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Digital Services Taxes in the European Union: What Can We Expect?

Juan Manuel Vázquez · Tuesday, February 14th, 2023

Introduction

The growing uncertainties about Pillar One's success, coupled with the recent EU Council's mandate to the Commission to submit an EU legislative proposal in case Pillar One fails, have reignited the debate on whether Digital Service Taxes (DSTs) are a possible and suitable solution to address the challenges raised by the digitalization of the economy at the European level. This document provides a brief overview of the DST debate within the EU context, looking specifically at its origin and evolution, its current status and the future of this type of measure in the Single Market.

1. What are DSTs?

In a nutshell, DSTs are taxes on gross revenue derived from a variety of digital services. They are a mix of gross receipts taxes and transaction taxes that apply to receipts from, for example, the sale of advertising space, provision of digital intermediary services, and the sale of data collected from users. DSTs are distinct from income taxes and online sales taxes, and they are not a VAT/Goods and Services Tax (GST). To date, the OECD has defined DSTs based on three cumulative conditions: (1) impose taxation based on market-based criteria; (2) are ring-fenced to foreign and foreign-owned businesses; and (3) are placed outside the income tax system (and therefore outside the scope of treaty obligations). The OECD also notes that DSTs would not include, amongst others, VAT, transaction taxes, and withholding taxes that are treated as covered taxes under tax treaties, or rules addressing abuse of existing tax standards. It should be noted that the current definition of DSTs proposed by the OECD is not set in stone and will probably be adjusted based on the strong criticism it received from stakeholders during the recent public consultation on this topic.

2. Origin and Evolution: How did we get here?

The First Generation of DSTs (2012 – 2018)

Since 2012, the OECD has sought to address the tax challenges raised by the digitalization of the economy as part of Action 1 of its Base Erosion and Profit Shifting (BEPS) project. Given the unsatisfactory outcome of this action (no agreement/recommendation), as of 2014-2015 a meaningful number of countries forged ahead with their own digital tax measures. These measures embody the efforts of market jurisdictions to tax residual profits of non-residents that otherwise would not be attributable to them under existing tax principles. They include, amongst others, the introduction of digital presence or significant economic presence tests, expanded withholding taxes, equalization levies and, evidently, the so-called DSTs, which adopt the form of turnover taxes specifically targeting ‘digital companies or services’ and operating outside the framework of income taxes. Examples of this first generation of DSTs include Italy’s levy on digital transactions, Hungary’s advertisement tax and France’s tax on online and physical distribution of audio-visual content.

The failed proposal for an EU DST (2018)

Following this trend, in early 2018, the European Commission proposed two measures to tax the digital economy at the EU level.[1] One of these measures was the adoption of a Directive introducing an interim EU DST[2] which covered revenues created from online advertising, digital intermediary activities and the sale of users data. Despite certain compromises on a narrower scope, the EU DST proposal hit a roadblock in 2019, when the ECOFIN Council was unable to achieve unanimous support for this measure. In the meantime, the UK, France and other EU countries such as Spain, Austria, Italy, etc. proposed similar DSTs. In fact, the French DST proposal was the one that sparked the well-known trade controversy with the United States (US) in July 2019.

Proliferation of DSTs (2018 – 2021)

Over the following years and until October 2021, the adoption of DSTs became widespread around the globe, and especially within Europe and Africa.[3] As of January 2023, Austria, France, Hungary, Italy, Poland, Portugal, Spain, Turkey, and the UK have implemented a DST; while Belgium, the Czech Republic, and Slovakia have published proposals to enact one and Latvia, Norway, and Slovenia have either officially announced or shown intentions to implement such a tax. The proposed and implemented DSTs differ significantly in their scope and structure.[4]

OECD’s Pillar One and the Withdrawal commitment for DSTs (October 2021)

With the aim of stopping the proliferation of DSTs and other unilateral measures by replacing them with a consensus-based reallocation of taxing rights, in 2017-2018 the OECD launched its renewed BEPS 2.0 project. Ensuring an extended participation of countries by means of the Inclusive Framework on BEPS (IF), the BEPS 2.0 project led to the development of the Pillar One and Two proposals, which were agreed by 137 jurisdictions in October 2021. The agreement included a standstill and withdrawal commitment for DSTs and similar measures, which would be an essential part of the Multilateral Convention (MLC) implementing Pillar One.[5]

Also in October 2021, a joint statement from Austria, France, Italy, Spain, the UK, and the US laid out a plan to roll back DSTs and retaliatory tariff threats (i.e. punitive trade actions under Section 301 of Trade Act of 1974) once the Pillar One rules were implemented. In November 2022, the U.S. Treasury announced that Turkey had agreed to the same terms. The joint statement outlined a crediting approach to bridge between DST liability and new Pillar One tax liability for the companies that might have to pay both in the interim period.

In the meantime, the OECD continued working to achieve an IF’s agreement on the specific rules of Pillar One. In such context, in July 2022 a Progress Report on Amount A was published, which further elaborated on the framework for the standstill and withdrawal commitment that would be included in the MLC and provided several elements for the definition of DSTs and other relevant similar measures.[6]

In addition, the OECD published several public consultation documents on the building blocks of Amount A, including one published on 20 December 2022, which deals specifically with the MLC provisions for (i) removing DSTs and similar measures, and (ii) eliminating an Amount A allocation in the case of no such removal. The comments made to this consultation document provide a good overview of the main concerns that DSTs currently raise among stakeholders.

Other relevant EU developments relevant for DSTs

At the EU level, there have also been several developments that have an impact on the DST debate. These developments include the following:

1. The Commission's proposal for implementing an **EU Digital Levy**. This initiative:
    - Was first announced by the Commission in January 2021, and is one of the measures included in the Commission's Communication on Business Taxation for the 21st Century. The EU Digital Levy was supposed to be tabled in June 2021 and introduced at the latest by 1 January 2023.[7] However, the measure was put 'on hold' until the final details of Pillar One are completed and agreed upon;
    - Would be a source of additional own resources for the EU and it will be designed in such a way that it is independent of the OECD Pillar One agreement and compatible with WTO and other international obligations. This means, that the EU digital levy could co-exist with the Pillar One agreement, as implemented in EU law.
    - Could take the form of any of the following three policy options (as complementary actions): (i) A corporate income tax top-up to be applied to all companies conducting certain digital activities in the EU; (ii) A tax on revenues created by certain digital activities conducted in the EU; (iii) A tax on digital transactions conducted business-to-business in the EU. Although it is not clear, pursuant to some scholars, the EU Digital Levy would be highly based on the EU DST proposal of 2018.[8]
    - Has recently come back into the spotlight when:
        - The amendments passed by the European Parliament on the System of own resources of the EU (November 2022), stated that the Commission should submit a legislative proposal for a digital levy or a similar measure in the event of clear lack of progress of Pillar One by the end of 2023.
        - It was announced that the EU Commission is planning a consultation regarding the introduction of a digital levy or dedicated fund to ensure that content and application providers (CAPs) or digital players in general (e.g., Netflix, Alphabet, Meta, etc.) contribute to the electronic communications network deployment costs.[9]
2. The Commission's proposal for a new **Framework for Income Taxation for Businesses (BEFIT).** This initiative:
    - Was first announced in May 2021, and is one of the measures included in the Commission's Communication on Business Taxation for the 21st Century. In October 2022, it was opened for public consultation. For an overview of the BEFIT proposal, please see the public consultation document;
    - As announced in the communication The next generation of own resources for the EU Budget, the Commission will present a proposal for a second basket of new own resources by the end of 2023, building on the BEFIT proposal
3. The Council's statement included in the adopted Directive implementing Pillar Two in the EU

(December 2022) which expressly notes that, if appropriate, the Commission shall 'submit a legislative proposal to address those tax challenges in the absence of the implementation of the Pillar One solution' (Article 57); and

3. What are the main criticisms on DSTs?

The main criticism on DSTs include *inter alia* the following:

- Their faltering legitimacy due to a lack of empirical evidence of their central premise (under-taxation of digital businesses), the distortion of competition that they may induce and the related compression of the ability-to-pay principle.
- DSTs work as a tariff and are a discriminatory and punitive tax. It is claimed that they have a flawed rationale since there is no economic reason to target a narrow group of digital companies.
- DSTs contravene prevailing international tax principles and may lead to double or multiple taxation.
- DSTs may introduce market-disrupting distortions and their economic incidence might be passed on to consumers.
- The implementation of DSTs differs locally. This might lead to a significant administrative burden to be able to comply with the different rules.

4. Current Status: Where are we?

While the implementation of Pillar Two is already on its way, the experienced difficulties faced by the OECD to achieve consensus among the members of the IF on Pillar One's specific provisions has pushed its implementation from 2023 to 2024. In principle, the IF will aim to finalize the MLC for implementing Pillar One by mid-2023 and ensure its entry into force in 2024. However, the repeated delays of the OECD to deliver on Pillar One have raised a great degree of scepticism on the adoption of this measure and statements, such as 'Pillar One is dead', have become widespread among experts.

As prospects dwindle for adoption of the Pillar One, the threat to reinstate national DSTs looms, as does the EU's promise to renew its efforts to pass an EU-wide digital tax.[10] In such scenario, stakeholders have started asking themselves whether gross-based DSTs are here to stay and what would that mean for the global tax system. In this regard, the experiences of those countries which have already adopted a DST could become useful (e.g. on 23 November 2022, the UK published a report on its evaluation of the DST applied since 1 April 2020, which provides a very comprehensive overview of how this tax is operating).

In all events, on top of the shortfalls mentioned in the previous title, the main hurdle to be overcome by DSTs if they aim to become the global response to the taxation of the digital economy, is their expected political rejection by the US, the jurisdiction of residence of most companies impacted by this type of taxes.

5. The Future: Where are we going?

There are two broad scenarios that appear on the horizon. The first, although the less probable one, is that **Pillar One is agreed in 2023 leading to its entry into force in 2024**. In such improbable case, it is expected that global tax discussion beyond the Two-Pillar Plan will continue to be held worldwide in order to fully address the concerns of developing (and certain market) countries (which have expressed their dissatisfaction with Pillar One outcomes). Within the EU, it is possible that the Commission will move forward with the adoption of BEFIT and the EU digital levy (even after the global tax deal is finalized), which would likely create further tensions with the United States. Evidently, Pillar One negotiations could be put in jeopardy if, by the end of 2023 and due to the delays in achieving an agreement, the EU decides to move forward with its digital levy or its Members States resist repealing their unilateral DSTs. In such case, an interesting question would be whether such potential EU digital levy would be consistent or not with the terms of Article 38 of the OECDs' Draft MLC (i.e., provision eliminating Amount A allocations for parties imposing DSTs and relevant similar measures).

The second and most probable scenario is that **Pillar One will continue to delay and thus, end up failing.** In such a case, numerous jurisdictions might adopt unilateral or multilateral measures to protect their tax base and tax income derived from certain digital activities carried out within their jurisdiction.

At the global level, and considering that in certain regions DSTs have been indirectly encouraged (e.g., Africa, where a model DST law has been proposed), it is probable that a failure of the OECD to reach an IF agreement on Pillar One would lead to the proliferation of this type of taxes. In other regions, such as Latin America, there have been calls for a consolidated position of the region regarding the reallocation of taxing rights 'based on a more comprehensive fractional apportionment of multinationals' profits'. This initiative, led by Colombia, could result in a different type of unilateral or multilateral measures proliferating in such region.

At the EU level, the Pillar Two Directive has provided a clear indication that if, by 30 June 2023 there is insufficient progress in Pillar One's implementation, the Commission will be under a great amount of pressure to submit its own legislative proposal to tax the digital economy. While such scenario is not difficult to envision, the question here is what would such potential proposal be like. Considering the aforementioned EU developments, it is probable that such a proposal is poured into a revived version of the EU digital levy. Whether such a levy would finally look like the EU 2018 DST, like an existing unilateral DST already in force in Europe, or like completely different measures (e.g., indirect tax) remains unclear. Evidently, a potential action to tax the digital economy could also come from the additional EU own resource to be introduced in the EU by means of BEFIT. A scenario in which the Digital Levy and BEFIT are combined in one proposal/directive should also not be discarded.

Finally, if upon the failure of Pillar One, the Commission does not submit an EU proposal to tax the digital economy or, alternatively, the Council does not reach an agreement on such measure, the most probable scenario is that DSTs modelled on those already in place in some Member States would become widespread around Europe. Obviously, this is the worst of all the possible scenarios.

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[1] European Commission, Proposal for a Council Directive Laying Down the Rules Relating to the Corporate Taxation of a Significant Digital Presence, COM(2018) 147 final (21 Mar. 2018); and European Commission, Proposal for a Council Directive on the Common System of a Digital Services Tax on Revenues Resulting from the Provision of Certain Digital Services, COM(2018) 148 final (21 Mar. 2018).

[2] The proposed EU DST applied only to enterprises above two thresholds: total annual worldwide revenues above EUR 750 million, and total annual EU revenues exceeding EUR 50 million. The proposed single rate was 3%, to be levied on gross revenues and applicable to both non-resident and domestic companies and to domestic and cross-border transactions.

[3] On 30 September 2020, the African Tax Administration Forum (ATAF) released its Suggested Approach to Drafting Digital Services Tax Legislation

[4] For example, while Austria and Hungary only tax revenues from online advertising, France's tax base is much broader, including revenues from the provision of a digital interface, targeted advertising, and the transmission of data collected about users for advertising purposes. The tax rates range from 1.5 percent in Poland to 7.5 percent in both Hungary and Turkey (See https://taxfoundation.org/digital-tax-europe-2020/)

[5] The October 2021 Statement noted that: The Multilateral Convention (MLC) will require all parties to remove all DSTs and other relevant similar measures with respect to all companies, and to commit not to introduce such measures in the future. No newly enacted DSTs or other relevant similar measures will be imposed on any company from 8 October 2021 and until 31 December 2023 or the coming into force of the MLC, whichever is earlier. The modality for the removal of existing DSTs and other relevant similar measures will be appropriately coordinated.

[6] In addition to the operative provisions of Amount A, the MLC will contain provisions requiring the withdrawal of all existing DSTs and relevant similar measures with respect to all companies, and will include a definitive list of these existing measures. The MLC will also include a commitment not to enact DSTs or relevant similar measures, provided they impose taxation based on market-based criteria, are ringfenced to foreign and foreign-owned businesses, and are placed outside the income tax system (and therefore, outside the scope of tax treaty obligations). The commitment would not include value-added taxes, transaction taxes, withholding taxes treated as covered taxes under tax treaties, or rules addressing abuse of the existing tax standards. The development of the MLC will include work to further develop the definition of DSTs and relevant similar measures, and to provide for the elimination of Amount A allocations for jurisdictions imposing future measures that are within the scope of this commitment.

[7] EU budget: European Commission welcomes agreement (europa.eu).

[8] Pursuant to scholars, the EU digital levy would also be a turnover tax on the revenue of specific transactions, levied on taxpayers meeting certain conditions, the most noticeable being the presence of revenue (within the European Union or worldwide) above a pre-established threshold. (See Pinto Nogueira, João Félix and Pistone, Pasquale and Turina, Alessandro, Digital Services Tax: Assessing the Policy Reasons for its Introduction in the European Union: Feedback to the EU Consultation on the Introduction of a Digital Levy (12 April 2021). Intl. Tax Stud. 3(2021), Journal Articles & Opinion Pieces IBFD [ISSN: 2590 1117], Available at SSRN: https://ssrn.com/abstract=3826307)

[9] See TNI, European Commission Mulls Digital Levy to Finance Infrastructure, posted on 2 Feb. 2023, by Elodie Lamer

[10] See Ruth Mason, Legal Problems with Digital Taxes in the United States and Europe, Chapter forthcoming in Craig Elliffe, ed., International Tax at the Crossroads. 2 Feb 2023 https://papers.ssrn.com/sol3/papers.cfm?abstract_id=4346279

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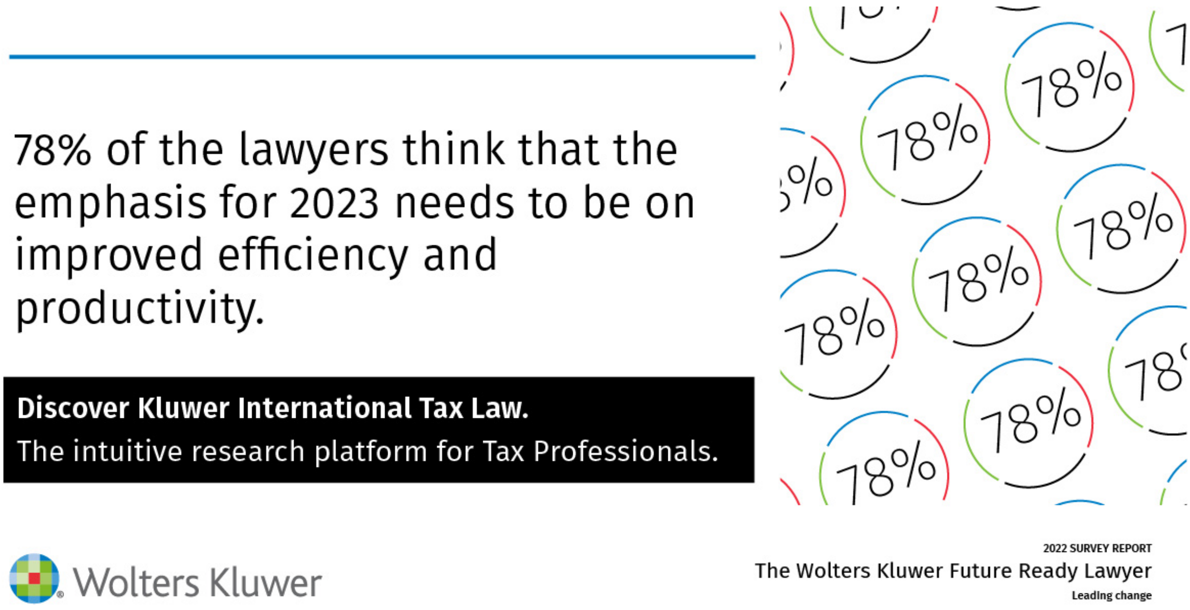

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