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Tax reformation in the digital economy: multinational tech companies targeted

Yesterday the European Commission released its communication “A Fair and Efficient Tax System in the European Union for the Digital Single Market”. This presents a fierce political will to alter the architecture of international tax for digital businesses as “the time to act has now come".

Background

Philosophical shift?

The current broad premise in international taxation is that a company should be taxed generally where it is resident, save that it should be taxed abroad where it carries on business through a permanent establishment (PE). This is sometimes portrayed as a long-standing tension between taxation in the state of residence or that of “source”. Residence taxation potentially jars with a digital economy where profits are made globally but without numerous PEs (and may accrue in a low tax jurisdiction) and so a shift towards source taxation is attracting increasingly vocal support. The issue is sometimes expressed as a desire to tax profits where “value is created”, the implication being that that is where sales are made. Advocates have for a while asserted that a state’s ability to tax e-commerce profits should not depend on the existence of a PE. The Commission asserts that international digital corporations enjoy a “free rider position” which “tilts the playing field in their favour compared to established businesses”.

OECD’s Base Erosion and Profit Shifting (BEPS) Action 1

In 2015, the OECD published its report on Action 1 of the BEPS Programme aimed at addressing the issue of taxing the digital economy. Proponents of change found the report highly unsatisfactory. In its recent Key Issues Paper, the OECD confirmed that this work is ongoing by the “Task Force on the Digital Economy”. An interim report is due mid-2018 and a second report in 2020 will confirm whether any tax challenges in respect of a digital economy remain. The OECD is also expected to publish a report for public consultation on digital taxation in November 2017.

Anti-avoidance: domestic responses

Despite the co-ordinated global BEPS project, some states have impatiently pressed ahead with unilateral responses.

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In seeking to address the perceived practice of multinational companies routing profits overseas to avoid UK tax, the UK introduced a diverted profits tax (DPT) in 2015[1] . This penal tax of 25% on the amount of profits diverted outside the UK aims to prevent multinationals artificially shifting UK generated profit overseas either through using entities or transactions lacking economic substance and/or arrangements designed to avoid creating a UK taxable presence.

In a recent session of the House of Commons Public Accounts Committee on online VAT fraud, concern was expressed that online retailers are profiting from such fraud by ignoring the presence of overseas sellers who sell products into the UK without paying VAT. In a further push to prevent tax evasion, a criminal offence of failing to prevent the facilitation of both UK and foreign tax evasion offences is to come into force at the end of this month[2].

An approach similar to the UK's DPT has been taken by Australia through its own DPT of 40%. This supplements the Multinational Anti-Avoidance Law which prevents significant global entities (defined as companies who are part of a group with a global income of A$1 billion or more) from using artificial tax arrangements to avoid profits being attributed to and thus taxable in Australia. Australia also has a goods and services tax of 10%, which a non-resident company must register for, on the cross-border supply of digital products to Australian consumers.

Along the same vein, Japan has introduced a consumption tax on digital services provided to Japanese customers. This operates through a reverse charge mechanism for business to business digital services whereby the obligation to pay consumption tax lies with the business receiving the digital service. For digital services provided to a domestic consumer, the overseas business is liable to pay the consumption tax.

India introduced an "equalization levy", effective from 1 June 2016, whereby six per cent. of any payment made to a non-resident towards online advertising is withheld by the Indian taxpayer. Israel has taken a holistic approach to reform and produced new guidelines on income tax and VAT which expand the concept of PE to include online businesses who sell or provide services through the internet to Israeli residents. In relation to VAT, such non-resident companies will be required to register and pay VAT on these services.

Within the EU, certain telecommunications, broadcasting and electronically supplied services are taxed according to the "destination principle" i.e. where the customer is located. The MOSS (mini one stop shop scheme) allows such suppliers to register in one jurisdiction thereby obviating the need to register for VAT in each member state in which it has customers. In December of last year, the Commission proposed a Directive to modernise VAT for cross-border business to consumer e-commerce including the extension of the MOSS regime.

Similarly, the OECD in its International VAT/GST Guidelines advocates the destination principle whereby VAT is levied only on the final consumption of goods. One can see, therefore, that indirect taxation on consumption can have a role to play in taxing digital services and so could be built upon with the proposed taxes on the digital economy detailed below.

Momentum gathers against tech giants

Particular focus has been placed on multinational companies who operate through technology without necessarily needing "people on the ground" (typically, a PE) to generate their profit. To that end, numerous tax authorities have sought to recover tax from tech companies with varying degrees of success.

The French tax authorities pursued Google for €1.12bn in back taxes on the basis of the allegation that Google channelled its French profits through Ireland where its European subsidiary and headquarters are based. This summer a court in Paris dismissed this allegation and found that Google's Ireland based subsidiary was not taxable in France on the basis that the Irish subsidiary did not have a taxable presence in France. This case arose after Google had settled with the Italian tax authorities for €306m, with the majority of this figure attributable to its tax position between 2009 and 2013, and the UK for £130m respectively.

Also in the news recently, the US (so far unsuccessfully) has brought a transfer pricing case against Amazon for $1.5 billion on the basis that Amazon allegedly utilised a non-arm's length cost-sharing arrangement with its Luxembourg subsidiaries for certain intangible assets transferred to those subsidiaries[3].

And, controversially, concepts based on EU state aid have been brought to bear against the technology multinationals. In August 2016, the Commission decided that Irish tax rulings allegedly substantially lowered the tax Apple had to pay in Ireland. The Commission contends that this constituted prohibited state aid and so Ireland has to collect this rumoured €13 billion in back taxes from Apple[4]. The Commission has also investigated Luxembourg for its tax ruling addressed to Amazon in 2003 and has made a preliminary finding (pending its final decision) that the ruling conferred a selective advantage on Amazon by reducing its tax liability in Luxembourg[5]. In general, these state aid cases are being vigorously defended.

[1] Part 3 FA 2015

[2] Sections 45 and 46 Criminal Finances Act 2017

[3] Amazon.com, Inc. & Subsidiaries v Commissioner of Internal Revenue, 23 March 2017 (148 T.C.No.8)

[4] SA.38373

[5] SA.38944

Recent EU proposals

Informal ECOFIN meeting in Tallinn 15/16 September 2017

The Estonian Presidency of the Council of the EU began on 1 July with one of their aims being to initiate a discussion on the challenges to achieving fair taxation in a digital economy. An informal meeting of Economic and Finance Ministers (ECOFIN) was held on 15 and 16 September 2017 in Tallinn in which one of the topics for discussion was titled Corporate Taxation Challenges of the Digital Economy. The accompanying discussion paper highlighted three main challenges: (i) the deficiencies in the international tax rules are said to go beyond issues of tax avoidance; (ii) "quick fixes" of the international tax rules will have limited success; and (iii) the EU should aim for a more comprehensive reform of international tax rules.

At the meeting, a majority of ministers agreed in principle that taxation rules need to be updated to address the digital economy challenges but the exact reform plan is not yet agreed. Tax reforms in the EU require unanimity among EU states. However President Juncker has strongly suggested that qualified majority voting should be introduced in order to facilitate quicker and more decisive action in the area of taxation. How this could be done without changing the Treaties remains nonetheless very complicated. Another option that the Estonian Presidency might consider is the possibility to work in enhanced cooperation, as is currently the case for other tax projects like an EU-wide financial transaction tax.

The next summit of EU leaders on this matter will be the Tallinn Digital Summit on 29 September 2017. The Vice-President for Financial Services for the Commission has said that the Commission might be able to present its draft proposal in spring 2018.

Estonian Proposal

The Estonian Presidency is of the view that the current BEPS measures are "outdated" in so far as they allow businesses to be taxed only where they have a physical presence. The Presidency proposes to address this by modifying the concept of PE to ensure taxation occurs wherever value is created meaning "a business with a significant digital presence would be deemed to have a (virtual) permanent establishment in a jurisdiction of operation and therefore be liable to its corporate tax regulations". This would augment the concept of PE to include "virtual permanent establishments". These changes would then be communicated to the OECD so that no changes are made to the EU system without corresponding changes at a global level.

"Equalization tax" proposal

Finance ministers from Germany, France, Italy and Spain proposed an "equalization tax"[6] (see the mention of the Indian equalization levy, above) at the ECOFIN meeting in Tallinn for the other member states and the Commission to consider. This tax would be imposed on a company's turnover rather than where the company accounts for its profits. The concept gained support of six additional member states namely: Austria, Bulgaria, Greece, Portugal, Romania and Slovenia, at the 15/16 September meeting. However a number of states, including Cyprus, Malta, Denmark, Ireland and the UK, remain very skeptical. Concerns have also been expressed that this momentum could be viewed by the US tech giants (and thus the US government) as an attack on them specifically. Some commentators take the view that the US government could obstruct progress at an international level in order to protect US tech companies. Certain member states, such as Luxembourg, are reluctant to overhaul the settled system on the basis that it would be too complicated to switch from a profit to a turnover based tax. Yesterday, the Vice President of the Commission commented that the "equalization tax" is a short term solution with the long term goal being to revise the concept of PE.

The proposed "equalization tax" builds on the OECD's BEPS Action 1 Report which considered, although ultimately did not recommend, the introduction of an "equalization levy" aimed at ensuring that companies are taxed where they have a significant economic presence. The "equalization tax" aims to complement and progress the OECD's work at an EU level. President Juncker has also expressed his wish for an EU proposal allowing for taxation of profits where those profits are made by multinationals in the digital economy. The OECD has cautioned against this route of reform and instead advocated changes at the OECD level through BEPS Action 1. EU Commissioner Moscovici has acknowledged that action is better achieved at a global level and consideration of the work done by the OECD and at G20, respectively, will have a bearing on EU proposals going forward.

Nonetheless the Commission now adopts a slightly threatening tone: it demands that the OECD "comes to appropriate and realistic conclusions" and "expects a high level of ambition", entailing reform of rules on PE, transfer pricing and profit attribution. Otherwise "EU solutions should be advanced".

A midway option, preferred by the Commission, is to implement a measure at EU-level to identify more clearly where digital companies book their profits, labelled a "digital common consolidated corporate tax base [CCCTB]", was also discussed at the 15/16 September meeting. The Commission contemplates further enhancements to ensure that the CCCTB effectively captures digital activities.

[6] Political Statement: Joint initiative on the taxation of companies operating in the digital economy

We will be keeping a close eye on this rapidly moving area of law, particularly over the course of the next few months where key decisions are expected at an EU level. International enthusiasm for a radical extension of taxing rights against the tech giants is unlikely to wane in the near future although the end of the current Commission's mandate in mid-2019 might make the political momentum weaken at EU level. In the short term, further news may emerge following the Tallinn Digital Summit on 29 September 2017.

Further reading

1. Source Taxation of Cross-Border Intellectual Supplies – Concepts, History and Evolution into the Digital Age, 2007, Niv Tadmore

2. Addressing the Tax Challenges of the Digital Economy, Action 1: 2015 Final Report

3. Key Issues Paper for Meeting of the OECD Council at Ministerial Level, 7-8 June 2017

4. OECD Tax Talks webcast, 30 June 2017, KPMG

5. Diverted profits tax, Australian Government

6. Combating multinational tax avoidance – a targeted anti-avoidance law, Australian Government

7. GST on imported services and digital products, Australian Government

8. Revision of Consumption Taxation on Cross-border Supplies of Services, May 2015, Japanese National Tax Agency

9. Online ads to be taxed 6% from June 1, says govt, 31 May 2016, International Business Times

10. Global tech firms targeted in new Israeli tax rules, 12 April 2016, Israel Herald

11. Guide to the VAT One Stop Shop, 23 October 2013, Commission

12. Modernising VAT for cross-border B2C e-commerce, COM(2016)757, 1 December 2016

13. International VAT/GST Guidelines, November 2015, OECD

14. Amazon and eBay turning blind eye to VAT evasion, say MPs, 13 September 2017, Guardian

15. Google wins tax case in France, Avoiding $1.3 billion bill, 12 July 2017, NY Times

16. Google agrees €306m Italian tax settlement, 4 May 2017, FT

17. The Estonian Presidency Programme for the Economic and Financial Affairs Council, July 2017

18. Agenda for informal meeting of Ministers of Finance and Economy, Tallinn, 15-16 September 2017

19. Discussion on corporate taxation challenges of the digital economy, Presidency Issues Note for the informal ECOFIN in Tallinn, 16 September 2017

20. EU finance ministers agreed to develop new digital taxation rules, 16 September 2017, Press Release

21. EU plans to raise tax bills of online giants gather momentum, 15 September 2017, Reuters

22. President Juncker's State of the Union Address 2017, 13 September 2017

23. EU agrees to draft proposal to raise taxes on internet giants, 18 September 2017, EURACTIV

24. Political Statement: Joint initiative on the taxation of companies operating in the digital economy

25. EU states propose 'turnover tax' to fight back against tech giants' corporation tax dodging, 11 September 2017, The Independent

26. EU Finance Ministers Mull Options to Tax Tech Companies, 15 September 2017, Bloomberg BNA Tax and Accounting Center

27. Letter of intent to the European Parliament and the Presidency of the Council, 13 September 2017

28. OECD Chief says BEPS' work best way to solve EU tech tax concerns, 19 September 2017, Bloomberg BNA Tax and Accounting Center

29. Commission joins 'fair taxation' bandwagon on digital industry, 22 September 2017, Politico

30. EU efforts to impose heavier taxes on tech giants gather momentum, 16 September 2017, FT