REFLECTIONS ON THE PROPOSALS OF THE EUROPEAN COMMISSION FOR A DIGITAL TAX

Oliver Sievering[1]

DOI: 10.24989/ocg.v335.20

Abstract
Digitalisation leads to significant changes in many areas of the economy. Chancellor Angela Merkel believes that the increasing collection and the use of consumer data associated with digitalisation is creating fundamental justice problems. The public debate focuses on the taxation of international digital companies. Facebook and other Internet giants make high profits in Europe, but they are hardly taxed there. In the opinion of many politicians, this is unacceptable - but it complies with the applicable standards of the international tax system. The current corporate tax rules are built on the principle that profits should be taxed where the value is created. The tax rules were mainly conceived in the early 20th century for traditional businesses. They define what triggers a right to tax in a country ("where to tax") and how much of corporate income is allocated to a country ("how much to tax") largely based on having a physical presence in that country and without reflecting the value created by user participation. That means that non-residents for taxation purposes become liable to tax in a country only if they have a presence that amounts to a permanent establishment there. The Commission has made two legislative proposals in 2018. The new rules would ensure that online businesses contribute to public finances at the same level as traditional 'brick-and-mortar' companies. 1. A digital platform will be deemed to have a taxable 'digital presence' or a virtual permanent establishment in a Member State if it fulfils certain criteria. 2. The European Commission intends to introduce a 3% tax on sales through the sale of user data, the provision of online advertising and the provision of online marketplaces. The tax will apply to companies with a total turnover of EUR 750 million worldwide and a digital turnover of EUR 50 million in the EU. The digital tax raises various questions about the justifications. Especially for the export nation Germany, it could turn out to be a dangerous boomerang.

1. The problem

Digitalisation is leading to profound changes in many areas of the economy. New business models are emerging, the border between goods and services trade become indistinct. The collection and processing of data as well as intangible assets are becoming more and more important for the gross domestic product (GDP) and of course for the gross national product (GNP). Digital companies are growing faster than traditional businesses, this trend will continue. Without exception, the six most valuable companies in the world now are technology companies, with a strong digitalisation relevance. Five of them are from the USA (Apple, Amazon, Alphabet (Google), Microsoft, Facebook) one is from China (Alibaba). [1]

The public debate (not only) in Europe focuses on the taxation of international digital companies. The transformation of the global economy due to digitalisation is putting pressures on national

[1] Hochschule für öffentliche Verwaltung und Finanzen Ludwigsburg, Reuteallee 36, D-71634 Ludwigsburg

corporate tax systems. Furthermore, the problem of international tax avoidance plays an important role. Some of the named companies have attracted attention because of spectacular tax avoidance strategies. Especially large US companies such as Google and Amazon are accused of withdrawing most parts of their profits from proper taxation. It is argued that local companies are contributing significantly to the financing of domestic infrastructure and social benefits, while international digital companies do not (adequately) do so. However, international tax avoidance is not only a problem of digital companies.

The digital giants mentioned above make huge profits with their business in the EU and of course in Germany, but they are hardly taxed in the EU and respectively in Germany. In the opinion of many politicians - not only in Germany - this is unacceptable, but it complies with the applicable standards of the international tax system. Accordingly, profits of foreign companies - may in principle - be taxed only domestically if they have a permanent physical presence there, but many foreign Internet companies can serve a certain market without having a branch in Germany. Profits made with lucrative activities, such as selling user-generated data and content, are not captured by today's tax rules - which in principle have been valid for decades - because these rules were not designed to encompass those companies acting global but having no physical presence in that country where they offer digital services.

The EU Commission has recognized this problem too: “In the digital economy, value is often created from a combination of algorithms, user data, sales functions and knowledge. This data will be used for targeted advertising. The profits are not necessarily taxed in the country of the user, but in the country where the advertising algorithms has been developed. This means that the user contribution to the profits is not taken into account when the company is taxed.” [2]

Many Member States of the EU called the EU-Commission to take action to improve the fairness of tax systems. Meanwhile the taxation of the digital economy is a key part of the EU-Commission's fair taxation agenda. The Commission takes the view that uniform rules for the whole EU are needed to ensure that these companies pay taxes where they make profits. The Commission also sees a need for action, for a further reason. She argues that between companies with conventional business models on the one hand and the digital business models on the other hand, there is an overall tax differential in favor of the digital economy.

The Commission argues: “The effective tax rate for digital companies - such as social media companies, collaborative platforms and online content providers - is around half of traditional companies – and often much less. On average, digitalised businesses face an effective tax rate of only 9.5%, compared to an effective tax rate of 23.2% for traditional business models.” [3] This tax gap is an indication of distorted competition. The challenge - from the view of the commission - is to ensure that digital companies also contribute their fair share of tax.

But this figures, called by the Commission, are not the result of measured tax payments but are based on calculations of the effective average tax rate using the method of Devereux and Griffith. In this method a hypothetical investment project with a given profit and a given structure of capital goods is considered and for this purpose, a hypothetical tax burden is calculated, which results from the difference of the capital values of the investment project before and after taxes. If one considers the actual average tax burden instead of the hypothetical tax burden, the result is not quite so clear. In another calculation, the ifo-Institute (a research Institute in Munich) came to the conclusion that the tax burden of digital companies is 20.9 % and the tax burden of non-digital companies is 26.7 %. [4] This tax differential is based on balance sheet data and the actual tax payments. These figures represent the difference between profit before tax and profit after tax divided by pre-tax profit. The average total tax burden for digital businesses - according to this calculation - is therefore only 5.8 percentage points below the tax burden for non-digital companies. The tax differential between digital and non-digital companies is significantly lower than indicated by the European Commission - but there is a difference.

"The reason for this is an assumed higher share of non-capitalized costs in the investment structure [...] as well as more favorable depreciation rules for digital capital goods and the applicability of tax incentives for research, development and innovation." In other words, the European Commission complains that national taxation policies favor investment goods, which are widely used in the digital economy, and now they want to introduce completely new taxes in order to compensate the benefits caused by politics. The more accurate and appropriate approach would be to eliminate unjustified benefits that causes the differences. [5]

2. Common EU-wide solution

Even considering this smaller difference of percentage, the tax system seems to be unfair, traditional companies usually have a higher tax burden than digital companies. On 21 March 2018, the European Commission has made two proposals of tax rules for digital companies. This proposals aims at addressing the issues raised by the digital economy by setting out a comprehensive solution within the existing corporate tax systems of the Member States. It is said to provide a common system for taxing digital activities in the EU, which properly takes the features of the digital economy into account. A common EU-wide solution for the taxation of digital companies allows Member States to tax profits made in their territory, even if the companies do not have a physical presence in this country. The new rules should ensure that online businesses contribute to public finances in the same way as traditional businesses.

2.1 Proposal 1: A common reform of the EU's corporate tax rules for digital activities [6]

“A digital platform will be deemed to have a taxable “digital presence” or a virtual permanent establishment in a Member State if it fulfils one of the following criteria:

- It exceeds a threshold of € 7 million in annual revenues in a Member State
- It has more than 100,000 users in a Member State in a taxable year
- Over 3,000 business contracts for digital services are created between the company and business users (B2B) in a taxable year.”

This proposal is to be regarded as an additional aspect of the existing tax rules. The concept of a significant digital presence is intended to establish a taxable nexus in a jurisdiction. The new system secures a link between where digital profits are made and where they are taxed. It enables Member States to tax profits made in their countries, even if a company does not have a physical presence there. The proposed rules for establishing a taxable nexus of a digital business in a Member State are based on revenues from supplying digital services, the number of users of “digital services” or the number of contracts for a digital service. For the three user-based criteria mentioned above (revenues, number of users and number of contracts) different applicable thresholds are set. There is a “significant digital presence” in a Member State if one or more of the following criteria are met: the revenues from providing digital services to users in a jurisdiction exceed € 7,000,000 in a tax period, the number of users of a digital service in a Member State exceeds 100,000 in a tax period or the number of business contracts for digital services exceeds 3,000.

The Commission defines the term digital service: “digital services” means services which are delivered over the internet or an electronic network and the nature of which renders their supply essentially automated and involving minimal human intervention, including in particular: [7]

(a) the supply of digitalised products generally, including software and changes to or upgrades of software;

(b) services providing or supporting a business or personal presence on an electronic network such as a website or a webpage;

(c) services automatically generated from a computer via the internet or an electronic network, in response to specific data input by the recipient;

(d) the transfer for consideration of the right to put goods or services up for sale on an internet site operating as an online market on which potential buyers make their bids by an automated procedure and on which the parties are notified of a sale by electronic mail automatically generated from a computer;

(e) Internet Service Packages (ISP) of information in which the telecommunications component forms an ancillary and subordinate part, in other words packages going beyond mere internet access and including other elements such as content pages giving access to news, weather or travel reports, playgrounds, website hosting, access to online debates or any other similar elements;

(f) the services listed in an Annex (II), for example:

- website hosting and webpage hosting,

- automated, online and distance maintenance of programmes,

- remote systems administration,

- online data warehousing where specific data is stored and retrieved electronically,

- online supply of on-demand disc space,

(g) Digital services shall not include the services listed in an Annex (III) or the sale of goods or other services which is facilitated by using the internet or an electronic network.

List of services that are not deemed to be digital services (for example):

- radio and television broadcasting services,

- telecommunications services,

- goods, where the order and processing is done electronically,

- CD-ROMs, floppy disks and similar tangible media,
- printed matter, such as books, newsletters, newspapers or journals,
- CDs and audio cassettes,
- video cassettes and DVDs,
- games on a CD-ROM.

The mere sale of goods and services via the Internet or an electronic network is not considered as a digital service.

2.2 Proposal 2: An interim tax on certain revenue from digital activities [8]

The second proposal is only an intermediate step, until the comprehensive reform (proposal 1) will be implemented. In the medium term, the EU Commission wants to enact the concept of a permanent establishment in corporate taxation for digital companies.

The tax will apply to revenues created from activities where users play a major role in value creation and which are hard to capture with current tax rules, such as those revenues:

- created from selling online advertising space
- created from digital intermediary activities which allow users to interact with other users and which can facilitate the sale of goods and services between them
- created from the sale of data generated from user-provided information.

With a suggested tax rate of 3 % on gross annual revenues, derived from specific digital services, the EU-Commission estimates € 5 billion revenues for all Member States. The tax will only apply to companies with total annual worldwide revenues of € 750 million and EU revenues of € 50 million. [9] The proposed thresholds will ensure that only large companies will come under the scope of the new tax. Smaller start-up and scale-up companies will not be burdened.

For a short-term the EU-Commission proposed this (also called) “digital tax service”. This system (proposal 2) will apply only as an interim measure, until the comprehensive corporate tax rules (proposal 1) has been implemented and has inbuilt mechanisms to alleviate the possibility of double taxation. It should help to avoid unilateral measures in certain Member States, which could lead to a patchwork of national proposals and solutions. This “indirect tax” would apply to revenues created from certain digital activities which escape the current tax framework more or less entirely. The activities include: The placement of advertising on a digital interface (e.g., websites or mobile applications) targeted at the users of that interface, providing platforms (multi-page digital interfaces) that allow users to interact with others (e.g., Facebook), as well as from the sale of customer data (for example from Facebook).

So it would target the most urgent gaps and loopholes of digital activities and will apply to two main types of digital services. “Firstly, it will cover services where a huge value is created by user data, either through advertising or by the sale of the data collected by companies for example as social media or search engines. Secondly, it will cover services of supplying digital platforms that facilitate interaction between users, who can then exchange goods and services via the platform (such as peer-to-peer sales apps).” [10]

In order to simplify administration, it is envisaged that the tax declaration and tax payment for the entire EU will only be made in one EU member state (so-called one-stop-shop principle). This is responsible for forwarding to the other recipients. It avoids companies having to submit separate digital tax returns in each of the EU Member States.

3. Critical remarks

On 21 March 2018, the European Commission has made two proposals of tax rules for digital companies. A long-term solution is to embed the taxation of the digital economy in the international corporate tax framework.

A short-term measure is to levy a separate tax, a kind of equalization tax, a Digital Service Tax (DST) that covers the main digital services. In doing so, the Commission respond to a request of some member states to develop a corresponding concept by extending the right of the member states to tax profits earned domestically, even if, according to previous understanding, there is no domestic permanent physical presence and so there is no basis for domestic taxation.

The proposal stipulates a tax rate of 3 % on the gross income of a taxpayer from the provision of certain digital services minus VAT and other similar taxes. In the medium term, the EU Commission wants to use the concept of a permanent establishment in corporate taxation for digital companies. The DST will be repealed if comprehensive measures have been adopted and Double taxation treaties with third countries have been implemented.

Initially, Germany, France and several other countries called for swift measures to increase the taxation of digital giants like Facebook and Google. While the German government initially endorse a “kind of digital taxation”, it has more and more doubts. The German government criticized the specific proposal made by the EU-Commission. Even the Advisory Council of the German Bundestag recommends not to support the proposals of the new tax rules. The Council argued that the proposals encounters serious legal concerns and it would be in their economic effects very questionable. The Digital Service Tax breaks with existing international tax rules of corporate taxation in different kinds. The introduction of this tax would be a paradigm shift. [11]

The EU Commission defines the Digital Service Tax as an indirect tax and sees the legal basis for the proposed directive as the common system of a digital tax in Article 113 TFEU concerning the harmonization of indirect taxes. This is controversial. Assuming that the DST is actually an indirect tax, it should burden the beneficiaries, the consumer. However, the intention of the EU Commission is to tax the profits of the companies via the detour of gross revenues. Understood as a direct tax, it is an intervention in the objective net principle. Gross income would be the subject of this kind of tax, not the net income of these companies. However, companies with low profit margins (often young companies) or companies with losses would be affected severely if gross income would be choose for the tax base. That is a paradigm shift, even as the marginal costs of these companies are very low and there is no serious and systematic impact on traded volumes (macroeconomic) or market prices expected. The digital tax reduce the margin of digital companies and thus acts as an income tax. [12] But the new tax would be levied in addition to the taxes already due under applicable law. The consequence would be a double taxation. This would also hit companies already paying their "fair share" of taxes under the regime of their country of residence.

A problem of equity arises from the two thresholds proposed by the European Commission, namely worldwide revenues of € 750 million and taxable revenues of € 50 million in the Union, to cover only large companies. Due to the specific thresholds of the EU digital tax, only large-scale suppliers with market power are taxed. Why should a tax only hit very large companies?

One of the arguments put forward by the European Commission to justify digital taxation is the loss of tax revenue created by aggressive tax planning and tax avoidance practices of digital companies. According to the European Commission, digital taxation can help ensure that digital businesses make an appropriate contribution to public infrastructure financing. In addition, the revenue from digital taxation could contribute to the sustainability of public finances. But the estimated revenue from the EU digital tax would be relatively low. The EU-Commission estimates an amount of € 5 billion, the ifo-Institute Munich estimates additional revenue of € 3-4 billion for the member states. At around € 836 million, Germany receives by far the largest amount of digital tax revenue. The revenues of the digital tax of the United Kingdom and France are significantly lower at € 595 million and € 587 million, respectively. The volume of revenue in relation to the total tax revenue is negligible. In Germany and the United Kingdom, digital tax revenue would be just 0.1% of total tax revenues. In France, the share would be around 0.09%. [13] The justification put forward by the European Commission that digital taxation could generate additional public revenues that make a significant contribution to the sustainability of public finances is unrealistic.

The EU Digital Tax is also called as a “GAFA tax”, a tax on the US tech giants: Google (Alphabet), Apple, Facebook and Amazon. In fact, much of the digital tax revenue is borne by US companies. Half of the forecast total digital tax revenue will come from companies headquartered in the United States.

Expected relative distribution of digital tax burden by region: [14]

40% EU

50% USA

10% rest of the world

This has the potential to further fuel the already smoldering trade dispute between EU and USA. Against the backdrop of the US and the European Union, it seems likely that the United States will impose trade, tariffs or other tax restrictions as a countermeasure. In such a scenario, income losses within the EU may occur that far exceed the fiscal revenue from the digital tax.

In this context, it is also possible that important countries like the USA or EU trading partners may wish to transfer the new tax rules (withholding tax in accordance with the revenues generated in the individual countries) to companies in the so-called Old Economy. For example, the US may want to tax profits generated by the German automotive and engineering industries. German automotive and engineering-industrie exports a lot of cars and machines. The taxes of these export-oriented companies like VW, Daimler and BMW are paid in Germany and not (or only to a relatively small extent) in USA or in the other countries where the goods are exported. A potential backlash would hit especially the German export-oriented economy. With regard to such countermeasures, Germany is therefore particularly vulnerable, so that the digital tax can prove to be a boomerang that does not improve Germany's fiscal and trade position, but rather worsen it. [15]

If that's the case, Germany cannot reverse the legislation immediately. For the introduction, modification or abolition of this tax in the context of an EU directive requires unanimity. Should the directive be adopted, a new form of tax competition would be launched without a single Member State or group of Member States having a realistic opportunity to shape or stop this process in the light of new events and lessons learned. Limiting the freedom of design would go both ways: Neither could individual Member States or groups of Member States enforce higher rates of taxation against the Directive, nor could lower tax rates be set, nor could this tax be abolished. [16]

4. References

[1] FUEST, C.; Digitalisierung und Steuerpolitik, Vortrag bei der Jahresversammlung des ifo Instituts am 28. Juni 2018, ifo Schnelldienst, 14/2018, p. 21, source: https://www.cesifo-group.de/DocDL/sd-2018-14-fuest-digitalisierung-steuerpolitik-2018-07-26.pdf

[2] European Commission; Fair Taxation of the Digital Economy (2018); source: https://ec.europa eu/taxation_customs/business/company-tax/fair-taxation-digital-economy_en

[3] European Commission - Fact Sheet; Questions and Answers on a Fair and Efficient Tax System in the EU for the Digital Single Market; 2018; source: http://europa.eu/rapid/press-release_ MEMO-18-2141_de.htm

[4] ifo-Studie im Auftrag der IHK für München und Oberbayern; Die Besteuerung der Digitalwirtschaft. Zu den ökonomischen und fiskalischen Auswirkungen der EU-Digitalsteuer; (2018), p. 6; https://www.cesifo-group.de/DocDL/Studie-Digitalsteuer-2018.pdf

[5] FUEST, C.; Digitalisierung und Steuerpolitik, Vortrag bei der Jahresversammlung des ifo Instituts am 28. Juni 2018, ifo Schnelldienst, 14/2018, p. 22, source: https://www.cesifo-group.de/DocDL/sd-2018-14-fuest-digitalisierung-steuerpolitik-2018-07-26.pdf

[6] European Commission; Fair Taxation of the Digital Economy (2018); source: https://ec.europa .eu/taxation_customs/business/company-tax/fair-taxation-digital-economy_en

[7] EUROPEAN COMMISSION; Proposal for a COUNCIL DIRECTIVE laying down rules relating to the corporate taxation of a significant digital presence; pp. 14; source: https://ec.europa.eu/taxation_customs/sites/taxation/files/proposal_significant_digital_presence_21032018_en.pdf

[8] European Commission; Fair Taxation of the Digital Economy (2018); source: https://ec.europa.eu/taxation_customs/business/company-tax/fair-taxation-digital-economy_en

[9] European Commission; Fair Taxation of the Digital Economy (2018); source: https://ec.europa.eu/taxation_customs/business/company-tax/fair-taxation-digital-economy_en

[10] European Commission - Fact Sheet; Questions and Answers on a Fair and Efficient Tax System in the EU for the Digital Single Market; 2018; source: http://europa.eu/rapid/press-release_MEMO-18-2141_de.htm

[11] Bundesfinanzministerium; Monatsbericht Januar 2019; Stellungnahme des unabhängigen Wissenschaftlichen Beirats beim BMF zu den EU-Vorschlägen für eine Besteuerung der digitalen Wirtschaft; source: https://www.bundesfinanzministerium.de/Monatsberichte/ 2019/01 /Inhalte/Kapitel-3-Analysen/3-2-stellungnahme-wissenschaftlicher-beirat.html

[12] ifo-Studie im Auftrag der IHK für München und Oberbayern; Die Besteuerung der Digitalwirtschaft. Zu den ökonomischen und fiskalischen Auswirkungen der EU-Digitalsteuer; (2018), p. 15; https://www.cesifo-group.de/DocDL/Studie-Digitalsteuer-2018.pdf

[13] ifo-Studie im Auftrag der IHK für München und Oberbayern; Die Besteuerung der Digitalwirtschaft. Zu den ökonomischen und fiskalischen Auswirkungen der EU-Digitalsteuer; (2018), p. 25; https://www.cesifo-group.de/DocDL/Studie-Digitalsteuer-2018.pdf

[14] ifo-Studie im Auftrag der IHK für München und Oberbayern; Die Besteuerung der Digitalwirtschaft. Zu den ökonomischen und fiskalischen Auswirkungen der EU-Digitalsteuer; (2018), pp. 28; https://www.cesifo-group.de/DocDL/Studie-Digitalsteuer-2018.pdf

[15] Bundesfinanzministerium; Monatsbericht Januar 2019; Stellungnahme des unabhängigen Wissenschaftlichen Beirats beim BMF zu den EU-Vorschlägen für eine Besteuerung der digitalen Wirtschaft; p. 3; source: https://www.bundesfinanzministerium.de/Monatsberichte/ 2019/01/Inhalte/Kapitel-3-Analysen/3-2-stellungnahme-wissenschaftlicher-beirat.html

[16] Bundesfinanzministerium; Monatsbericht Januar 2019; Stellungnahme des unabhängigen Wissenschaftlichen Beirats beim BMF zu den EU-Vorschlägen für eine Besteuerung der digitalen Wirtschaft; p. 4; source: https://www.bundesfinanzministerium.de/Monatsberichte/ 2019/01/Inhalte/Kapitel-3-Analysen/3-2-stellungnahme-wissenschaftlicher-beirat.html