Virtual presence

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Bill Dodwell considers EU and global developments on taxing digital services, including possible new taxable presence rules

In March 2017, the G20 Finance Ministers asked the OECD secretariat to re-establish the Digital Taskforce set up under the Base Erosion and Profit Shifting project. The taskforce was asked to produce an interim report for April 2018 and a final report for 2020.

That pace has apparently proved too slow for France (one of the co-chairs of the taskforce). Prior to the informal ECOFIN meeting in Tallinn on 16 September, France persuaded Germany, Italy and Spain to sign a letter calling for the introduction of a turnover tax on digital companies providing services in a country without a taxable

presence there. This would be similar in concept to the so-called equalisation levy introduced by India on digital advertising. By the time of the meeting a further six countries (Greece, Bulgaria, Romania, Slovenia, Austria and Portugal) had also signed up. The European Commission is expected to publish shortly a policy paper on the tax contribution of large technology companies and 'the manner in which their activities can elude traditional systems of taxation'.

There are several challenges in a turnover tax. The basic economic question is that it can deter companies from operating at all, or bear unduly on those with low profits. Turnover taxes are used in the online gaming sector. Gaming is regulated in many countries and several EU states, including the UK, have followed this up with a requirement that online gaming companies pay a turnover tax based on national sales. The practical challenge is that a high rate can prevent businesses from operating at all. The Financial Times noted that one online company withdrew completely from the German market as the tax would have pushed it into losses. Equally, an unduly low rate might not raise much money at all. It's almost impossible to design a tax on sales to act as a proxy for a tax on profits – sales less costs.

One partial solution to this might be only to apply the turnover tax to companies which did not have a taxable presence in the country – or allow the levy to be creditable against domestic corporate income tax. This could have the effect of turning a sales-based tax into a profits-based tax, which is economically less distortive. The EU has additional questions to deal with, though. Firstly, there is supposed to be only one tax levied on turnover: VAT. Secondly, state aid rules need to be considered. Hungary's advertising tax breached state aid rules because it applied a higher rate to large businesses compared to small businesses. This entirely logical position unfortunately offered illegitimate aid to part of the market. Finally, freedom of establishment is relevant, as Italy found out when it tried to mandate that digital advertising platforms needed to establish a taxable presence in Italy. No doubt the Commission's forthcoming paper will need to address these issues – and there is also recognition that not all member states may wish to move ahead with this plan. The EU's enhanced cooperation process allows a sub-group to take a measure forward, provided it does not bear adversely on those states which do not participate. A minimum number of nine is needed.

The ECOFIN debate also covered what some see as a better long-term approach: the adoption of a digital, or virtual, permanent establishment as a taxable presence. Global rules, as reinforced by the G20/OECD Base Erosion and Profit Shifting project,

require a physical presence before a taxable presence arises. However, the digital world could mean that companies without physical infrastructure in a country could offer digital services there. As the world digitises, it may no longer be acceptable to limit definitions of taxable presence to the activities of the group's employees or agents.

Advocates of the Virtual permanent establishment (PE) approach see this as retaining the focus on allocating taxable profits based on value creation. They adopt a new factor to define value, though: the location of users or customers.

Taking this idea forward will not be easy. Perhaps we can agree that the presence of a large customer or user base adds value to some digital activities. Some activities benefit enormously from scale. However, today's digital world may have a separation between users – who pay nothing for the service – and advertisers, which get access to a much better-defined base of potential customers. Should the Virtual PE be defined by reference to users, or to advertisers? How should profit be allocated to a Virtual PE? There are well-tried methods of assessing value in the physical world, based on the functions that a multinational conducts in each location. Finding value virtually is not at all obvious, even if intuitively value may be perceived. Perhaps a defined percentage of global profit should be used. Trying to find value based on intangible assets looks unrealistic, since there is no accepted method to value users in a manner linked to current year profits.

The other major issue is that the definition of taxable presence is set out in the world's 3,000 double tax treaties – which override national law. New definitions will need a fair amount of global consensus if they are to be adopted.

OECD Secretary General Angel Gurria told the EU finance ministers 'It is critical that we continue a globally inclusive dialogue on the tax challenge of the digital economy.' Much more debate will be needed if an effective way forward is to be agreed.