, Joachim Englisch (University of Muenster)

Please refer to this post as: Johannes Becker, Joachim Englisch, 'EU Digital Services Tax: A Populist and Flawed Proposal', Kluwer International Tax Blog, March 16 2018, http://kluwertaxblog.com/2018/03/16/eu-digital-services-tax-populist-flawed-proposal/

> *On 21 March, the European Commission will publish a proposal for a two-fold strategy to reform the taxation of digital companies like Google and Facebook. The most recent draft of the proposal that has been distributed on March 15 suggests that one should lower one's expectations.*

Last autumn, a group of EU Finance Ministers propelled the taxation of digital companies on top of the tax reform agenda. The existing international tax system is unfit for the 21st century as its focus on brick-and-mortar companies fails to address crucial features of the modern bits-and-bytes business. Digital firms like Facebook, Apple and Google exploit this by lowering their worldwide tax payments to levels that have repeatedly provoked public uproar. Next week, the EU Commission will come up with a double strategy for reform. The following analysis is based on the most recent draft of this proposal that has been circulating since March 15.

Digital Services Tax as an interim measure

In the long term, the Commission envisages a "comprehensive solution", i.e. a coordinated reform of the international tax system that centers on the introduction of a virtual permanent establishment (so-called "significant digital presence"). In the short term, a "targeted solution" is supposed to close the largest among the loopholes that the Commission has identified in the current system. A key element of the latter solution is a specific tax on certain digital services: the Digital Services Tax (similar versions of such a tax have commonly been labeled as “equalization taxes”). This interim tax instrument is supposed to be introduced in all EU Member States and is to be levied on gross turnover at a uniform tax rate of 3 %. Vis-à-vis third countries, the tax is a unilateral measure, i.e. the EU does not seek the coordination or the consent of its trading parties (notably the US).

According to the Commission, the underlying idea is to tax firms with business models in which users contribute considerably to value creation. More specifically, the tax would concern all operators of “digital interfaces” that provide one of the following three categories of services: (1) Offering advertising space for advertising that is aimed at users of that interface (like Google, Facebook, or YouTube); (2) intermediation services directly between (end-)users, i.e. especially in the sharing economy (like Airbnb and Uber); (3) the sale or other form of transmission of data collected about users and generated from users’ activities. By contrast, e-commerce platforms like Amazon and firms which only provide media content or other digital services (e.g. Netflix, Spotify and FinTech companies) are out of scope.

Due to the EU Internal Market requirements and the relevant WTO non-discrimination clauses, the tax applies to both foreign and domestic companies. However, there are size thresholds: Only firms with a worldwide turnover of above 750 million Euro which, at the same time, generate revenues from digital services in the EU above a threshold of 50 million Euro would be liable to pay the tax. An earlier draft suggested that the Commission had considered even higher thresholds; however, in that case all European firms would have fallen below the threshold, which would have rendered its discriminatory effects all too obvious. But even with the currently envisaged thresholds, the tax falls mainly upon US multinational firms. Only a few European players are affected by the tax, predominantly from the media industry.

The issue with taxing digital firms

As mentioned above, the Digital Services Tax is supposed to be only temporary. It is intended to close an alleged gap in the current system of international business taxation. This system identifies local value creation in a two-step procedure. First, there has to be a nexus between the firm and the state; in business taxation this is usually the firm’s headquarters or a permanent establishment (PE). If this is given, internal transfer prices that satisfy the arm’s length principle determine the local value creation for tax purposes. In principle, the latter is then subject to local source taxation.

The taxation of digital firms often fails to take the first hurdle since the provision of digital services (as e.g. offering a digital market place) does not require a physical presence – and, thus, no PE is identified.

From a competition point of view, this could be considered an acceptable outcome if the home state of the digital firm (or the jurisdiction that hosts an affiliate that is responsible for the activity under consideration) fully taxed the firm. In the case of the internet giants targeted by the Digital Services Tax, this would predominantly be the USA. However, at least until the recent tax reform, the American fiscal authorities did not effectively tax the (otherwise untaxed) foreign income of their firms, as the latter manage to avoid foreign taxation by complex structures involving tax havens.

So, from the Commission’s viewpoint, the large digital firms derive huge revenues from their European operations based on the contributions from European users. But due to the lack of a physical presence, they are able to completely avoid business taxation in most EU Member States. Since the US does not tax them either, the domestic firms in the EU are at a competitive disadvantage as they compete with low- or non-taxed firms from abroad. Thus, the Digital Services Tax has two goals, (1) restore the coherence of value creation and taxation and (2) “level the playing field”, as the draft says – the latter objective might have motivated the frequent labeling of this kind of tax as “equalization tax”.

It is almost uniformly agreed in the academic community and among policy-makers that the current rules of the international tax system are unfit for the digital age. Accordingly, there is not much resistance among economists against a “virtual PE” (most of all because the allocation of taxing rights is rather a convention than a theoretically derived proposition) if it is part of an internationally coordinated reform. From a legal point of view, the virtual PE could be consistent with the fundamental principles of adequate and practicable allocation of taxing rights (“inter-nations’ equity”) – provided all the nexus issues and definition problems (e.g. the criteria for profit allocation) can be solved in a satisfactory way.

But this is where the sympathy ends. The Commission's proposal for an interim Digital Services Tax is badly motivated and fails to reach every single goal mentioned by the Commission. It creates a nightmare of complexity and legal uncertainty. Moreover, it challenges Europe's most important trading partners – in a situation where international coordination is already under pressure and the prospective of trade wars looms.

Badly motivated…

The proposal for the tax is motivated by an alleged "mismatch" of value creation and taxation. The Commission claims that the traditional rules of allocating taxing rights do not sufficiently reflect "the value created by user participation".

The question what determines the value of a good has preoccupied the economic profession for centuries (think e.g. of Karl Marx who made an attempt to establish his labor theory of value). Nowadays, textbook economics teaches that the value of a good or service lies in the eye of the beholder, i.e. the consumer. If a good or service can be produced at a cost that does not exceed the consumer's valuation (and in the absence of market frictions), a market occurs and the good is traded at a certain price. Under perfect competition, this price equals both the marginal willingness to pay, i.e. the marginal consumer's valuation of the good or service, and the marginal production cost. As the average consumer's willingness to pay (i.e. the true value of the good or service) mostly exceeds the market price, there is gain from trade and welfare increases. From this perspective, supply without demand cannot – conceptually speaking – *create* value.

The international tax system, however, uses the term "value creation" in a fundamentally different sense. The value of a good or service is set equal to its selling price, and the value is entirely created by the supplier by way of producing it. The *locus* of value creation is therefore the location where production takes place. According to this logic, consumers can only be assumed to be contributing to value creation if they take part in the production process. This, again, can have different meanings.

First, it is sometimes argued that, producing and posting platform content (e.g. videos of your cat at YouTube) creates the value of platforms. However, since both supply and demand of this "service" is costless, it is indistinguishable from consumption (in the same sense, one could argue that hanging around at a bar contributes to the lively atmosphere which attracts other pub crawlers). As many other platforms, YouTube derives its income by selling advertising space – which is valuable because it has many users who consume each others' uploaded videos. It is the simple presence of consumers that makes YouTube valuable for advertisers, not the uploading or streaming of video clips in itself.

The second approach is based on the idea that part of the production requires the proximity of the consumer. Advertising can only be done when consumers look at billboards, newspapers, TV screens or websites on their laptop or smartphone. When a billboard may, in principle, qualify as a permanent establishment, then why shouldn't millions of small sort-of-billboards on smartphones? This approach has, however, nothing to do with consumers contributing to value creation (which, of course, does not preclude that this motivates a virtual permanent establishment as part of a "comprehensive solution").

In an earlier draft, the Commission, however, explicitly mentioned Facebook and Twitter as examples of platforms at which users contribute to platform content. Thus, the Commission seems to assume that merely the use of these platforms is sufficient to considerably contribute to value creation (as the sheer presence of users as consumers increase the value of advertising space and, thus, increases the platform's revenues). This, however, would imply that the Commission effectively redefines the term value creation for its purposes compared to the one used by international tax standards, as mentioned above.

Such a redefinition creates problems of its own, though. When consumers are assumed to create value merely due to network effects, this is not limited to platform markets. The size and the 'thickness' of markets (in terms of liquidity) is, of course, of value for every seller on every market. Network effects like those mentioned by the Commission draft (in other context also called spillovers or agglomeration effects) are omnipresent in the modern interdependent economy – usually, however, without any tax consequences. The presumption that users provide an "essential input" to production blurs the conceptual dividing line between consumption and production and denies that it is, in many of the cases under consideration, pure consumption of online services that creates the data which is then used and monetized by the platforms. Had the Commission acknowledged this fact, the obvious consequence would have been to extend the tax to a whole range of other digital services and business models. For example, e-commerce marketplaces such as Amazon rely heavily on such network effects for the success of their business model, but they are excluded from the scope of the tax.

The same conclusions apply, finally, to a possible third approach according to which consumers reveal data that is, later on, either sold, used to tailor advertising to potential customers, or relied on to point out interested trading partners – which makes these platforms more attractive (also) for their paying users and other business partners. However, this kind of consumers' contribution to production is usually merely a by-product of their consumption, too. And even if one were to argue that from the platform operator's perspective, the users' purposeful involvement in the data mining process turns consumers into an instrument of the operator's own production activities, such a view could not justify the Commission's limited choice of taxed digital activities. Clearly, user data are becoming increasingly relevant in the entire – "digitalized" – economy, not only in the online advertisement or sharing economy sector.

It is therefore hard to avoid the impression that the Commission had a certain "politically acceptable" outcome in mind from the very beginning and then fabricated a justification of the tax that could match its intentions.

… and off-target

Apart from the above conceptual objections, the arbitrarily limited approach of the Commission has other flaws as well. The goal of levelling the playing field for domestic and foreign competitors is missed almost completely. Although the tax is obviously focused on (under-taxed) foreign companies, domestic firms must pay it as well, for non-discrimination reasons. As a consequence, the existing differences in tax burden are largely untouched by the Digital Services Tax (the only effect, if any, might result from its eventual deductibility from the corporate tax base). The tax-induced competitive advantage of US firms benefitting from tax havens or low-tax regimes remains.

Moreover, it is highly questionable that an under-taxation of profits can be compensated for by a specific tax on turnover. Given the large heterogeneity in business models and profit margins – which are completely neglected by the Digital Services Tax – one cannot expect that the tax does its job of "levelling the playing field", as the draft claims, i.e. equalizing the tax framework for competition in the first place.

Originally, the Commission planned to introduce a (direct) corporate income tax where the untaxed income of large internet firms would have been estimated based on their EU revenues. In order to avoid a clash with existing double taxation agreements (DTAs), the Commission now chose to go for a specific (indirect) tax on both foreign and domestic firms that falls out of the substantive scope of tax treaties. This desired effect comes, however, at the cost of giving up the original intention to "equalize".

In addition, the new tax design raises questions as to the Union competence to harmonize such a tax. According to Art. 113 TFEU, the EU may legislate on indirect taxes only to the extent that this is necessary for the functioning of the Internal Market and to avoid distortions of competition. The Commission claims that "unilateral measures are in place or are concretely planned in 11 Member States […] and the measures adopted are very diverse in terms of scope and their rationale. Such uncoordinated measures taken by Member States individually risk further fragmenting the EU Single Market and distort competition, hampering […] the EU's competitiveness as a whole." However, fragmentation in itself is no justification for legislative action under Art. 113 TFEU, as it is the natural consequence of Member States' exercise of their national tax sovereignty. It is also far from obvious that harmonising the indirect tax approaches currently pursued in some Member States (who remain free to still implement other approaches even if the Commission's proposal would be adopted) would avert significant distortions of competition, because the territorial scope of such taxes is usually determined by the destination principle that tends to avoid any distortions, anyways. Finally, apart from the fact that the proposed Digital Services Tax will certainly not make the EU more competitive, either, this objective in itself also does not legitimise legislative action under Art. 113 TFEU.

"Suboptimal, with a series of drawbacks"

On thing is for sure, though: The tax – provided that it is actually introduced – will be a nightmare of complexity and a mess of legal uncertainty. Just look at the size thresholds or the definition of the scope of the tax. What's more, in deliberating the proposal in Council, the EU Member States will have to agree on a allocating the resulting revenue among themselves. A first draft still proposed "some sort (sic!) of apportionment of revenue across jurisdictions based on geographical user statistics". The new proposal is more specific and allocates revenues, depending on the underlying business model, according to the number of users (differentiating between registered users, logged-in users and data-transmitting users) or the “number of times an advertisement has appeared on users’ devices”. It seems obvious that this will be no less complex and administratively burdensome.

The problem is worsened by the suggestion that the Digital Services Tax on transactions with a third country may be dropped once a Member State has reached an agreement with that country in the sense of the “comprehensive solution” (including a virtual PE). If and to what extent this implies that the tax can be dropped for purely domestic firms as well, is not the only question that comes to mind. In addition, there is the risk of verification deficits: Most potential taxpayers will be located in the US; and different from most other jurisdictions, in its tax treaties and also when acceding to multilateral agreements on EoI, the US has only agreed to assist in the collection of direct taxes.

Finally, the fact that the tax mostly falls on US firms is, to put it mildly, debatable from the viewpoint of the prohibition of de-facto discrimination under international trade law. At the very least, the tax is prone to be interpreted by the US as a hostile act in the already begun trade war (including the tariffs on steel and aluminum imposed by the Trump administration). One can doubt whether this brings the world any closer to a coordinated approach to reforming the international tax system in the direction of a comprehensive solution, as envisaged by the Commission, too.

The Commission is, however, under pressure itself. In a still EU skeptic environment, it is eager to show to the Member States (and their electorates) that it is able to act and, at the same time, to increase pressure on the OECD to push for a coordinated approach. As an earlier draft still put it in surprising honesty:

> *There is a high political pressure for Member States to adopt short-term measures with a more targeted scope (…). (The proposal is about) reducing the political pressure and providing a clear signal that the EU is determined to pursue the agenda on the fair taxation of the digital economy.*

At the same time, the Commission admitted:

> *We are nonetheless aware that such a short-term measure is sub-optimal and has a series of drawbacks and limitations.*

The European tax policy should aim for better.