

O.E.C.D. AND EUROPEAN COMMISSION UNVEIL PROPOSALS ON TAXATION OF THE DIGITAL ECONOMY

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BRIEF SYNOPSIS

Following the release of the O.E.C.D.'s B.E.P.S. Action Plan and the European Union's approval of the Anti-Tax Avoidance Package, the taxation of the digital economy continues to be unfinished business in the international tax arena. New O.E.C.D. and the European Commission ("E.C.") documents mark a milestone (especially the latter, which include two different approaches). They also highlight the difficulties in achieving a consensus, which seems desirable when implementing measures that increase the tax burden of digital activities.

INTRODUCTION

After several years of work, the O.E.C.D.'s¹ Tax Challenges Derived from Digitalization – Interim Report, 2018 ("Interim Report") was published on March 16 and approved on March 20 by the G-20 after a meeting in Buenos Aires.² The E.C. released several documents on March 21: two proposals for a Council Directive (the "Directive Proposals"), a recommendation for the Members States, and a communication for the Council and the European Parliament.³

None of these documents has direct implications for taxpayers, although they establish the course for future developments.

The main aspects that should be taken into account may be summarized as follows:

- Both the O.E.C.D.'s Interim Report and the E.C.'s documents start from the same basic premise: The digitalization of the economy and the limitations of the current rules to allow for taxation of value where it is created (a crucial, unquestioned principle) lead to an unlevel playing field and a risk for states' tax revenues. Consequently, the criteria for allocating taxing rights among

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¹ Through the Inclusive Framework and the Task Force on the Digital Economy, a dependent body of the Committee on Fiscal Affairs of the O.E.C.D., working groups where both members and non-members of the O.E.C.D. are included, which shows the widespread approach of the project.

² The *communiqué* of the G-20 Meeting of Finance Ministers and Central Bank Governors of 2018 mentions that:

The impacts of the digitalization of the economy on the international tax system remain key outstanding issues. We welcome the OECD interim report analyzing the impact of digitalization of the economy on the international tax system.

³ The E.C. has published an impact assessment explaining the basis of the measure. Although mandatory rules are not in this document, it includes comments and data important for understanding the E.C.'s proposals.

states, known as nexus, and the criteria for calculating tax liabilities, known as profit allocation, should be reviewed to confirm that the rules are adapted to the current situation.

- States' concerns and interests, which are in conflict at times, make an international consensus impossible to achieve. Although the consensus is desired by all the parties, some international actors have implemented unilateral measures that could generate economic inefficiencies.
- The E.C. has released both long-term and short-term solutions in order to address the tax-related challenges raised by the digital economy. In comparison, the O.E.C.D. has not managed to produce a concrete proposal, given the need for consensus. Some alternatives have been analyzed and the comments expressed are relevant.
- The E.C.'s long-term proposal creates a new nexus standard and establishes the profit split as the default profit allocation method. (This is not a commonly used method because of practical difficulties.) While the nexus approach is defined in straightforward terms in the Directive Proposal, the criteria for profit allocation requires further development to avoid situations of overtaxation or nontaxation. Assuming this measure will create consensus within the E.U., it will require an amendment of double tax conventions ("D.T.C.'s") signed with non-E.U. states. This will take time.
- The digital services tax, a short-term solution proposed by the E.C. and applicable as an interim measure, has been drafted in detail, so it can be implemented if there is a consensus within the E.U. or if the Member States are willing to implement this measure as if it were approved. This tax is levied on three types of specific digital services: on line advertising, transfer of user data, and intermediation on platforms that allow interaction between users. The implementation of this measure could run into legal problems, as its compatibility with D.T.C.'s and E.U. law is questionable, as pointed out in the analysis of short-term proposals in the O.E.C.D.'s Interim Report.

THE O.E.C.D. APPROACH

Today, there is no doubt about the active involvement of the O.E.C.D. and the E.U., particularly the E.C., in reviewing international taxation standards and current challenges regarding the taxation of the digital economy. Intense activity, largely coordinated, has taken shape with the publication of the aforementioned O.E.C.D. and E.C. documents. Although only intermediate measures in the broader process of analyzing the taxation of the digital economy, each sheds light on the current situation and the trend that guides the process.

The O.E.C.D. Interim Report

It is well known that the effects of the digital economy in the field of taxation are linked to the origin and the *raison d'être* of the O.E.C.D.'s B.E.P.S. Action Plan. As a reference, Action 1 was titled "Addressing the Tax Challenges of the Digital Economy."⁴ However, this action does not include a specific recommendation to

⁴ Considering that the Interim Report is titled "Tax Challenges Derived from Digitalization," one can observe a certain change of focus in the works, if it is

that effect. Instead, it calls on states to review the progress made through the plan's other actions and to seek consensus by 2020.

The Action 1 Final Report reflects the expectation that the measures of the B.E.P.S. Project could be sufficient to substantially address the challenges raised by the digital economy.⁵ Together with the lack of consensus, this seems to be one of the reasons why Action 1 does not recommend introducing concrete measures relating to the broader tax challenges of the digital economy, such as establishing a nexus relating to a significant digital presence, withholdings for digital transactions, or an equalization levy.

The O.E.C.D. has presented the Interim Report as a means to describe the development of this work under the mandate that it is necessary not only to establish new regulations on the matter that can adapt to a changing environment but also to provide certainty and facilitate growth.

One of the starting points of the Interim Report confirms that, to date, implementation of the B.E.P.S. Action Plan has achieved significant progress in two areas:

- The lawmakers recognize an emerging B.E.P.S. effect, which can be verified by analyzing the new developments in domestic tax legislation inspired by the B.E.P.S. Action Plan. At a regional level, an example would be the activity of the E.U., and at a global level, it would be the adoption of the Multilateral Instrument.⁶
- Companies have modified some business models by giving prevalence to their local agents, by passing from a remote sales model to a local reseller model, or by aligning their corporate structures with the economic activity actually carried out, accomplishing the latter by reviewing transfer pricing policies and reconsidering the location of their intangible assets, graphically described as “on-shoring assets.”⁷

understood that the focus is transferred from the digital economy to a wider phenomenon such as digitalization that affects the economy as a whole, including tax administrations.

⁵ “As a result, it is expected that the implementation of these measures, as well as other measures developed in the BEPS Project, will substantially address the BEPS issues exacerbated by the digital economy.” (“Addressing the Tax Challenges of the Digital Economy, Action 1 – 2015 Final Report,” O.E.C.D./G-20 Base Erosion and Profit Shifting Project (O.E.C.D. Publishing, Paris: 2015), p 94.)

⁶ At this point, we highlight the low percentage of adoption to date (17%) of the modifications related to the existence of a permanent establishment (“P.E.”) in the case of *commissionaire* agreements. These structures are traditionally used in the field of the digital economy. The O.E.C.D. recognizes this low acceptance in the Interim Report, although it also points out the possibility that adoption rates may increase when progress is made in the work related to attributing benefits to P.E.’s or due to their inclusion in the O.E.C.D. Model Tax Convention.

⁷ In practical terms, this change in the companies’ business models facilitates the analysis of the nexus problem, although it brings the discussion back to profit allocation in the case of a local reseller. It is striking that the O.E.C.D. document reflects two positions: (i) Member States that recognize that this change has allowed a widening of taxable bases in their jurisdictions when moving from a remuneration based on costs to one based on sales and (ii) Member States

“Because of the absence of consensus, the O.E.C.D.’s Report does not include specific proposals.”

However, Action 1 also recognizes that it is necessary to carry out follow-up work to address the broader challenges raised by the digital economy. This particularly applies to the concept of nexus, the value of data, and the characterization of digital operations. Therefore, the implementation of additional measures is necessary. Following this insight in its Interim Report, the O.E.C.D. acknowledges that the progress of the B.E.P.S. Action Plan may not be sufficient.

Because of the absence of consensus, the O.E.C.D.'s Report does not include specific proposals. This lack of consensus is not minor. It reflects the importance of needed modifications in the areas pointed out and the relevance of data and user participation in the rules regarding distribution of benefits and distribution of tax powers among states.

Countries seem to be grouped by blocks. The Interim Report identifies three blocks of jurisdictions:

- A first group of countries understands that the main challenges raised by the digitalization of the economy refer to the value of the data and the participation of the user as key elements in the process of creating value. These countries do not suggest that the principles on which international taxation is based should be modified as a consequence of the digitalization of the economy. Rather, they simply maintain that the rules must be adapted to consider the relevance of the value of the data and the participation of the user. Some E.U. countries such as Spain maintain this position.
- A second group of countries pleads for a thorough revision of the principles of international taxation relating to the concepts of nexus and the attribution of benefits. The rationale is that the digitalization of the economy is a general phenomenon that affects most digital business models. Some countries, such as the U.S., maintain that data and user participation are not relevant *per se* to the process of creating value but that they should be treated as inputs for the company.
- A third group of countries understands that significant reform in the field of international taxation is not necessary after the B.E.P.S. Action Plan. This group consists of countries that have taken advantage of the current rules to become centers for digital companies and often provide a reduced tax burden.

The classification of the different jurisdictions can be interpreted as an initial step from which the work of the O.E.C.D. can proceed.⁸ The document approved by the

that denounce that, in essence, the tax base remains essentially the same considering that the remuneration that the reseller must receive for the functions performed is not far from the remuneration that under the previous scheme should have received commissionaire. From a Spanish standpoint, the position that the tax authorities *sometimes* maintain is the differences between the compensation that corresponds to an agent, according to arm's length, and the economic result of the activity that is developed through a subsidiary or a P.E.

⁸ These different positions are derived from the value chains of the states involved. The U.S. position is consistent with a state where value is created through research and development activities with high added value intangibles. However, the position of certain European states with large populations logically emphasizes the relevance of the client (*i.e.*, user). In an intermediate situation, hub states have opted for a service platform model for digital businesses,

O.E.C.D. expects an update on the progress of the work. A new Interim Report is expected in 2019 and a Final Report is expected in 2020, in which a consensus is expected to be reached.⁹

THE E.C. APPROACH

E.U. concerns about the taxation of the digital economy first arose at the Summit of Heads of State and Government held in Tallinn in September 2017. They were preceded by the conclusions of the E.C. and Ecofin in October and December of the same year and finally by the E.C.'s active collaboration with the O.E.C.D.

The E.U.'s vision, now represented by the E.C.,¹⁰ centers on certain characteristics of the digital economy – lack of physical presence, importance of intangible assets, and relevance of data and user participation – for which the current tax rules are not adapted, allowing digital companies to bear a low tax burden that reduces tax collection and distorts competition. The same ideas underlie the O.E.C.D.'s work.

While there is no consensus at the O.E.C.D. level, the E.C. maintains a clear position in this area, based on the following precepts:

- A unified solution at the international level within the O.E.C.D. is desirable. However, its attainment presents certain challenges, and reaching a consensus will take time. The E.C. supports the attainment of consensus by proposing concrete solutions that can “serve as an example” at the international level.
- Measures taken in the absence of O.E.C.D. consensus should have at least an E.U. consensus and be consistent at the E.U. level. Impatience at the level of the O.E.C.D. has led to the introduction of unilateral measures, which threaten to fragment the unique digital market and distort competition.
- “It’s a matter of justice” to make modifications that give an appropriate fiscal response to the challenges posed by the digitalization of the economy.
- Data and user participation are important in the digital economy. This argument underlies the E.C.’s assertion about the current discord between the place of taxation of benefits and the place of creation of value. All of the E.C. proposals reflect a consensus on the value of data and user participation in the process of creating value.
- The desirable solution to achieve fair taxation of the digital economy relies on the concept of significant digital presence. It is proposed that this concept be added to the definition of P.E., whose benefits would be attributed under



which are comfortable with the classic definitions.

⁹ As mentioned in the *communiqué* of the G-20 Meeting, “We are committed to work together to seek a consensus-based solution by 2020, with an update in 2019.”

¹⁰ We also highlight the media impact achieved by the letter signed in September 2017 by the Ministers of Finance of France, Germany, Spain, and Italy (which Austria, Bulgaria, Slovenia, Greece, Poland, and Portugal later signed) addressed to the Presidency of the E.U. in favor of introducing an equalization tax.

a functional analysis that takes into account the value of the data and the user's participation as a critical issue. This solution appears in the Proposal for a Council Directive Laying Down rules Relating to the Corporate Taxation of a Significant Digital Presence. According to the Proposal, once implemented in domestic legislations, this Directive would be effective within the E.U. and within states without D.T.C.'s in force, but not with non-E.U. countries that have signed D.T.C.'s with Member States. To facilitate the work of modifying these conventions, the E.C. has issued a Recommendation Relating to the Corporate Taxation of a Significant Digital Presence.

- As a long-term solution will take time, a new tax levied exclusively on certain digital services ("Digital Services Tax" or "D.S.T."¹¹) will be introduced as an interim measure. The main feature of this tax is the relevance of the user's participation in a digital activity as a central element in creating value. It defines three types of services in which this circumstance occurs, leaving all other cases outside the scope of the D.S.T. This short-term solution is also projected in the form of the Proposal for a Council Directive on the Common System of a Digital Services Tax on Revenues Resulting from the Provision of Certain Digital Services.

The E.C. has also published a Communication to Parliament and the Council, named Time to Establish a Modern, Fair and Efficient Digital Economy Standard, as a summary of the proposed measures which are substantiated in the two Directive Proposals. The E.C.'s initial position is to process each Directive Proposal as a directive. They have been submitted for consultation to the Parliament and the Council for adoption.

The E.C. proposes the above texts "in a strict sense," meaning they should be analyzed at the E.U. level to ensure they have the modifications required and consensus for approval as directives. Given the possible lack of consensus, the focus is on the enhanced cooperation procedure, which allows a minimum of nine E.U. countries to establish advanced integration or cooperation in an area of European structures without the participation of the other E.U. countries.¹²

CONCLUSION

The digitalization of the economy is a complex issue, raising problems from both a legal and a political point of view. From a legal standpoint, it questions the fundamental rules of international taxation. Politically, the pressure from stakeholders to tax these activities is as high as the discrepancies between states about the way to do it.

¹¹ When using Spanish terms, some confusion could be avoided if the terminology the E.C. uses (*Impuesto sobre Servicios Digitales* – I.S.D.) is replaced with an alternative acronym (I.S.D.i.), as the former is usually used in Spain to refer to the Inheritance and Gift Tax (*Impuesto sobre Sucesiones y Donaciones* – I.S.D.).

¹² At a press conference on March 21, Commissioner Moscovici was asked about the possible application of the enhanced cooperation procedure to achieve progress on the proposals. Moscovici expressed his optimism on the possibility of reaching a consensus within the E.U., so that it would not be necessary to resort to this unfavorable option.

“The new rules proposed by the E.C. (and analyzed by the O.E.C.D.) depart so markedly from the traditional legal framework of international taxation that they require additional work from both institutions.”

In this situation, both the O.E.C.D. and the E.C. are attempting to generate consensus. By its nature, the O.E.C.D. seeks a quasi-global consensus, which is difficult to achieve. Additionally, it may not be easy for the E.C. to get all E.U. Member States to accept its proposals, without using the enhanced cooperation mechanism (which is not desirable).

Regarding the E.C.’s proposals, it is notable that it establishes a long-term solution together with a short-term, interim solution to avoid the serious problem of fragmenting the common market.

The E.C.’s long-term measure will be effective only if there is consensus at the O.E.C.D. level, which does not exist today. This leads to questions of whether the proposal to rely on significant digital presence, rather than to significantly alter existing tax rules, has important political content and how this positions the E.U. in the international discussion on the taxation of the digital economy.

Regarding the interim solution to establish a D.S.T., there is concern that the measure that could be implemented unequally in the E.U., because of a lack of consensus between Member States. In contrast with the long-term solution, this measure is defined in clear terms (probably more characteristic of a regulation than of a directive) and its implementation, based on a tested V.A.T. mechanism, should not be complex. However, its implementation sparks certain questions: How should a tax be assessed if it is designed to grant taxing rights to a state in a situation where, under a D.T.C., that state would have been prevented from taxing the income? And to what extent can existing taxes and this new tax have a different nature, essentially on the basis of formal arguments, when the economic capacity that they both seek to tax, in light of the facts, is the same?

In conclusion, the new rules proposed by the E.C. (and analyzed by the O.E.C.D.) depart so markedly from the traditional legal framework of international taxation that they require additional work from both institutions to remove any doubts raised about their validity and ability to achieve the objective that digital activities support fair taxation. This work should take into account, in particular, possible conflicts between taxpayers and tax administrations that could arise from the introduction of measures of this nature.