Deloitte.

International Tax | 23 March 2018

European Union alert

European Commission proposes tax on digital services, structural changes to PE rules

On 21 March 2018, the European Commission issued two draft directives on the taxation of the digital economy. Under the proposed new long-term comprehensive solution, companies would have to pay corporate income tax in each EU member state where they have a significant digital presence. In the interim, the Commission proposes a 3% revenue-based digital services tax on specific digital services where the main value is created through user participation. The Commission aims for an effective date of the interim measures on 1 January 2020.

Background

The European Commission's proposal is based on the fact that companies offering digital services in the EU may pay no or little tax on their profits in the country where the value of the services is created. One reason for this is that the service provider often has no physical presence in the country where the services are performed, which may mean that there is no possibility for that country to tax the related profits under current tax rules. The Commission considers this outcome to be undesirable, and it intends to structurally change the concept of a permanent establishment (PE) to prevent this result. Specifically, the supply of such services would create a deemed PE—a "digital" or "virtual" PE—linked to specific transfer pricing rules for digital services. These structural changes would be complex and would take time to implement, so the Commission is proposing an interim solution that would tax the gross revenue derived from digital services.

The proposal for an EU-wide digital services tax would generate revenues estimated to be worth up to EUR 5 million a year across the EU and help avoid a patchwork of unilateral actions that could fragment the single market and create uncertainty for businesses.

Interim tax on digital services

Scope of tax: Pending multilateral, international solutions to taxing the digital economy, the European Commission is proposing a 3% digital services tax on the gross revenue resulting from the supply of certain digital services characterized by user value creation:

- Online placement of advertising;
- Sale of collected user data; and
- Digital platforms that facilitate interaction between users that then can exchange goods and services directly via the platform.

The provision of digital content, payment services, online sales goods or services, and certain regulated financial and crowdfunding services are specifically excluded from the new digital services tax.

The measure is targeted at businesses with:

- Sufficient scale that established strong market positions allow them to benefit relatively more from network effects and exploitation of big data, i.e. those with total consolidated annual global revenues exceeding EUR 750 million; and
- A significant digital footprint in the EU, i.e. those with annual revenues from taxable digital activities in the EU exceeding EUR 50 million.

The digital services tax would apply irrespective of whether a business is established within the EU.

Place of supply of services: The following rules would apply to determine the place where the services would be deemed to be supplied, and where the tax would be due:

- For services involving the provision of user data collected by means of making advertising space available, or the sale of data: Where the advertisement is displayed or where the users that supplied the data that is being sold are located; and
- For services involving making available digital platforms/marketplaces to users: Where the user paying for access to the platform (or to conclude a transaction within the platform) is located.

In situations where two platform users are involved in an underlying transaction, they are paying for the use of the platform and are resident in different EU member states, the digital services tax would be levied in both member states on the amount of revenue generated in each.

In line with the concept of user value creation, the digital services tax would be payable to the member state where the users are located. Where users are in different member states, one member state would be responsible for collecting the tax and allocating it to the other member states, based on allocation keys.

Tax administration: The annual gross revenue derived from digital services would be taxed at a rate of 3%. Thus, individual transactions would not be taxed, and there would be no deductions for costs incurred. It would not be possible to settle any tax levied at an earlier stage of the supply, but the tax would be deductible as an expense for corporate income tax purposes.

Additional reporting requirements would need to be imposed due to the specific information EU member states would need to levy the digital services tax. A single EU-wide payment and reporting portal would be established, based on the one-stop-shop model currently used for VAT purposes, meaning that all information would need to be provided to only a single member state that subsequently would exchange the information with other affected member states. Businesses would be required to self-assess the tax liability and pay it on an annual basis. Consolidated groups would be able to nominate one company to deal with compliance and payment.

Longer-term structural changes to taxation of digital services

In a separate draft directive, the European Commission is proposing common EU rules to allow member states to tax profits generated from a significant digital or "virtual" presence in their jurisdiction, regardless of physical presence. The proposed significant digital presence concept builds on existing international tax principles to create a new category of PE in respect of a broad range of digital services.

The proposal would extend the current PE rules by establishing a taxable nexus for digital businesses operating across borders where at least one of the following conditions is fulfilled with respect to a tax year:

- Revenues from digital services provided to users located in a member state exceed EUR 7 million;
- Number of active users of digital services located in a member state exceeds 100,000; or
- Number of business contracts for digital services concluded by users located in a member state exceeds 3,000.

The definition of digital services would follow that used for VAT purposes under the EU VAT directive.

These thresholds would apply by reference to the activities of the services supplied by the entity itself aggregated with those supplied by any associated enterprises. The associated enterprises test would be broad and include cases of significant influence through participation in management, a direct or an indirect holding that exceeds 20% of voting rights, or participation in the capital through a direct or indirect right of ownership that exceeds 20% of the capital.

According to the European Commission, the structural tax changes to the PE concept eventually should be included in the proposal for a common consolidated corporate tax base (so that taxable profits are allocated in proportion of the share of activity of an EU member state). EU member states also would have to implement the rules on digital PEs and profit allocation for corporate income tax purposes.

"Anti-fragmentation" rules would be introduced to prevent tax avoidance.

Profit allocation: The profit allocation rules relating to digital services would be aligned with the OECD transfer pricing guidelines. The basic assumption would be that profits should be taxed where value is created. In terms of digital services, the commission intends to relate value creation to the location where the buyers of the digital services are established and data is collected and processed. To this end, additional criteria for profit allocation would be developed, focusing specifically on digital services, which could relate to:

- Users' engagement and contributions to a platform;
- Data collected from users in an EU member state through a digital platform;
- Number of users; and
- Amount of user-generated content.

Comments

The European Commission intends that the directive would require the amendment of tax treaties between EU member states, and that also would apply to transactions between member states and third countries that have not concluded tax treaties with member states. In cases where there is a tax treaty between an EU member state and a third country, the Commission intends to recommend that the member state apply the measures by amending the tax treaty. The European Commission would seek to have the changes incorporated into the OECD model tax treaty through amendments to articles 5 (permanent establishment) and 7 (business profits).

Unanimous approval by all member states is required for the adoption of the proposed directives. It is unclear when the measures would effectively be introduced, but as noted above, the Commission aims for an effective date of the interim measures on 1 January 2020.

The EU would prefer rules agreed at the global level but considers that an unacceptable amount of profits is currently untaxed and, therefore, has proposed solutions at an EU level. Notable, the EU proposals were released within days of the OECD's *Tax Challenges Arising from Digitalization: Interim Report 2018*, and the European Commission intends that its latest proposals will contribute to the ongoing work at the OECD level to influence international discussions on a global solution.

Contacts

If you have any questions or would like additional information on the topics covered in this alert, please email one of the following Deloitte professionals:

Peter Kavelaars
pkavelaars@deloitte.nl

Jasper Korving
jkorving@deloitte.nl

Additional resources

Global Tax Alerts subscription page

Global Tax Alerts archive

World Tax Advisor

Deloitte International Tax Source (DITS)

Deloitte tax@hand app

Dbriefs

www.deloitte.com/tax