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15 May 2018

European Commission
Rue de Spa 3, Office 8/007
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Via online submission

RE: Comments on Proposed Directives Addressing Taxation of the Digital Economy

Dear Sir or Madam:

The European Commission released two proposed council directives on 21 March 2018. The first proposal would impose an interim tax on revenues derived from the provision of certain digital services (the Digital Services Tax Proposal). The second proposal would define the concept of a "significant digital presence," which would be used to impose corporate income tax on multinational enterprises doing business in the EU but do not have a physical presence in the EU, or only have a physical presence in certain EU Member States (the Digital Presence Proposal; together with the Digital Services Tax Proposal, the "Proposals"). Both Proposals invite input from relevant stakeholders regarding the substance of the proposed directives by 16 May 2018.[1] On behalf of Tax Executives Institute, Inc. (TEI), I am pleased to respond to the EC's request for input on the Proposals.

TEI was founded in 1944 to serve the needs of in-house tax professionals.[2] Today, the organization has 57 chapters around the world, including one in Europe. As the preeminent association of in-house tax professionals worldwide, TEI has a significant interest in promoting fair tax policy at all levels of government. Our nearly 7,000 members represent 2,800 of the largest companies in Europe, North and South America, and Asia. TEI's members work for companies operating across all industries and thus we

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[1] This letter includes specific comments on the Digital Services Tax Proposal and Digital Presence Proposal, as well general comments relevant to both Proposals.

[2] TEI is a corporation organized in the United States under the Not-For-Profit Corporation Law of the State of New York. TEI is exempt from U.S. Federal Income Tax under section 501(c)(6) of the U.S. Internal Revenue Code of 1986 (as amended). TEI is included in the EU Interest Representative Register (Register ID number 52413445902-12).

believe our perspective brings a balanced view of how the Proposals may impact companies operating both inside and outside the "digital economy."

General Comments

TEI commends the EC for its invitation to stakeholders to comment on the Proposals. TEI appreciates the opportunity to participate in the process by which the EC addresses the challenges represented by the digitalization of the economy as reflected in the Proposals and their accompanying documents. TEI previously submitted comments in response to the EC's consultation regarding the fair taxation of the digital economy.[3]

As a threshold matter, we question whether the "digital economy" or "digitalization of the economy" requires the EU to adopt distinct tax rules for "digital transactions" or propose a new definition of permanent establishment (PE) for a "significant digital presence." As we have noted in other submissions, and as the OECD stated in its 2015 final report on Action 1 of its base erosion and profit shifting (BEPS) project,[4] the digital economy is the economy and attempts to "ring-fence" digital companies or transactions are likely to fail. Despite its previous conclusion, however, the OECD subsequently set forth options for taxing the digital economy in an interim report on the subject.[5] Thus, despite our view that a special tax regime is unnecessary to address digital economy challenges, the general trend of multinational bodies, as well as certain countries, appears to be toward implementing a special digital tax regime.

Given this trend, from TEI's perspective it would be preferable for the EC to work with the states comprising the OECD's Inclusive Framework on BEPS to devise a uniform multilateral approach to any tax issues raised by digitalization. Unilateral measures adopted by individual countries outside of multilateral cooperation would almost certainly result in double taxation and unduly inhibit the growth of the taxed industries, to the detriment of consumers and businesses alike. Addressing tax issues arising from the digital economy through a broader multilateral framework such as the OECD's Inclusive Framework would ensure the best chance at adopting uniform digital taxation measures and avoiding the risk of double taxation.

In this regard, we note the EC's case for action does not incorporate the changes to the international tax system that will take effect in the coming years. In particular, the recent tax changes in the United States, continued BEPS implementation, and implementation of the EU's anti-tax avoidance directives, will all have a significant effect on how and where corporate tax is incurred going forward, including by digital businesses.

More broadly, the (apparent) attribution of value to data collection in all cases is a significant and far-reaching change to taxation principles. In our view, whether data collection

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[3] TEI's comments on the fair taxation of the digital economy are available at https://www.tei.org/advocacy/submissions/tei-comments-european-commission-digital-economy-survey.

[4] The Action 1 final report is available at http://www.oecd.org/ctp/addressing-the-tax-challenges-of-the-digital-economy-action-1-2015-final-report-9789264241046-en.htm.

[5] The OECD's interim report on the tax challenges arising from digitalization is available at http://www.oecd.org/tax/tax-challenges-arising-from-digitalisation-interim-report-9789264293083-en.htm.

has value in every case is unclear. Similarly, it is not certain whether there is a real or implied bargain between the data provider and the data collector that the data has been provided for value or in return for access to a service. In TEI's view, the Proposals do not sufficiently grapple with the implications of giving such a widespread imputation of value to data collection, which may have collateral impacts on other aspects of the international tax regime (such as transfer pricing) or on areas other than tax policy.[6]

Comments on the Digital Services Tax Proposal

The Digital Services Tax Proposal would impose a digital services tax (DST) on revenues from the supply of certain digital services characterized by user value creation. The proposal notes "[t]he services falling within the scope of DST are those where the participation of a user in a digital activity constitutes an essential input for the business carrying out that activity and which enable that business to obtain revenues therefrom."[7] The Proposal defines the revenues subject to the DST as revenues from (i) targeted advertising; (ii) business models facilitating user interaction and possibly the supply of goods or services between users (essentially, social media); and (iii) the transmission of data collected about users and generated from users' activities on digital interfaces.[8]

The application of the first two categories set forth above appears relatively straightforward. It is unclear, however, what revenues and activities the third category encompasses. It is also difficult to envision how companies would trace data transmitted under category (iii) to any corresponding revenues. The rise of "the Internet of Things," where devices automatically transmit data during user operation, presents particular problems. For example, modern heavy equipment regularly communicates performance data, including information regarding impending and current breakdowns, to the equipment's manufacturer. The manufacturer may then use the information to improve future products and assess when in-service machinery may need repair, overhaul, or replacement. Thus, the manufacturer may or may not provide additional services or equipment to the asset user as a result of the data transmission. Similarly, software that takes advantage of user connectivity collects information to improve future products and modify current ones (*e.g.*, the seemingly ever present "bug fixes" associated with smart phone applications). Revenue attributable to this kind of data collection, if any, and thus subject to the proposed DST, is unclear. Thus, as written, the Digital Services Tax Proposal appears to provide broad discretion for Member States to enact legislation that includes a wide variety of digital data transmission without any guarantee that the legislation would be consistent among States and not lead to double taxation.

In addition, while the Digital Services Tax Proposal is clearly devised with business-to-consumer digital transactions in mind, there is nothing in the Proposal limiting the DST to such transactions and it may also apply to business-to-business transactions. As such, the Digital

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[6] For example, does the Digital Services Tax Proposal reach revenues generated by newspapers through information gathered from users who read their papers online?

[7] Digital Services Tax Proposal, page 7.

[8] *Id*. at 25.

Services Tax Proposal does not distinguish between personal data collected from end-users, and commercial data collected from, or exchanged with, other businesses. TEI would welcome clarification of whether the EC intends to apply the DST to purely business-to-business transactions or data transmissions.

More broadly, if the DST is not a turnover tax, then the revenues subject to the tax must be allocated across the jurisdictions in which a multinational enterprise does business. Paragraphs 29-32 of the Digital Services Tax Proposal posit, in part, that the allocation of profit across Member States should be performed differently for each underlying service. This approach would lead to confusion and controversy as it is likely that Members States will have varying interpretations of the allocation method that applies to a particular service. In TEI's view, a more generally applicable allocation method would be preferable to minimize the compliance burdens.

Moreover, to the extent the new EU General Data Protection Regulation (GDPR) requires the deletion of user data, or gives users the option to have their data deleted, it is unclear how companies will be able to demonstrate where their revenue arises from or who the value generating data was shared with, in order to properly collect a DST. For example, if a company uses a user's internet protocol (IP) address to identify the user's country, what are the implications for the DST if companies cannot (or will not) collect that data under the GDPR? Moreover, some user accounts are not actively used, so some minimum degree of activity should be required for an account itself to be used as a proxy for value creation.

Whether a DST would be creditable under a double tax convention is another concern. It is unclear from the Digital Services Tax Proposal whether the DST constitutes an income tax or equivalent under most income tax treaties. If the DST is not an income tax, then there is a substantial risk of double taxation, particularly with non-EU countries. Paragraph 27 of the Digital Services Tax Proposal recommends Member States allow businesses to deduct the DST paid from the corporate income tax base. In TEI's view, Member States are unlikely to adopt this recommendation as tax is commonly considered a non-deductible expense and, in any event, even a mandatory deduction for the DST in the EU would not apply to non-EU countries. In addition, making the DST deductible for corporate tax does not eliminate double taxation. Avoiding double taxation on the same source of revenue requires a credit in this case. This could, as in the case of a deduction, be taken into account in determining the applicable rate of DST. In any event, TEI recommends that the Directive should explicitly provide for double taxation relief, whatever its form.

Of additional concern is while the proposed three percent DST rate on turnover may appear low, it translates into a high effective rate on local profit: approximately twelve to thirteen percent at the EU average tax rate of 23 percent. It is not evident from the DST impact assessment how such a rate is a reasonable proxy for a tax on the profits associated with digital activities. As an alternative, the DST could apply only if the corresponding profits were not taxed in another jurisdiction with which the state having a right to levy the DST had a tax treaty.

The Digital Services Tax Proposal also notes that digital businesses are marked by particular characteristics, including "winner-takes-most market structures rooted in the strong presence of network effects and the value of big data."[9] If this is an accurate characterization of digital businesses, and assuming that the DST is imposed primarily upon such companies, it is highly likely that the cost of the DST would be easily passed on to consumers, given such companies' market power. Indeed, it is unclear to TEI why, from a tax policy point of view, the proposed DST could not be implemented via changes to the EU VAT regime. While such an approach would focus on "buyers" rather than "users" it would further the end of ensuring digital companies pay tax. Compliance and administration would also be easer via the now familiar VAT rules. Utilizing the VAT regime would also promote transparency, making it clear that the DST burden falls primarily on consumers due to price increases.

The Digital Services Tax Proposal also highlights the need to coordinate responses to digital tax issues across Member States to avoid undermining the principles of the single market through a proliferation of Member State unilateral actions. To further such coordination, TEI recommends the final directive require Member States to repeal their unilateral measures upon the EU's adoption of the DST.

Finally, TEI is also concerned that, while the DST is styled as an "interim" measure for taxing so-called digital companies until a more permanent solution can be devised, there is nothing in the proposed directive requiring the EU to abolish the DST once the EU has adopted a permanent solution – whether in the form of a significant digital presence or otherwise. The VAT rules have been "interim" for over 25 years and there is little reason to expect a fully implemented DST to expire in the near future. TEI recommends the DST directive specifically provide that the DST will be repealed upon the entry into force of a permanent solution to the tax issues raised by the digital economy.

Comments on the Digital Presence Proposal

The Commission's proposal to implement rules regarding the corporate taxation of a significant digital presence suffers from some of the same defects as that of the Digital Services Tax Proposal. In particular, it is unclear whether non-EU countries would accept this new digital presence standard for asserting taxing jurisdiction under double tax treaties between those countries and EU Member States. If not, then a multinational enterprise would face double taxation on income arising in the EU from a "significant digital presence" as well as in the enterprise's home country. For this reason, TEI again urges the Commission to work with the OECD's Inclusive Framework on BEPS to develop a universal multilateral approach to the digital taxation problems identified in the Proposals, rather than establishing a separate EU standard that other countries may or may not accept.

With regard to the Digital Presence Proposal specifically, how to attribute and allocate profits to the proposed significant digital presence is unclear. Of late, profit attribution has been a contentious issue in multilateral tax forums. For example, the OECD recently amended its

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[9] *Id*. at 2.

guidance on the attribution of profits to PEs and changed the definition of a PE itself. Should the EC adopt its own changes to the PE definition and rules for profit attribution, more confusion will be created, which will lead to controversy and double taxation. The final Directive should provide more detail regarding profit attribution and allocation to this new type of PE to avoid confusion and ensure such profit suffers only a single layer of tax.

More broadly, the adoption of a significant digital presence as a PE raises foundational tax jurisdiction questions. Such issues were so controversial that the OECD intentionally avoided the "source versus residence" allocation during its BEPS Project. If the EC believes the current multinational business environment warrants a reexamination of taxing jurisdiction, then TEI recommends the EC address that issue in the broader context of the international tax system, rather than under the guise of addressing tax problems specific or unique to digital transactions. Broader multilateral engagement would increase the likelihood of non-EU countries accepting any devised solution and also avoid difficulties with attempting to ring-fence the digital economy.

Annexes II and III to the Digital Presence Proposal each list services that are, or are not, treated as "digital services" for purposes of the proposed Directive. As noted above, however, physical assets, machinery, engines, *etc.*, increasingly automatically exchange data (the Internet of Things). Similarly, remote, automated installations monitor and analyze such data. This data may or may not be used for commercial exploitation. The lists in both annexes do not appear to recognize the Internet of Things as either specifically included or excluded from the Digital Presence Proposal. In TEI's view, the interconnectivity of modern machines is likely to result in the creation of a digital PE for most manufacturers or suppliers of connected assets in any country in which their products are used under the current definition of a digital PE. This would impose a substantial compliance burden on taxpayers who sell such connected products around the world. TEI recommends the EC specifically address the Internet of Things to avoid unintended domestic law drafting that includes, or excludes, such data exchange in the determination of a digital PE.

We also note that it is very likely that companies who fall within the scope of the DST will also be have a digital PE. The Proposals as written, and absent an effective double taxation relief mechanism, would subject such companies to double tax through a three percent DST as well as a corporate income tax on the profit allocated to the digital PE. While double taxation would not occur if the DST is abolished upon the adoption of a digital PE, if the DST remains, TEI recommends the EC adopt a robust double taxation relief mechanism upon implementation of the digital PE regime. Relatedly, as the Digital Presence Proposal intends to render unnecessary the DST, the Directive should make it a precondition that the latter is terminated as of entry into force of a digital PE as a basis for asserting taxing jurisdiction.

Conclusion

TEI appreciates the opportunity to provide additional comments on the Digital Services Tax and Digital Presence Proposals. These comments were prepared under the aegis of TEI's European Direct Tax Committee, whose Chair is Giles Parsons. If you have any questions about

the submission, please contact Mr. Parsons at +44 (0)1455 826561, Parsons_Giles@cat.com, or Benjamin R. Shreck of the Institute's legal staff, at +1 202 464 8353, bshreck@tei.org.

Sincerely yours,
TAX EXECUTIVES INSTITUTE, INC.

Robert L. Howren
International President