European Commission - Fact Sheet

Questions and Answers on the Communication on a Fair and Efficient Tax System in the EU for the Digital Single Market

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Why is the Commission addressing digital tax now?

The taxation of the digital economy is part of the Juncker Commission's fair taxation agenda. The President's call for digital companies to pay their fair share of taxes in his State of the Union speech on 13 September reflects the Commission's commitment to tackling this issue. It is this Commission's view that the international tax framework needs to be reformed so that it effectively captures the value created from the new business models, as was already stated in a 2014 Commission report. However, it has so far proved difficult to agree on the solutions at global level, as is evident from OECD report in October 2015.

At the same time, our Member States face increased domestic political pressure to act now to ensure that businesses in the digital economy pay their fair share of tax. Some countries have already introduced unilateral measures in an effort to tax the digitalised economy more effectively, while others are considering their own solutions. If we fail to address the challenge of taxing the digital economy, there will be fewer tax revenues for public budgets at a time when our Member States need them most.

Ministers at the informal ECOFIN in Tallinn this September also called for a common solution to tackle these challenges and agreed to move forward swiftly. Political pressure from the European Parliament is also growing.

Now is the time to take action. The Commission wants an ambitious EU agenda on taxing the digital economy, which should feed into ongoing international work on the issue. The EU will look closely at the OECD's interim report on the taxation of the digital economy to the G20, due in early 2018. It is essential that this report comes to appropriate and realistic conclusions on the way ahead and identifies genuine policy options to tackle the challenge.

This new agenda on taxation of the digital economy will complement the major strides that have already been made in improving the corporate tax framework in recent years, both at EU and international level. Within the EU, Member States have agreed to a series of ambitious new rules to tackle aggressive tax planning and increase tax transparency. They have intensified efforts to improve tax good governance across the globe by agreeing to the Commission's External Strategy on Effective Taxation. Today's work programme will also support the Commission's key priority of completing the Digital Single Market.

Why has this become an issue in recent years?

The digitalisation of the global economy is happening fast and permeates almost all areas of society. Close to a third of the growth of Europe's overall industrial output is already due to the uptake of digital technologies. In 2006, only one digital company was among the top 20 firms by market capitalisation, accounting for only 7% of the market capitalisation. In 2017, 9 out of the top 20 companies were technology companies accounting for 54% of the total top 20 market capitalisation. Between 2008 and 2016, the revenues of the top 5 e-commerce retailers grew by 32% on average per year. During the same time period, revenue in the entire EU retail sector grew on average by 1% per year.

A new generation of information technologies will spur the development of the internet of things, artificial intelligence, robotics and virtual reality. Digital solutions are increasingly used and open up new opportunities for people, businesses, investors and public administrations. It is essential that EU businesses grasp these opportunities to remain competitive, and that EU start-ups are able to scale-up quickly, with full use of cloud computing, big data solutions, robotics and high-speed broadband. The challenge is to make the most of these digital opportunities to ensure Europe's competitiveness, while ensuring fair taxation.

What's different about digital companies compared to traditional brick and mortar ones?

Digitalisation affects all businesses but to varying degrees. A challenge for tax policy is the diversity of business models enabled through technology and the exploitation of large amounts of data. Customers are able to purchase goods and services from anywhere in the world via the internet rather than the local high street. New generations of consumers favour instant access over ownership. Asset-light digital platforms connect spare capacity and demand, and facilitate huge amounts of collaborative transactions which are forecast to grow by 35% per year over the next decade. Businesses of all kinds now derive much of their value from intangible assets, information and data. There is no single defining feature of new ways of doing business in the digital space and the different aspects are often combined together in a single business. All this makes it harder to answer two essential questions: what is the value and where is the value created?

Example:

An online social network business model
Users in the EU have free access to a social network run by a business located outside of the EU. This business collects data on its users, for example information on their spending habits, tastes and preferences. Although most of the company's business and income is generated from selling advertising space to other businesses - so that it can deliver targeted marketing messages via the network to its users in the EU - it does not have a taxable presence in the EU. Under the current international tax framework, **the business is not subject to corporate tax in the EU.**

What evidence is there that digital economy firms are not paying their fair share of taxes?

On average, domestic digitalised business models are subject to an effective tax rate of only 9%, less than half compared to traditional business models (see graph below). This is mainly due to the characteristics of digitalised business models, which rely heavily on intangible assets and benefit from tax incentives. Cross-border digital businesses are able to further reduce their taxes as their intangible assets are highly mobile. By taking advantage of the most beneficial tax regimes, they can bring down their tax burden to effectively zero.

In addition, businesses can take full advantage of the networks, infrastructure and rule of law institutions available in EU Member States, without paying any tax in that country.

What has the Commission done to address the issue of taxation of the digital economy so far?

The Commission's Expert Group on Taxation of the Digital Economy produced a report in May 2014 that identified the need to review the international tax rules on permanent establishment and transfer pricing as key priorities.

Within the EU, Member States agreed to a series of ambitious new rules to tackle aggressive tax planning and increase tax transparency. They are also now addressing the international tax good governance through the EU's External Strategy on Effective Taxation. Negotiations are advancing on the Common Consolidated Corporate Tax Base (CCCTB), which was re-launched by the Commission in 2016. Once agreed, the CCCTB will provide a competitive, fair and robust framework for taxing companies in the Single Market. In the area of Value-Added Tax (VAT), the Commission is addressing head-on the challenges posed by the digital economy with its proposal on e-commerce.

What is transfer pricing and how can it be used by companies in the digital economy to reduce tax bills?

Transfer pricing refers to rules determining the prices for transactions of goods and services between companies within the same multinational group. The principle underlying transfer pricing is that these prices should be at "arm's length" – i.e.: the price paid within a corporate group should be the same as the price paid between two independent companies on the open market. The transfer pricing rules are used to attribute the profit of multinational groups to the different countries based on an analysis of the functions, assets and risks within the value chain of the group.

But these rules were developed for traditional business models. The digital economy relies heavily on intangible assets, such as intellectual property. These assets are becoming more and more lucrative within multinational groups but are difficult to value. The challenge remains to identify and value these intangible assets as well as determine how they contribute to value creation. This work requires alternative methods for attributing profit that better capture value creation in the new business models.

Example:

Transfer pricing using intellectual property in a digital company

Company A is located in a low-tax country outside the EU and owns the intellectual property for the multinational group. Companies belonging to the same group in the EU pay royalty fees to company A for the use of the intellectual property. Company A charges very high prices to the companies in the EU for these royalty fees, which facilitates the shifting of profits to company A in the low tax country. The current transfer pricing rules are unable to challenge the inflated prices charged for the royalty fees because they do not have a comparable transaction in the independent market and it is hard for the tax authorities to determine what the value of the intellectual property really is.

What is a permanent establishment and how can the concept be updated to include the digital economy?

International permanent establishment rules are used to determine how much a company should be taxed based on a threshold of its activity in a given country. At the moment, the concept is largely based on physical presence (for example, offices, factories, warehouses etc.).

However, digital businesses are now able to have a significant economic presence in a market jurisdiction without necessarily having a substantial physical presence. That is why we need to examine what alternative factors should be considered to determine whether these new types of business models have a significant economic presence in a particular country. As outlined in work already carried out by the OECD, these factors could be based on the level of revenue generated from digital transactions, the number of users of a digital platform, the volume of data collected from users through a digital platform or the local domain name.

Example:

Business that provides music digitally to customers via an online platform
Customers located in the EU pay subscription fees to access streaming digital music services via an online platform. Although the revenue generated from the subscription fees comes from customers in the EU, the platform provider does not have a taxable presence in the EU under the current international tax framework. **The business is not subject to corporate tax in the EU.**

Why do we need a common EU approach?

All businesses operating in the EU should pay their taxes where profits and value are generated. This principle is essential for a fair and effective taxation in the Single Market, and it can only be enforced through common and coordinated measures. Divergent national approaches within the EU can fragment the Single Market, increase tax uncertainty, destabilise the level playing field and open new loopholes for tax abuse.

A common EU approach will strengthen our position in the international discussions to push for progress on this issue and the development of meaningful, multilateral solutions.

Should Member States move ahead in groups to address the problem by themselves?

Effective solutions to the taxation of the digitalised economy will be best achieved through multilateral action at the global level to ensure a consistent and comprehensive approach. Divergent national approaches within the EU can fragment the Single Market, increase tax uncertainty, destabilise the level playing field and open new loopholes for tax abuse. That is why a common EU approach is needed to feed into international discussions to ensure that the digital economy is taxed effectively and in a way that ensures fairness and supports growth.

A common EU approach will also need to consider the compatibility of any proposals with the double-taxation treaties, state aid rules, fundamental freedoms and international commitments under the free trade agreements and WTO rules.

How quickly can you propose a way forward on this?

The taxation of the digital economy is a complex, multidimensional issue. The Commission's preferred solution is to embed the EU's approach in the general international corporate tax framework. Early in 2018, the OECD will present an interim report on the taxation of the digital economy to the G20, which should set out genuine policy options. In parallel, we also need to assess the technical feasibility and legal compatibility of the alternative options before proposing any EU common approach on digital taxation.

This work will require detailed analysis of the scope, form and application of various measures. The Commission will need to consider the compatibility with international taxation rules and trade agreements. It will also need to consult with relevant stakeholders and industry representatives, as well as conduct an impact analysis of the various options.

What would be the Commission's preferred option?

The Commission would like for appropriate and meaningful solutions to taxing the digital economy to be agreed at the international level by spring 2018. These could then be integrated into a Commission proposal that would establish binding rules for digital companies operating in the EU's Single Market. If no international solutions can be found, the Commission will present a legislative proposal to ensure a fair, effective and competitive tax framework for the Digital Single Market.

At EU level, the Common Consolidated Corporate Tax Base (CCCTB) proposal is the Commission's preferred option and offers a basis to address these key challenges. The Commission believes that the CCCTB provides an EU framework for revised permanent establishment rules and for allocating the profit of large multinational groups using the formula apportionment approach based on assets, labour and sales that should better reflect where the value is created. There is scope within the current CCCTB proposal to examine further enhancements to ensure that it effectively captures digital activities. Discussions are already underway on this in the Council under the Estonian Presidency, and in the European Parliament. The Commission stands ready to work with Member States in examining these options within the ongoing CCCTB negotiations, to find an ambitious and EU-law compatible approach for the Single Market.

What are the short-term solutions?

There are also more immediate, supplementary and short-term measures that should be considered to protect the direct and indirect tax bases of Member States. Different ideas have been presented in the EU and internationally to capture the digital activity in an alternative way to the international corporate tax framework.

All these short-term options have pros and cons, and will require detailed work to find a workable model for the Single Market and the global economy as a whole. The Commission will need to consider the compatibility with international taxation rules and trade agreements (see above).

Alternative options for shorter-term solutions

- **Equalisation tax on turnover of digitalised companies -** A tax on all untaxed or insufficiently taxed income generated from all internet-based business activities, including business-to-business and business-to-consumer, creditable against the corporate income tax or as a separate tax.
- **Withholding tax on digital transactions** - A stand-alone, gross-basis, final withholding tax on certain payments made to non-resident providers of goods and services ordered online.
- **Levy on revenues generated from the provision of digital services or advertising activity** - A separate levy could be applied to all transactions concluded remotely with in-country customers where a non-resident entity has a significant economic presence.

What kind of companies will you target?

No individual company or sector in particular is being targeted. We want a tax system that maintains a level playing field for all businesses whether they are EU or non-EU based, large or small, more or less digitalised. We also want a tax system that offers the right tax environment for the scaling-up of start-ups and all other businesses to flourish in the Single Market. Finally, we want a tax system which remains competitive, fosters innovation and creates jobs.

What's the Commission's view of the "equalisation tax" supported by several EU Member States?

The Commission will examine this proposal alongside other options. There is very little detail about this proposal available at the moment so it is impossible to say exactly how it would work in practice until the idea has been properly fleshed out. There are still a lot of questions around what the scope and basis of such a tax might be. For example, how do we define digital companies or digital activities? What constitutes "turnover" and how does this vary with different business models? How should such a tax be collected? Questions about the compatibility of this approach with the double-taxation treaties, state aid rules, fundamental freedoms, and international commitments under the free trade agreements and WTO rules would also need to be examined.

How will you balance the twin needs of ensuring the emergence of a strong digital sector in the EU and the fair taxation of the sector?

Digitalisation is growing at a rapid pace and Europe needs to seize digital opportunities to ensure its global competitiveness. We need a tax framework that is fit for the Digital Single Market. This should be one that provides businesses with certainty, stability and a level playing field, while also ensuring sustainable revenues for Member States. We need a coordinated EU approach to prevent the fragmentation of our Single Market and to avoid new tax obstacles and loopholes that would emerge with different national approaches. The question is becoming even more urgent given the fact that a number of countries have already introduced or are considering unilateral measures.

How do you expect to reach consensus when tax decisions are taken under unanimity rule?

Ground-breaking new rules have already been agreed unanimously over the last two years in the EU's agenda for fair taxation. Furthermore, Member States have already agreed that action needs to be taken in the area of the taxation of the digital economy.

What are the next steps?

There will be further political discussions between Member States at the Tallinn Digital Summit of 29 September. As announced at the informal ECOFIN of September, the Estonian Presidency will continue working on these issues with a view to having clear and ambitious Council conclusions by the end of the year. These conclusions should represent the EU's position in international discussions on digital taxation and lay the basis for future work in the Single Market.

In the absence of adequate global progress at the OECD, EU solutions should be advanced within the Single Market and the Commission stands ready to present the appropriate legislative proposals. The Commission will continue to analyse the policy options and consult with relevant stakeholders and industry representatives on this important and pressing issue ahead of possible proposals by spring 2018.

For More Information:

Press Release (IP/17/3305)

DG TAXUD webpage on digital taxation

MEMO/17/3341

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