Digital Presence and the EU (Breakout J)

TEI-SJSU High Tech Tax Institute (34th Annual)

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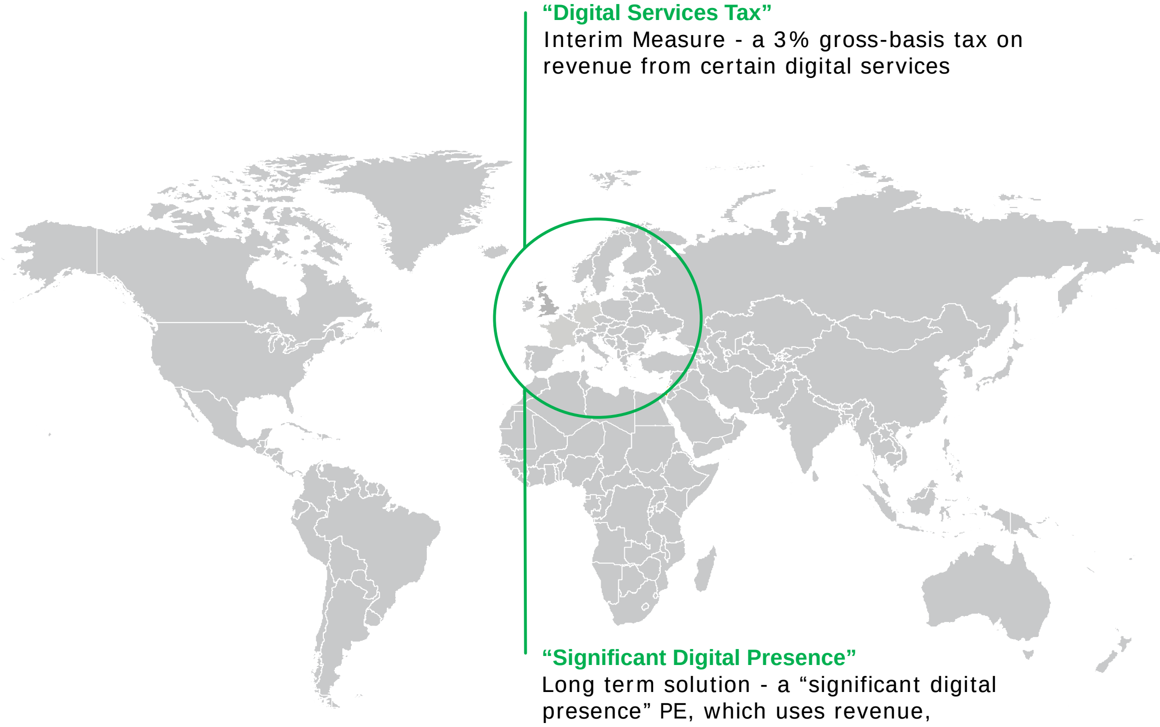
1 EU Initiatives

European Union– DST and SDP

Proposed Directives



EU Proposed Directives

- European Commission ("EC") asserts that users are part of value creation, digital companies growing faster than others, and have lower ETR
- EC "ultimately" supports global solution, but progress is slow
- So proposing 2 Directives:
  - "Interim" Digital Services Tax (DST) of 3% of gross revenue from specific digital services, payable at user location
  - New "significant digital presence" (SDP) PE, defined by reference to digital services revenue, number of online users, and number of business contracts for digital services, plus new rules for attributing profits

EU Proposal: Digital Services Tax

- Taxable services:
  - Online advertising services targeted at users of interface
  - Intermediation services – enabling users to find and interact with other users (but not communication or payment services)
  - Transmission of data collected about users
- Two thresholds for taxability must be met:
  - Consolidated group's worldwide revenue exceeds €750 million
  - Consolidated group's taxable digital services revenue obtained within EU exceeds €50 million

EU Proposal: Digital Services Tax

- DST taxable revenue allocated to Member State where user is "located" (using IP address or other geolocation proxy), regardless of whether user has paid money:
  - Advertising: allocation based on number of times advertisement is displayed on users' device in a tax period in Member State
  - For multi-sided digital interfaces:
    - If facilitating a transaction between users: allocation based on location of users concluding underlying transactions.
    - Otherwise, based on number of users opening an account using a device in Member State
  - Transmission of data: allocation based on number of users from whom data transmitted in taxable period was generated from having used a device in Member State, whether in that taxable period or earlier

EU Proposal: Significant Digital Presence PE

- Applies if (i) digital services revenue from users in Member State exceeds €7 million; (ii) number of users in MS exceeds 100,000; or (iii) number of contracts for digital services concluded by users in MS exceeds 3,000
- Profit attribution based on functional analysis taking into account "economically significant activities" performed by SDP through digital interface
- Taxpayers must use profit split method unless another method is more appropriate
  - splitting factors may include R&D vs. marketing expense, and number of users and data collected per Member State

EU Proposal: Arguments in Favor of DST & SDP

- Value creation:
  - International tax rules are outdated
  - Users create value for enterprises justifiying direct tax nexus for such enterprises
  - Lack of taxation of user-created value under current rules creates misalignment between the place where profits are taxed and where value is created.
  - Misalignment exists where: (i) online trading occurs across borders with no physical presence; (ii) businesses largely rely on hard-to-value intangible assets; (iii) user generated content and data collection have become core activities for value creation in digital businesses
- Other arguments:
  - Digitalized companies are undertaxed
  - "Scale without mass" requires new PE definition
  - Necessary to counter tax avoidance opportunities

EU Proposal: Critique—Value Creation

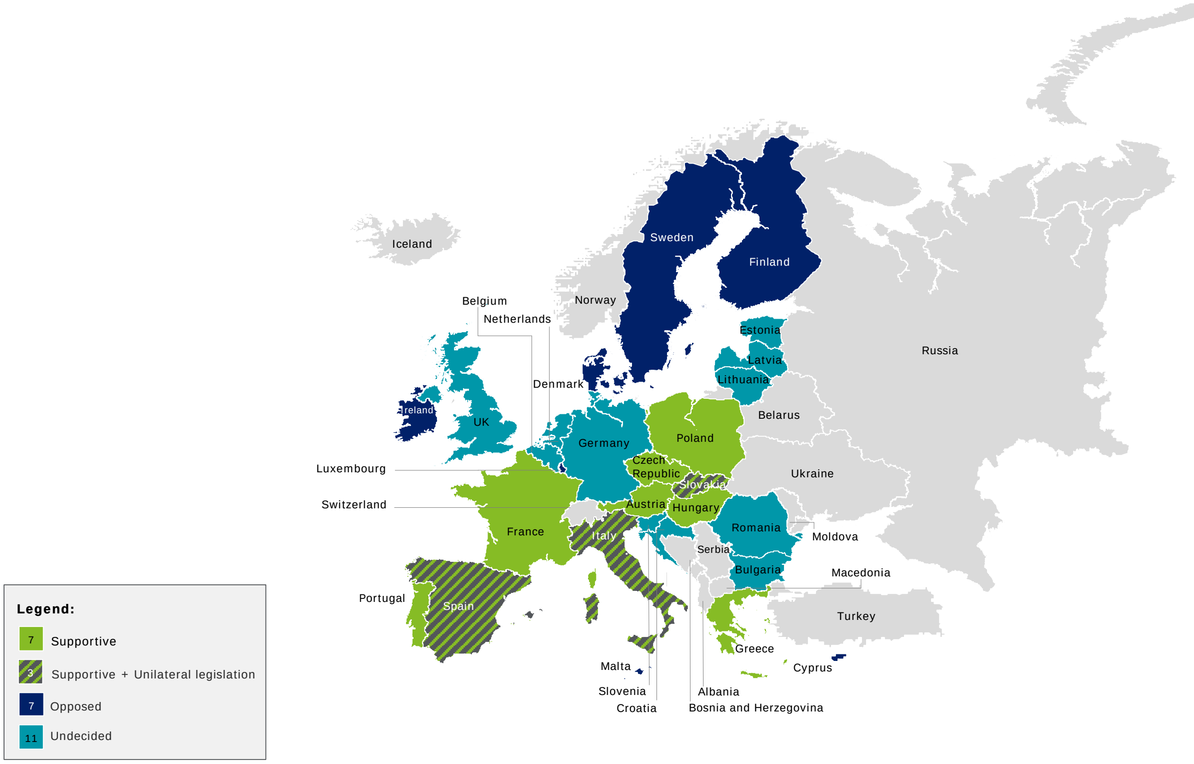
- Value creation:
  - International tax rules are outdated
    - What is outdated about allocating taxation rights to location of assets and employees?
    - Why is a ring-fenced digital specific solution appropriate?
  - Users create value for enterprises justifiying direct tax nexus for such enterprises
    - How can persons not employees be regarded as creating value by the enterprise?
    - Why not wait until OECD releases its research on this?
  - Lack of taxation of user-created value under current rules creates misalignment between the place where profits are taxed and where value is created.
    - Are countries willing to abandon the arm's length principle?
  - Misalignment exists where: (i) online trading occurs across borders with no physical presence; (ii) businesses largely rely on hard-to-value intangible assets; (iii) user generated content and data collection have become core activities for value creation in digital businesses
    - Not possible to attribute profit to SDP PE under traditional assets, functions, and risks analysis

EU Proposal: Critique—Level and Location of Tax

- Other arguments:
  - Digitalized companies are undertaxed
    - Refuted by various commentators, including the source of data cited in the EC Staff Assessment
    - Ignores US tax reform, which eliminates stateless income for US MNCs
  - "Scale without mass" requires new PE definition
    - False implication that digitalized businesses have significantly fewer assets / personnel overall compared to traditional enterprises
    - If the issue is **local** scale without **local** mass, this concern is remote sales, not digital specific
  - The EC Proposals are necessary to counter tax avoidance opportunities
    - Not clear how EC Proposals counter tax avoidance
    - Ignores the achievements of the BEPS Project

Current positions towards the proposed EU directives?

October 2018



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2 UK Proposals

Updated UK proposals for taxing the digital economy

UK Government's current view (March 2018):

- The participation and engagement of users is an important aspect of value creation for certain digital business models.
- The preferred and most sustainable solution to this challenge is reform of the international corporate tax framework to reflect the value of "user participation".
- But, in the absence of such reform, there is a need to consider interim measures such as revenue-based taxes.

What is meant by "user participation"?

- HM Treasury: "the process by which users can create value for certain types of digital businesses through their engagement and active contribution". In particular through:
  - Generation of content by users (e.g. through social media/other online platforms)
  - Depth of engagement with the platform (e.g. where sustained engagement allows businesses to tailor their platforms/platform content to each user)
  - Networks effects (e.g. where the value that a user derives from a platform is strongly linked to the number of other active users on that platform)
  - Contribution to brand (e.g. where businesses are reliant on their users for platform content or for goods/services provided on that platform)

Updated UK proposals for taxing the digital economy

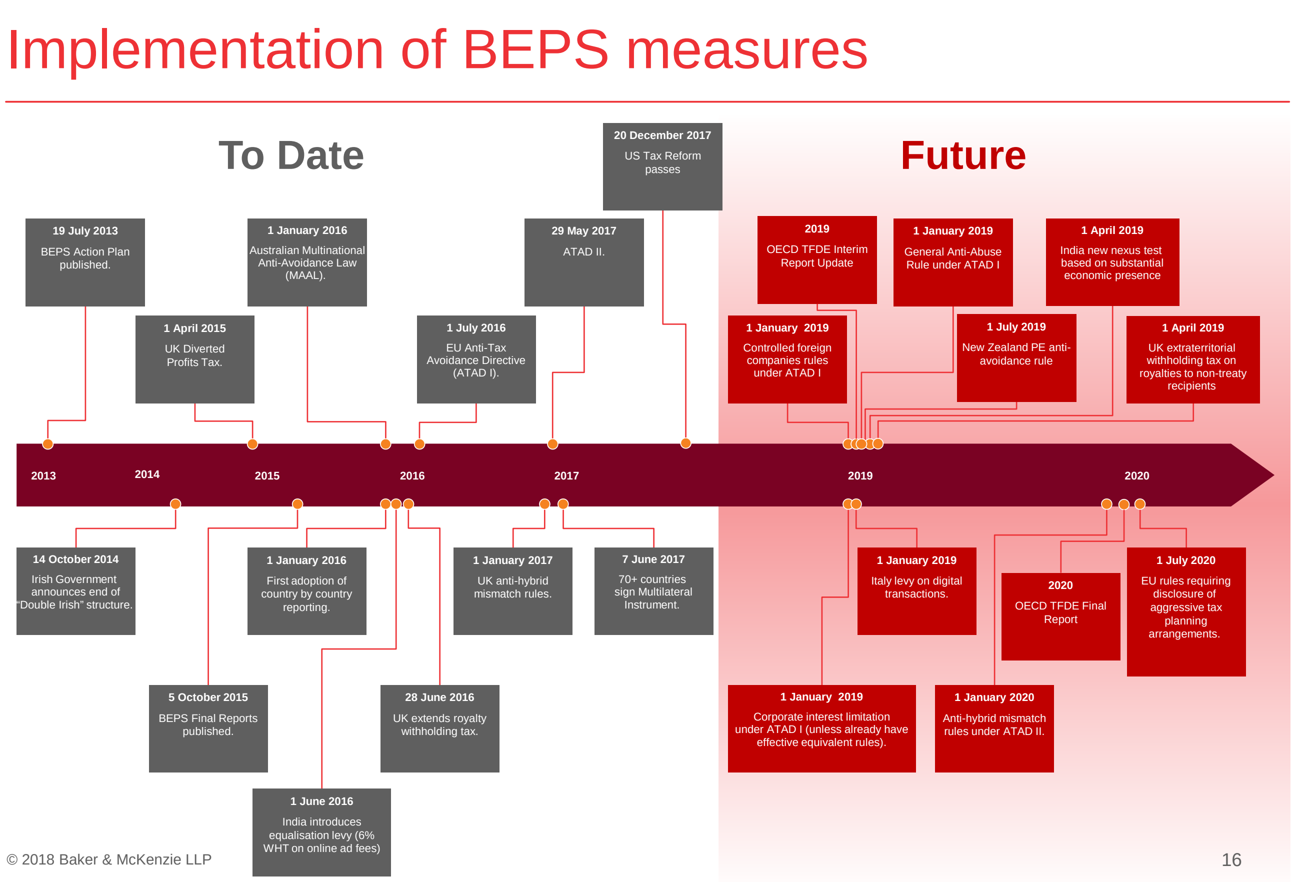
What interim measures are proposed?

- UK Government receptive to a tax on the revenues of digital businesses deriving significant value from UK user participation (regardless of physical presence in the UK).
- There are currently 3 approaches being considered for how the tax might apply to businesses, but it is likely to capture: social media platforms, search engines and online marketplaces including revenues derived from advertising, monetising data and facilitating third party transactions.
- To ensure the measures do not discourage growth and innovation in the UK digital sector, measures may also include: a high de minimis threshold, a flexible application of the tax rate to businesses and/or safe harbour mechanisms.

What long-term reform is proposed?

- The reallocation of business profits currently realised in non-user jurisdictions to user jurisdictions where there is "user-created value".
- Implementation could be through amendments to Articles 5, 7 and 9 of the Model Tax Convention.
- E.g. Where UK users are deemed to be affiliated with a non-UK sales company, that sales company could create a PE in the UK depending on the scale of/revenues from the UK user base. Profits arising from UK user participation would then be allocated to the UK PE.

3 OECD Developments



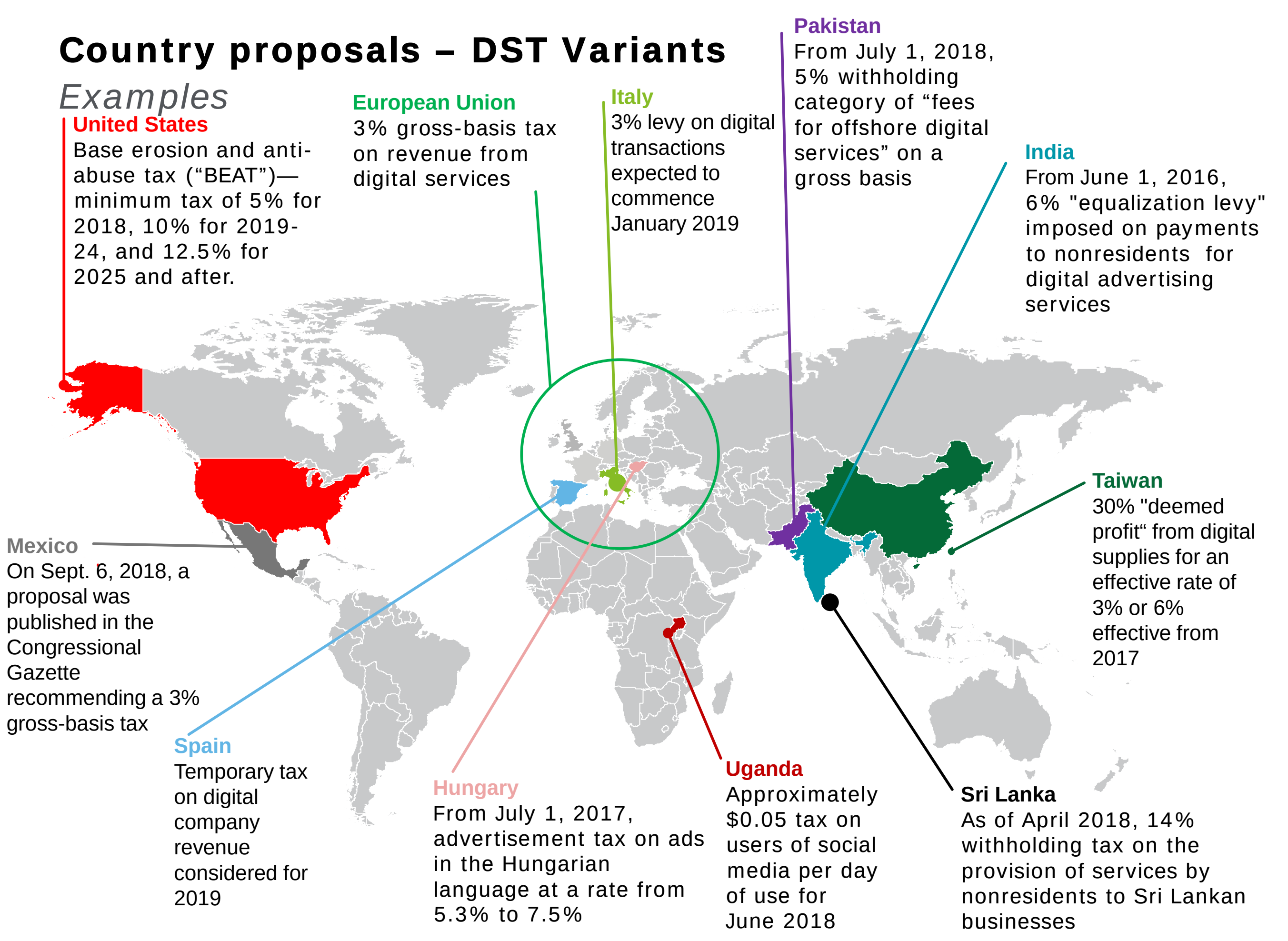
Current OECD Digital Economy Work

- Three possible proposals reportedly under development
  - To be debated at December TFDE meeting
- Is US tax reform a game-changer?
  - Elimination of stateless income removes the principal lightning rod of the BEPS Project
  - Removes arguments re "undertaxed" digital enterprises
  - But adherents to "user engagement" as nexus theory argue that US tax reform does not solve the problem of no / insufficient tax in the user state
- Winning candidate(s) then move to WP1 / WP6 for technical development
- Will this be enough to dissuade the DST or other unilateral action early movers?

OECD: Possible Long-Term Solutions

- **Significant Digital Presence PE**
  - Favored by the UK
  - Limits tax to digital service providers that demonstrate continuous user engagement, as opposed to the Indian SEP that covers a broader scope
- **Minimum Tax**
  - Favored by Germany
  - The proposal might include deduction denials or withholding taxes imposed on payments to low tax jurisdictions
- **Marketing Intangibles**
  - Favored by the US
  - Market IP related to the market country (trademarks, tradenames, etc.) should be solely allocated to the market country
  - Distinguish between production intangibles and market intangibles
  - Likely to attribute more residual profit to the market state

4 Unilateral Measures



Country proposals – PE / Nexus Variants

Examples

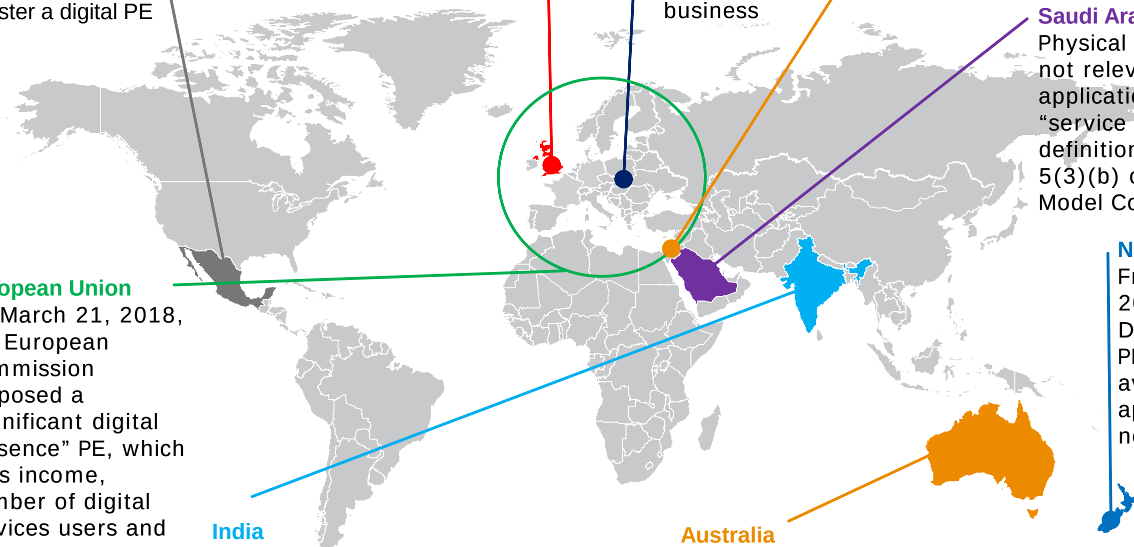
Mexico
From 2019, tax authorities are considering requiring nonresident digital service suppliers to register a digital PE

United Kingdom
From April 2015, UK imposes a diverted profits tax (“DPT”) at a rate of 25% on profits that are artificially diverted away from the UK

Slovakia
From Jan. 1, 2018, 21% tax on the income of nonresident "digital platforms," despite the absence of a fixed place of business

Israel
From April 2016, the Israel Tax Authority issued a Circular that arguably reduced the level of physical presence necessary to impose direct tax on remote sales

Saudi Arabia
Physical presence is not relevant for the application of “service PE” definition of Art. 5(3)(b) of the UN Model Convention.



European Union
On March 21, 2018, the European Commission proposed a “significant digital presence” PE, which uses income, number of digital services users and contracts as thresholds to deem a PE

New Zealand
From July 2018, the a DPT-inspired PE anti-avoidance rule applies to nonresidents

India
From April 1, 2019, a “substantial economic presence” PE rule applies under domestic law, which is broader than the EU’s “significant digital presence” PE.

Australia
From 2016, the Multinational Anti-Avoidance Law imposes tax on certain profits earned by nonresident enterprises. From July 1, 2017, the Australia imposes a DPT where profits have been artificially diverted from Australia

Extraterritorial VAT Collection Obligations

- Widespread adoption around the world after the 2015 Report
- Businesses’ main goal—consistent rules on the following:
  - Transactions within scope
  - Customer identification proof
  - Location proxies
  - Administrative requirements
- Alternative financial intermediary collection mechanism emerging in Latin America
  - Reasonable administrative approach or likely to result in over and/or under payment?

5 MNE Structure

Effects on MNE Structures

- Spillover into non-“highly digitalized business model” structures
  - Transfer pricing
  - Remote sales
  - New standards for nexus?
- Location of principal company
  - PE changes would require treaty changes
  - Comfort level in relying on local Competent Authority for effective controversy resolution
- Location of IP
  - Onshore to tax favored jurisdiction?
  - Repatriate to US?
  - Stick it out where it is?

Effects on MNE Structures

- Reseller structure
  - PE protection
  - Revenue characterization
- Foreign Tax Credit Issues
  - Credibility of EL, DPT, SEP, DST, etc.?
  - Effective utilization of credits after the TCJA?
- Matching DEMPE Functions and returns to intangibles

6 Advocacy

OECD: High-Tech Engagement Strategy

- Long-standing principles remain relevant
  - Tax only profits, not revenue
  - Effective double tax relief
  - Effective dispute resolution
  - No sector specific taxes
- Anything else?

OECD: High-Tech Engagement Strategy

- Planning an engagement strategy
  - Does the high-tech community have a preferred result at OECD?
    - Among the three OECD alternatives?
    - None of the above?
- What is likely to happen if there is no consensus
  - Process falls apart and status quo remains?
  - Many unilateral measures flourish?
- What is the best engagement strategy?
  - Point out flaws of each alternative?
  - Suport one of the alternatives?
  - Propose design features?
  - Refrain from commenting at all?

Advocacy Possibilities

- Channels
  - TEI
  - Trade associations
  - Individual company initiatives
- Audiences
  - OECD / TFDE work on possible consensus proposals
  - Individual EU Member States
  - non-EU countries
  - U.S. government
- Connections and synergies beyond tax
  - Trade issues
  - OTT regulation

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