TAXATION OF DIGITAL ACTIVITIES IN THE SINGLE MARKET

1. Justification for EU Action

The starting point is the internationally accepted premise that **taxation should take place where value is created**. Currently, there is a **mismatch** between where taxation of the profit takes place and where value is created for certain digital activities.

**Why is there a mismatch?** Because of the combination of several factors:

1) businesses can supply digital services where they are not physically established – "**scale without mass**";

2) the development of specific software such as social platforms which allow user interaction – "**reliance on Intellectual Property assets (IP)**"; and

3) the value from the business perspective comes from the participation of the users in the digital activities that they offer – "**user value creation**".

It is important to highlight that such factors in themselves do not create a problem and are not specific to the digital economy, but them being used together can lead to the mismatch that we should address.

In particular, the problem is that the input "user value creation" is located in a tax jurisdiction (market jurisdiction) where the company carrying out a digital activity is not physically established – not established for tax purposes – and where its activities thus cannot be taxed. This is so because the users' contribution to the value of a digital business is not sufficiently reflected in the current corporate tax framework.

Ideally, the solution is to redefine the corporate tax framework to take into account the "value creation input" in the attribution of taxing rights/profit allocation for a jurisdiction. This is the aim of the comprehensive solution. As indicated in the Communication on Digital Taxation, **the ideal solution to the taxation of the digital economy would be a global approach**. The definition of a digital permanent establishment (PE) together with the rules for allocating profit from digital activities should be inserted into the OECD Model Tax Convention, which would then be translated into countries' tax treaties. This would ensure fairer taxation and a level playing field globally. The EU should encourage and support a move by global partners in this direction and set out the EU's vision to serve as an example to influence the international discussions in the direction we want to see.

However, a reform of the corporate tax rules will take time. And there is a high political pressure for Member States to adopt short-term measures with a more targeted scope which could somehow address the problem outlined. **In order to avoid the adoption of unilateral measures by Member States and to preserve the Single Market, it is necessary for the Commission to act** and to propose a harmonised approach on such targeted solution. We are nonetheless aware that such a short-term measure is sub-optimal and has a series of drawbacks and limitations. This is why it is foreseen as an interim measure.
The paper first sets outs a proposal for EU action on a comprehensive solution for the taxation of profits in the digital economy and secondly describes the elements of an interim targeted measure for the taxation of revenues from certain digital activities in the EU.

2. Comprehensive Solution

The comprehensive solution within the Corporate Income Tax (CIT) framework should reflect what we would like to see internationally and also be easy to align to any eventual international solution. This will require a careful approach, as the more specific the EU provisions are, the more they risk clashing with an eventual global agreement. Therefore, the comprehensive solution should be quite broad and flexible in its approach, setting out the key principles without prescribing detailed guidance, while still providing Member States with a solid base to tax digital activity.

2.1. Form of EU Action

We would consider the best available approach for EU action would be:

1) a standalone Directive on digital permanent establishment (PE) and profit allocation rules, which should be included in the Common Consolidated Corporate Tax Base (CCCTB) negotiations; and

2) a Recommendation to Member States to implement digital permanent establishment and profit allocation rules in their double tax treaties.

The current PE definition and rules for attributing profit to PEs in the CCCTB proposal (Articles 5 and 57) are based on the current OECD approach and are insufficient to deal with taxation of the digital economy. Therefore, once the standalone Directive on digital PE and profit allocation rules has been agreed in Council negotiations, the same rules should be adopted in the CCCTB to cover digital activities in a coherent way.

2.2. Legal base for Directive

Article 115 TFEU (direct tax on net profits).

2.3. Standalone Directive

The Commission should propose a Directive with common EU rules for establishing a digital permanent establishment (PE) and for allocating profits to digital activities of such PEs. Member States will have to implement the provisions of this Directive in their national CIT framework. The principle of the
Directive entails the application of corporate tax on profits resulting from providing
digital services in the EU.

This Directive will address situations where there is a certain level of digital activity,
but Member States are currently prevented from taxing it, due to a lack of physical
presence. This Directive will also address situations where there is currently a
permanent establishment in a Member State but that permanent establishment is not
taxed on the profits from the digital activity in that Member State, due to limitations
of the current profit allocation rules.

2.4. Scope of the standalone Directive

In terms of the scope for the Directive, the options we have discussed on defining
what constitutes a significant digital tax presence (e.g. digital PE) together with
revised profit attribution rules are:

1. Directive that applies only in intra-EU situations between Member
   States – this would override the double tax treaties between Member States
   but would have no effect in relation to third countries, and is therefore limited
   in effectiveness;

2) Directive that applies in intra-EU situations between Member
   States and also to situations between Member States and third
countries – this would introduce rules that are inconsistent with Member
   States' double tax treaties with third countries and oblige Member States to
   renegotiate them – this option is not viewed as being politically feasible;

3) Directive that applies in intra-EU situations between Member
   States and situations between Member States and third countries where
   there is no applicable double tax treaty, together with a Recommendation
   to Member States to update their double tax treaties in the same way in
   relation to all third countries – this is seen as the most pragmatic approach to
   bridging the gap between the limitations of the effectiveness of an EU
   Directive and delivering something that is politically feasible.

Based on the recommended option 3, with such a Directive laying down digital PE
and profit allocation rules, Member States will gain taxing rights over the profits from
digital activities carried out in their territories by digital PEs of enterprises
incorporated or established in the EU. The proposed Directive should provide
solutions to taxing the digital economy where enterprises are incorporated or
established in the EU but not where an enterprise is incorporated or established in a
third country with which there is a double taxation treaty with Member States, so as
not to conflict with Member States' tax treaties

2.5. Digital Permanent Establishment rules

Any EU company or foreign company based in a third country where there is no
applicable double tax treaty would trigger a digital PE in a Member State, and
therefore be subject to taxation on its digital activities, if it meets one or all of the
criteria below:
1) by itself or together with its associated enterprises, the entity derives realised **revenues from digital services** in a Member State exceeding EUR [10 000 000] in a tax year;

2) the **number of active users** of the digital service in a Member State in a tax year exceeds [X]; or

3) the **number of online contracts** concluded exceeds [Y][1].

A definition of digital services for the purposes of the revenue criterion could be inspired by the definition of electronically supplied services, which exists for VAT purposes[2]. **This would entail covering a broader range of digital services than is currently proposed for the targeted solution.** There is also no group size threshold proposed for this Directive (i.e. EUR 750 million consolidated global revenue) so it could also cover smaller businesses that have a large digital footprint in one or more Member States.

The proxies identified, such as number of as active/registered users/clicks/contacts, can be identified and linked to a Member State using, for example, the prevailing IP address of the user, local domain names, language, local platform criteria. The Directive should include anti-fragmentation rules, to avoid excluding digital services which are considered as preparatory or auxiliary, when in fact they are core business activities (e.g. gathering and processing data).

2.6. **Profit allocation rules**

As well as defining what constitutes a digital PE, the Directive should also set out the rules for how profit would be attributed to the digital PE, whether that is based on the current or revised OECD approaches, for example the profit split method. Once the taxing right has been established in a Member State through the changes to the PE definition, Member States' tax authorities need to be able to attribute profits to the PE to reflect the digital activities in that Member State. If we do not set out some rules for how to attribute profit to the digital PE then the Directive is likely to be viewed as incomplete and largely ineffective at addressing the fundamental issues.

The fundamental principle for profit allocation should remain that taxation takes place in the jurisdiction where value is created. This said, sticking to the current rules for profit allocation, which are based on the risks managed, functions performed and assets held by the PE, is unlikely to offer effective solutions for digital PEs. Thus, it would not lead to much additional tax on profits because a digital PE is unlikely to undertake these itself (e.g. a digital platform does not require people on the ground performing significant functions in that Member State to provide digital services users in that Member State). **Considering that in the digital economy, a significant part of the value of a business is created where the users are based and data is collected and processed, we would propose setting out some additional criteria specifically and exclusively targeted at attributing profit to a digital PE, for example:**
1) the users' engagement and contributions to the development of a platform;

2) the data collected from users in a Member State through a digital platform;

3) numbers of users;

4) user-generated content.

2.7. Rates, chargeability and payment

Member States will apply their national CIT rules with respect to the profits attributable to a digital PE in their jurisdiction. The rate of tax to be applied to the digital activities would be determined by Member States. The tax charge would be annual and the payment would be to the Member State where the digital PE is.

2.8. External impact of the standalone Directive

The proposed approach for a Directive defining what constitutes a digital tax presence and the rules for profit attribution to digital activity is to apply it to situations between Member States (thereby overriding double tax treaties between Member States) and to situations between Members States and third countries where there is no applicable double tax treaty (so no issue of incompatibility with double tax treaties). This would avoid a situation that would force Member States to immediately and unilaterally breach all of their double tax treaties with third countries, and the serious legal uncertainties and political consequences that this comes with. However, this approach would have no impact in relation to situations between Member States and third countries where the existing double tax treaties would remain applicable. Therefore, a company based in a third country where there is a double taxation treaty (e.g. US), which provides digital services to users in Member States, will not be caught by the EU Directive. That is why we need a dual approach with a Directive setting out rules covering situations between Member States together with a Recommendation for the same rules to be incorporated into Member States' double tax treaties with third countries.

2.9. Commission Recommendation for changes to double tax treaties

In order to address situations involving third countries in a way that does not violate Member States' current double tax treaties, the digital PE and profit attribution rules would ultimately have to be mirrored by corresponding changes in Member States' double tax treaties and the OECD Model Tax Convention at international level, which would extend the approach to include digital PEs of treaty third country enterprises.

To facilitate this renegotiation of double tax treaties, the Commission should issue a Recommendation setting out the proposed changes to the double taxation treaties of Member States in relation to Article 5 Permanent Establishment and
Article 7 Business Profits of the OECD Model Tax Convention. We could also promote the idea of updating the OECD Model Tax Convention itself in order to align international tax principles with the new EU rules through a Chapeau Communication. We could also promote the idea of revising and expanding the profit split method to focus more on the user-based criteria proposed for the profit allocation rules in the Directive.

In the absence of new international rules, Member States would have to negotiate such solutions bilaterally with third countries, which could be a heavy and lengthy process. Alternatively, Member States could mandate the Commission to negotiate on their behalf, which worked well as an approach for the Transparency agreements with Switzerland and other neighbouring countries.

3. Targeted solution

The targeted solution, designed as an interim measure while agreement on the comprehensive solution is sought, covers only the scenarios where there is a higher mismatch between the taxation of profits and value creation for a business (that is, digital activities with a high involvement of users). EU Action will prevent the adoption of unilateral measures by Member States that could hamper the Single Market. At OECD level, guidance on the adoption of short-term, interim measures is also being discussed.

3.1. Form of EU Action

The best available approach for EU action would be a Directive on a common system of a tax on certain digital activities.

3.2. Legal base

Article 113 TFEU (other forms of indirect taxation).

3.3. Objective scope (what is taxed)

It is a tax with a targeted scope, levied on the gross revenues (with no deduction of costs) of a business resulting from the exploitation of digital activities characterised by user value creation.

Why focus the scope of the tax on user value creation? A targeted measure should cover the business models where the mismatch between taxation of profits and value creation is more acute: revenues stemming from digital activities heavily reliant on user value creation.

It is true that "user value creation" is not an issue in itself, because it has always existed (e.g. data collected by supermarkets on their users' habits). But the novelty in the digital sector, following the previous example, is that the users are established in a different jurisdiction than the supermarket (and that the supermarket is not necessarily subject to corporate taxation in the jurisdiction where the users are). Moreover, the
scenarios targeted by this measure are those where its users play a very active role in the value creation for the business. In other words, users do not merely "consume" a good or service (such as in the traditional brick-and-mortar business models), but their participation in a digital activity constitutes an essential input for the business carrying out that activity, that will later on be processed and monetised.

The gross revenues obtained from the processing of that input are the object of this tax, not the user participation "per se". If we did not focus on user value creation, all digital services provided through the Internet by business to customers in other jurisdictions would be captured by this new tax (very wide scope). The latter should rather be addressed by the comprehensive solution.

It covers revenues stemming from all stages of the production and distribution process B2B/B2C (all transactions concluded by business with other businesses and consumers).

**Which revenues would be within the scope of the tax?** Revenues included in the scope of this tax would be those derived from digital activities with user value creation. This would cover, in particular:

a) services supplied for consideration consisting in the valorisation of user data, by means of making available advertisement space (e.g. Facebook, Google AdWords, Twitter, Instagram, "free" Spotify), or the sale of such user data. For instance, in the case of online advertising, the added value of such advertising services is that they are specifically targeted at their optimal audience, based on user preferences obtained through user participation in social networks.

b) services supplied for consideration consisting in the making available of digital platforms/marketplaces to users (i.e. "intermediation services"), and where such users supply goods and/or services directly between themselves (e.g. Airbnb, Uber). The business model of such marketplaces heavily relies on the participation of end-users in the platform (actual suppliers and recipients of the underlying services).

On this basis, services supplied for consideration consisting in the making available of digital content/solutions to users would not be in scope of the tax. This category would potentially cover any electronically supplied service other than those referred to above. For example, activities such as electronically supplied media, streaming, online gaming, IT solutions, cloud computing services, and also "Fintech" activities\(^3\) (e.g. Netflix, Spotify with subscription, Ubisoft Entertainment SA, Automatic Data Processing INC).

It has long been discussed within the Commission services whether to include some or all digital content/solution services in the scope of the new tax. Such discussions are also currently taking place in the OECD. Doubts stem from the fact that the intensity of user participation varies considerably within this category. Cases where there could be a high level of user participation are, for instance, online gaming with a network where users interact with each other. In other scenarios, however, it seems that user involvement is rather minimal (e.g. IT solutions).
Our preference for not including activities consisting in the making available of digital content/solutions in the scope of the tax is based on several factors, as explained below.

1) The rationale for the introduction of this interim targeted measure is to tackle scenarios where there is a higher mismatch between taxation of profits and value creation, that is, activities with high user involvement. This category nonetheless covers digital services with minimal user intervention (e.g., IT solutions, where the user is a mere "consumer") whose inclusion in the scope would be difficult to justify (and would weaken the coherence of this EU action).

2) The need for this new tax to be simple and applicable suggests excluding this category as a whole rather than including it partially (or totally), given that user involvement is a grey area and it would be very difficult to ring-fence and to define which electronically supplied services should be in or out. This could create legal uncertainty from the business perspective, risk of dispute, as well as high administration and compliance costs.

3) The revenue-raising potential of the targeted measure is rather limited, and it seems that including the supply of digital media content (e.g., video, games, books electronically supplied) would make little difference.

4) From a political perspective, excluding this category as a whole is in line with the direction of the OECD work on targeted measures. Moreover, it would limit the risk to be perceived as an extreme solution, while still reducing the political pressure and providing a clear signal that the EU is determined to pursue the agenda on the fair taxation of the digital economy.

3.4. Subjective scope (who is taxed)

The tax would apply to businesses that meet the two cumulative conditions below:

1) Carrying out supplies of the digital services falling within the scope of the tax; and

2) Being above both of the following thresholds:

i. Annual worldwide total revenue above EUR [750] million, at the level of the multinational group to which the business belong, if applicable. Although some may argue that the size of the company should not be taken into account, this threshold could be necessary to provide with legal certainty to businesses (it is easy for companies to identify whether they fall within the scope of the tax through their worldwide revenues). Moreover, it limits the application of the tax to the biggest multinational companies where greatest risks lie, and also takes account of the fact that only companies of a certain scale
provide digital services for which user data and other user contributions play a central role. The EUR 750 million figure is the threshold already used for Country-by-Country reporting (CbCR). The use of this threshold is also being examined by the OECD.

ii. Annual revenue from the provision of digital services in the EU somewhere in the range EUR 10 to [20][4] million. This threshold limits the application of the tax where there is a significant level revenues derived from a digital activity ("digital footprint") carried out at EU level, and would serve to target more effectively the most relevant cases. Establishing the "digital footprint" threshold at EU level, rather than setting an annual threshold for revenues stemming from the provision of digital services in each Member State, also allows disregarding the differences in market sizes which may exist within the EU. The lower bound of the recommended range of EUR 10 million is in line with the EU definition of "small" companies preliminary data suggests that it would capture both non-EU and EU companies (which is of importance in order for the measure to be seen as non-discriminatory from the perspective of the TFEU fundamental freedoms and WTO obligations).

The tax would apply to cross-border transactions between Member States (a business established in a EU Member State supplying digital services in EU another Member State) and between third countries and a EU Member State (a business established in a third country supplying digital services in a EU Member State).

The tax would also have to apply in purely domestic scenarios (domestic transactions within one EU Member State), as confirmed with SJ and DG TRADE, in order to respect the freedom to provide services and freedom of establishment according to the EU Treaties, as well as the World Trade Organisation (WTO) legal framework. If the tax was only applied to revenues made by non-established businesses in a Member State, and not to domestic companies in that Member State carrying out comparable digital activities, the tax would be said to be discriminatory towards foreign companies.

In order for the tax not to be seen as discriminatory, it is necessary that it is not designed in such way that domestic companies are systematically excluded. In other words, it is not possible to de facto restrict the application of the new tax only to foreign business, for instance, by establishing a very high revenue threshold which most domestic/EU comparable businesses would not exceed.

3.5. Where the tax will be levied

There is a need to assign taxing rights (which jurisdiction is entitled to collect the new tax on digital activities). To that extend, the focus should also be placed on user value creation.
From an enforcement perspective, there will be a need for businesses to disclose information on where there revenues from the provision of these digital services to users are recorded. This would entail additional reporting requirements (e.g. a self-declaration system) so that the tax authorities of Member States can calculate how much tax is due in their jurisdiction. To minimise compliance burdens, a simplification mechanism based on the One-Stop-Shop model for the declaration and collection of the tax at EU level will be proposed.

a) For activities consisting in the valorisation of user data, by means of making available advertisement space or the sale of data: where the advertisement is displayed (“where the eyeballs are”, which is where the users generating the value for the platform are located), and where the users having supplied the data which is being sold are located. This will require some sort of apportionment of revenue across jurisdictions based on geographical user statistics.

It must be stressed that the place of supply (i.e. the place where the users are) may not be that where the person paying for the advertisement or the sale of data is established. As a result of this, please note that in some cases the tax will be due in a Member State while the cash-flow of the transaction remains in a third country. For instance, the scenario concerning a cash-flow between a US advertising company (e.g. Coca-Cola) and a US company offering advertisement space (e.g. Facebook), where the advertisements target EU users (tax due in the EU). In such circumstances, it seems nonetheless possible to enforce the collection of the tax simply based on the obligation to declare (e.g. the HU advertising tax already in place also follows this model).

b) For the making available of digital platforms/marketplaces to users: where the user paying for being able to access the platform (or to conclude a transaction within the platform) is located; and irrespective of the nature of the underlying transaction (e.g. supply of accommodation services, or supply of transportation services).

In case where two platform users involved in an underlying transaction are paying for the use of the platform (e.g. In Airbnb, both the host and the guest of the renting accommodation pay a fee to the platform), and where they are resident in different Member States, the tax will be levied in both Member States for the amount of revenues generated therein.

3.6. Chargeability

The new tax will be charged annually (calendar year).

3.7. Taxable amount

The tax will be levied on the gross revenues (with no deduction of costs) of a business resulting from carrying out the digital activities within the scope of the tax
during a given period. It is not a transaction-by-transaction tax, but it is calculated on the **aggregated** gross revenues of a business, and it will be **not possible to deduct** the tax paid in previous stages of the production process.

### 3.8. Rate

There will be a **single rate** across the EU in the region of [1-5]%.

The rate will have to be decided taking into account both the amount of revenue generated from the tax and possible distortions from a business perspective. The tax is designed as a levy on gross revenues (thus not taking into account costs and profits) and, therefore, the impact of the tax on the profits of a company will depend on its profit margin. This could be said to have a significant distortion effect for companies with small margins (for companies with a 50% profit margin, a rate of 5% corresponds to a profit tax of 10%; but for companies with a 5% profit margin, a rate of 5% corresponds to a profit tax of 100%).

Small enterprises will be excluded from the scope of the tax (i.e. via the applicable thresholds) in order to reduce this problem.

### 3.9. Deductibility

The new tax paid by a business in any Member State could be **deducted as a cost from the CIT base in their territory** in order to alleviate potential cases of double taxation, and irrespective of whether both taxes are paid in the same Member State or in different ones.

Given that the new tax would apply equally to revenues derived from the provision of digital activities not only in cross-border scenarios but also purely domestic ones (see section 3.4), the risk is that double taxation arises where the same revenues are taxed under both the new tax and CIT. Notably, this problem would affect domestic companies established in the Member State where the digital services are provided, these being subject to CIT on all their profits (including those attributable to revenues generated by digital services), and which would also have to pay the new tax on the same digital services. Double taxation could also arise, for instance, in cases of companies without a PE in the Member State where the digital services are provided, these being subject to CIT in their Member State of residence and to the new tax in the Member State where the services are provided.

Treating the amount of the new tax paid as a deductible cost against CIT (which is equivalent to the treatment of irrecoverable VAT, for instance) would mitigate this problem. Deductibility would be available in both domestic and cross-border situations within the EU, meaning that a Member State would be obliged to allow the amount of digital services tax paid domestically or in another Member State to be deducted against their domestic CIT base.

Other options, such as the possibility to credit the new tax against CIT – or vice versa – have been discarded. From a practical perspective, it could be difficult to credit taxes of a different nature which notably have a different tax base (i.e. CIT is calculated on the basis of all revenues, which include not only those derived from the
provision of digital activities). Furthermore, from a legal perspective, to allow crediting against CIT could lead to the new tax being seen as a *de facto* restriction on the freedom to provide services within the EU (i.e. in practice, only those businesses not established in a Member State would be taxed for their digital activities in that Member State).

3.10. Payment and collection

The payment of the tax will be made to the Member State where the supply takes place in accordance with the place of supply rules above. There will be an obligation for the business to declare and pay the tax in the Member State due. This would entail additional reporting requirements (e.g. a self-declaration system) so that the tax authorities of Member States can calculate how much tax is due in their jurisdiction.

A simplification mechanism will be made available. It will be based on the One-Stop-Shop model (OSS), where the taxpayer can register, declare and pay the tax due in several Member States via one Member State. There is previous successful experience in the field of VAT in this regard.

3.11. Relationship between targeted and comprehensive solutions

The targeted measure should only apply in the absence of a comprehensive solution. However, the comprehensive solution proposed at EU level (definition of a "digital PE") will only apply to intra-EU situations between Member States, given that SJ confirmed that the rules in the Directive for the comprehensive solution should avoid impacting on the Double Taxation Treaties between Member States and third countries (and despite a recommendation in that sense). Hence, the targeted measure should be applied to non-EU persons carrying out digital activities where EU users are involved, even after the agreement of a comprehensive solution.

Only after a Member State has re-negotiated their Double Taxation Treaties with a third country should the new tax cease to apply to businesses from such third country.

However, it needs to be tested whether such an approach would be consistent with WTO obligations as it would only apply the new tax to situations involving third countries and not to intra-EU situations, and could therefore be viewed as discriminatory.