The Advisory Board to the Federal Ministry of Finance

Response to the EU proposals for taxing the digital economy

September 2018

In March 2018, the European Commission proposed new rules for the "Fair Taxation of the Digital Economy". The Directive on the common system of a digital services tax on revenues resulting from the provision of certain digital services would oblige EU member states to levy a digital services tax (DST) as a special tax on some revenues that are generated when (certain) types of digital services are provided.[1] The proposed directive comes as a response to calls by individual member states to develop such rules. Article 3 of the proposed directive specifies that revenues from the following services are taxable revenues:

- revenues resulting from the placing on a digital interface (e.g. websites or mobile applications) of advertising targeted at users of that interface;
- revenues resulting from the making available to users of platforms (multi-sided digital interfaces) which allow users to interact with others (e.g. Facebook);
- revenues resulting from the sale of data collected about users (for example Facebook users) – simplified hereinafter as "digital revenues".

The DST would be levied on gross revenues generated by a taxable person through the provision of digital services which fall within the scope of the tax, net of value added tax (VAT) and other similar taxes (Article 3 (2) of the proposed directive). The proposed directive sets the DST rate at 3% of taxable revenues. The DST is only intended as an interim measure. In the medium term, the European Commission wants to broaden the permanent establishment definition for corporate taxation to include the concept of a digital permanent establishment, along the lines of the OECD's BEPS project.

It is indisputable that international differences in profit tax rates influence companies' choice of location, change the direction and extent of cross-border investments and create incentives for companies to change their corporate structure in order to reduce the tax burden. One way of countering this would be to extend countries' right to tax profits generated domestically even when, under the current understanding, a company does not have a domestic permanent establishment and thus provides no real grounds for domestic taxation.[2] The European Commission's proposals to tax the digital economy would be a step in this direction. Another goal of these proposals is to prevent a fragmentation of the EU

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[1] See the proposals by the European Commission for the fair taxation of the digital economy of 21 March 2018, on https://ec.europa.eu/taxation_customs/business/company-tax/fair-taxation-digital-economy_en (last consulted on 20 August 2018).

[2] See *Richter*, Die Besteuerung des Gewinns aus den grenzüberschreitenden Direktgeschäften von Google, Facebook & Co., Perspektiven der Wirtschaftspolitik, 2018, p. 132-140; *Schreiber*, Sales-Based Apportionment of Profits, Bulletin for International Taxation, 2018, p. 259-272.

market, which could arise if individual member states were to put in place unilateral solutions.[3]

Nevertheless, the Advisory Board cautions against supporting the European Commission's proposals: It believes that the DST raises serious legal concerns and would have questionable economic effects. Furthermore, the majority of the Advisory Board is not convinced that the revenues resulting from the provision of digital services significantly differ or display genuinely characteristic features when compared with other revenues in terms of indicating taxpaying capacity. For this reason, special tax regimes applicable only to revenues resulting from the provision of digital services would raise concerns regarding the principle of equal treatment.

The DST marks a break with the existing international tax law system for corporate taxation: first, it would impose a tax on gross revenues and, second, it would tax revenues in the country where the service is provided. In addition, the unilateral introduction of a DST in the EU is incompatible with the OECD's BEPS project, which relies on intergovernmental cooperation.

We also urgently warn against introducing a DST as an interim measure or "quick fix". This could result in entrenching what is really intended as a provisional tax, as the principle of unanimity stipulated by EU legislation in the area of taxation also applies to abrogating previously introduced rules.[4] The resulting lack of flexibility could put EU member states at a competitive disadvantage in the international tax arena.

In particular, we would like to point out the following concerns:

1. Risk of unintended double taxation: The OECD's BEPS initiative questions neither the allocation of the taxation right for taxes on earnings nor the systemic relationship between VAT and taxes on earnings. Business profits that are not attributable to a foreign permanent establishment must be allocated to the country in which the company has its registered office. VAT on remunerated services is levied by the countries in which these services are performed.

Providing digital services via export often does not require companies to have a local presence, i.e. does not require a permanent establishment as it has been understood thus far. For this reason, profits generated by providing digital services (for example streaming services by the likes of Netflix or Apple Music, software-as-a-service by Microsoft or Google) are taxed only in the country where the company has its registered office. The registered office, and thus the taxation right for taxes on earnings, is often located outside of Europe, most often in the U.S. Increasingly, however, European companies are affected, too.

Under the European Commission's proposal, levying the DST would not be made contingent on taxation being absent or too low in the country where the company has its registered

[3] See *Eilers/Oppel*, IStR 2018, 361 (365, 369).

[4] While it would be theoretically possible to limit the DST to a three-year period, with the possibility of an extension (provided there is unanimity) in order to prevent the tax from becoming entrenched, we are against such a limitation due to its implementation costs. Nor do we see a level of urgency that would warrant the immediate introduction of a temporary measure.

office. The new tax would therefore be levied on top of the taxes already due under applicable legislation. This would result in double taxation.[5] It would also affect companies that have already been paying their "fair share" of taxes under the regime of the country in which they have their registered office. It is understandable, then, that EU companies are concerned that competition would be distorted at their expense, which is not what the European Commission intends.[6]

2. The DST – a hybrid construct that raises legal concerns: The DST rate of 3% would be levied on taxable digital revenues (gross revenues) that arise from user contributions in member states. The person liable to pay the DST would be the entity which generate the taxable revenues. The European Commission describes the DST as an indirect tax[7] and sees Article 113, TFEU, on the harmonisation of legislation concerning indirect taxation, as the legal basis for the proposed directive on a common system for a digital services tax. Assuming the DST is truly an indirect tax, it should be levied on the customers (as the so-called ultimate taxpayers). However, the European Commission wants to use a tax on gross revenues to tax entities' profits. The European Commission has explained that digital companies would not pass on the costs, which would therefore not be borne by the consumers.[8] The DST is intended to function like a direct tax on profits and ensure that digital companies contribute their "fair share of tax".[9] From the perspective of the European Commission, the DST thus represents a new form of taxing earnings.[10]

Understood as a direct tax, however, the DST would interfere with the objective net principle, since gross revenues would be taxed. This raises concerns regarding the principle of equal treatment. Furthermore, in light of the German Federal Constitutional Court ruling on nuclear fuel duty, the digital tax, as a hybrid construct, raises the problem of the division of responsibilities as set out in the Basic Law (*Grundgesetz*)[11]. According to this court ruling, the Federation and the *Länder* do not have the right to freely create new taxes. Tax laws may only be adopted in accordance with the division of responsibilities set out in the constitutional rules on public finances. However, the DST would be a new tax which would have characteristics both of a value added tax and a tax on earnings.[12] While Union law takes precedence over national law, it seems unlikely that the German government would be authorised to approve, at the EU level, a directive which would force it to adopt a law that is incompatible with the Basic Law.

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5 See *Spengel*, DB 2018, issue 15, M4. – Member states would allow EU companies to deduct the digital services tax paid as an operating expense from the corporate income tax base (see recital 27 of the proposed directive). This, however, would at best attenuate the problem, and would only do so for companies with registered offices in the EU.

6 See *Buck*, in fastFT, 27/3/2018, Bertelsmann chief hits out at EU digital tax plan; *Eilers/Oppel*, IStR 2018, 361 (366 f.).

7 See https://ec.europa.eu/taxation_customs/business/company-tax/fair-taxation-digital-economy_en.

8 See the European Commission's Q&A on the proposal. There are also compelling economic arguments for this. See Wolfram Richter, 2018, Taxing Direct Sales of Digital Services: A Plea for Regulated and Internationally Coordinated Profit Splitting, CESifo Working Paper 7017.

9 See the European Commission's Q&A on the proposal.

10 See also *Eilers/Oppel*, IStR 2018, 361 (366).

11 German Federal Constitutional Court ruling of 13 April 2017, 1 BvL 6/13 (Neue Juristische Wochenschrift (NJW) 2017, 2249.

12 See *Eilers/Oppel*, IStR 2018, 361 (370).

In terms of the principle of equal treatment, another problem arises from the two threshold figures – worldwide revenues of €750 million and taxable EU revenues of €50 million – that the European Commission has proposed so as to ensure that only big companies are affected. It is not obvious how a tax that applies only to large companies is compatible with the principle of equal treatment.

3. DST would have undesirable economic side effects and generate low revenue: A DST would also have undesirable economic side effects. It may well be that very profitable big companies do not respond to the DST by adjusting their financial planning. The combination of market power and low marginal costs might mean, as assumed by the Commission, that the tax is not passed on to customers.[13] However, new businesses, whose profit margins are often still low, or businesses which are still generating losses (such as Spotify and Twitter), would be hard hit by a tax that is calculated on the basis of gross revenues. Tax discrimination against new businesses in particular creates barriers to entry, which is incompatible with the free market economy.

Lastly, the DST is expected to generate little additional revenue.[14] For example, the German maket for online advertising is estimated at approximately €6.5 billion. These advertising services are already subject to a VAT rate of 19%. Provided no intermediate transactions need to be taken into account, this amounts to a tax burden of €1.2 billion. A digital services tax of 3% would generate only an additional €195 million in tax revenue – but would likely come at the price of high administrative costs.[15] The risk is that revenue administrations would face high enforcement costs, while companies might also suffer high compliance costs.

4. A break with the existing principles of the international tax law system: The DST grants the country importing a digital service the right to tax the gross revenues generated by providing this service. This is a change of paradigm. The direct corporate income tax base is grounded in profits (i.e. a net value). The DST, however, taxes gross revenues. At the same time, in principle, the international tax law system grants the country in which a company has its registered office the right to tax the profits that result from the provision of a service. But the DST applies to these profits in the country in which the service is offered on the market. Thus the DST is an addition to VAT which, under WTO rules, is levied by the countries importing the services.

If customers are not internationally mobile, a company cannot avoid a profit tax based on gross revenues, such as the DST. The companies concerned may attempt to make up for the additional burden by increasingly shifting profits and investments out of countries where the service is provided, and into countries which apply a lower tax rate. Levying a DST would signal a new form of tax competition with other economic areas (primarily the U.S.).

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[13] See *Eilers/Oppel*, IStR 2018, 361 (369).

[14] See *A. Weichenrieder*, Digitalization and taxation: Beware ad hoc measures, SAFE Policy Letter No. 64, Frankfurt a.M., 2018; *Eilers/Oppel*, IStR 2018, 361 (369).

[15] See *Eilers/Oppel*, IStR 2018, 361 (369).

Consequently, it cannot be ruled out that other countries would respond in kind by levying a comparable tax on the turnover of European (and German) companies.[16]

It seems doubtful that such a new approach to taxing companies that operate internationally could be restricted to taxing revenues resulting from the provision of digital services. Even a precise delimitation is difficult.[17] The new tax might be expanded to revenues resulting from the provision of non-digital deliveries and services. Important EU trade partners might want to apply the new approach (taxing earnings according to the turnover generated in each country) to old economy companies. For example, China or the U.S. might try to tax the profits generated by the German automotive and mechanical engineering industries, since they could argue that these profits result from sales to U.S. and Chinese customers.[18] This kind of reaction would be a severe blow to the European economy, and especially the export-oriented German economy. Such a reaction by important German and EU trade partners (potentially also in retaliation, if trade conflicts escalate) would either result in double burdens for German industry (with the cumulation of German plus foreign profit taxes); or in losses to German tax revenue, since Germany would respond to such foreign profit taxes by lowering German taxes to prevent any competitive disadvantages and discrimination arising from the company's location.

5. Reduced flexibility in terms of tax policy represents a competitive disadvantage: Flexibility in adjusting tax policy is a prerequisite for successfully navigating tax competition. A European DST would not allow for such flexibility, as introducing the tax via an EU directive as well as amending or abrogating it would require unanimity. Adopting this new directive would trigger a new form of tax competition, without giving individual member states or a group of member states a realistic possibility of shaping or stopping the process in response to new events or findings. The restriction would work both ways: member states or groups of member states could impose neither higher nor lower tax rates than those proscribed by the directive.

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16 See *Fuest*, Die Spielregeln zu ändern schadet uns, Die Zeit No. 24 v. 7/6/2018, p. 24.

17 *Spengel*, DB 2018, issue 15, M4; *Kelm/J.P. Müller*, WPg 2018, 587 (594).

18 See *A. Weichenrieder*, Digitalization and taxation: Beware ad hoc measures, SAFE Policy Letter No. 64, Frankfurt a.M., 2018, p. 3 f.