

Reproduced with permission from Daily Tax Report: International, 246 TMIN, 12/21/18. Copyright © 2018 by The Bureau of National Affairs, Inc. (800-372-1033) <http://www.bna.com>

European Union

INSIGHT: Why the European Council Directive Proposal for a Digital Services Tax Should be Thrown Out



BY KEITH O'DONNELL AND MARIE BENTLEY

A European Union plan to tax certain digital services has encountered opposition from a number of member states and no agreement has been reached on a final proposal. In the authors' view, such a tax would be a serious mistake.

During the Economic and Financial Affairs Council ("ECOFIN") meeting held on December 4, 2018, European Finance Ministers discussed, once more, the proposed directive for a digital services tax ("DST"). The directive proposal aims at introducing a 3 percent tax on revenues resulting from the supply of certain digital services as determined by user value creation.

The services referred to in the directive proposal are the placing on a digital interface of targeted advertising, the making available to users of a multi-sided digital interface, and the transmission for consideration of data collected about users and generated from users' activities on digital interfaces.

Despite the fact that the last version of the text results from a compromise containing the elements that have the most support from EU member states, several member states still cannot consent on the text for political reasons as a matter of principle, and a few others are not satisfied yet with specific points in the text, notably on its scope. As a result, the text did not gain the necessary support and was neither discussed in detail, nor voted on as expected by some of its supporters.

The directive proposal seems thus in a stalemate. This is not bad thing. Indeed, beyond the technical issues, our view is that the introduction of a digital tax change would be a grave political mistake—for two main reasons.

Closing the Stable Door After the Horse has Bolted The creation of an "information economy" in which knowledge is the primary raw material and source of value, and an "attention economy" where the attention of consumers is a currency, has already happened, and at lightning speed.

To give just a few examples:

- Facebook's business model was revolutionized rapidly, following a steep drop in the price of its shares due to the explosion of the smartphone market when customer data and attention shifted from fixed devices to handheld ones.

- Tesla is using digital technology and data capture on a vast scale to disrupt the traditional car manufacturer business model.

- Netflix has transformed our watching behavior and the production of the content that we watch in a way that not even Netflix foresaw originally.

These shifts, like many others, seem obvious now and largely taken for granted. They were not so obvious five years ago, however. As a result, we believe the "quick fix" proposed—trying to tax what is currently seen as a

Keith O'Donnell is the Managing Partner and Marie Bentley is Knowledge Manager with ATOZ Tax Advisers (Taxand Luxembourg).

source of digital value—is unlikely to capture taxation rights to sources of digital value in five years’ time. We will be fighting to tax what will become yesterday’s profits.

The likely failure of this proposal to be adaptable to tomorrow’s sources of value could even be seen as a cost which might be acceptable following the philosophy of “move quickly and break things”. Seeking this quick fix on a regional basis, however, is likely to frustrate non-European trading partners and reduce our credibility when we seek to tax the next digital shift.

This brings us to the second damaging aspect of the DST proposal.

Sawing Off the Branch we are Sitting on Increasing taxation powers for states where users are located looks appealing in the short term, when we are faced with a shift of power and profits to large U.S. multinationals that have transformed the consumer economy by providing new digital services to EU consumers for no direct payment and with a minimal presence in Europe.

At best, it looks a bit like sour grapes—a resentment that there is no European Google or Facebook.

Worse, however, in our view, is that the DST lays the groundwork for a drastic reduction of Europe’s taxable base. While it is a simplification, in global terms Europe can be seen as a producer of high value goods and services that are exported around the world. When the population of the EU is compared to the global population, and to that of some of the EU’s larger trading partners, such as India or China, our population and therefore our consumer base is small.

A simple statistic can help us visualize this disparity: the EU population represents only 7 percent of the world population, while 60 percent of global citizens are located in Asia.

We can be proud of having a value added that is significantly greater in proportional terms than our population. It doesn’t take an economist or a mathematician to see what happens to our taxable base if we seek to allocate more of that taxable base to the states of consumers.

But, we hear the old economy argue, European exports such as luxury cars or luxury consumer goods are different from social networks or search engines. Are they, however? The amount of information being captured by modern cars is increasing exponentially, and the relative value of the electronics in luxury cars is increasing all the time. Adapting luxury products to emerging consumer tastes and behaviors is requiring luxury product companies to capture more information about their consumers, either by engaging with them directly or harvesting information indirectly.

The same logic is true for advanced engineering such as engines, robotics and many of the other sectors Europe can justifiably be proud of. In these cases, “internet of things” technology allows the capture of critical information where the machines are used, not where they are manufactured. The same is true for sophisticated services such as financial services, where AI enhancements depend increasingly on the end user data created by the ultimate consumer.

Thus, we fear, Europe, having argued for the right to tax foreign companies based on the presence of consumers with the DST, will have no legitimacy to resist countries with large consumer populations seeking to tax more of the profits of EU companies on the grounds that the intellectual property and the value added of the EU companies is largely generated in the consumer states.

Instead of arguing that exceptional value can be created by exceptional companies of which we are fortunate to have many within our borders, we will have sawed through this particular branch and will be facing a long drop down in tax receipts.

Taking it Forward In order to take the DST proposal forward, despite the concerns raised by different member states, on December 4, 2018 the French and German delegations submitted a joint declaration by which they invite the European Commission and the Council to limit the draft DST directive, as a starting point, to online advertising only.

Proposals on the taxation of the digital economy and a minimum taxation in line with the work of the Organization for Economic Co-operation and Development (“OECD”) would follow as a second step. Raising a new tax on online advertising, a major source of income of the GAFA (Google, Apple, Facebook, and Amazon) is tempting, as the main national sources of taxes are drying up in a number of EU member states in need of revenues.

However, creating a specific tax regime in order to target a particular activity (i.e., online advertising) performed by a limited number of businesses (i.e., the GAFA) raises some legal questions, notably in relation to the principle of non-discrimination and the coherence of such tax with the current international standards enacted in the OECD Base Erosion and Profit Shifting Inclusive Framework. It remains to be seen how this proposal will be articulated in writing and how member states will react to it.

Keith O’Donnell is the Managing Partner and Marie Bentley is Knowledge Manager with ATOZ Tax Advisers (Taxand Luxembourg).

The authors may be contacted at: keith.odonnell@atoz.lu and marie.bentley@atoz.lu
www.atoz.lu