

QUICK INFORMATION

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The Digital Services Tax – A Dangerous Quick Fix

POSITION OF STIFTUNG MARKTWIRTSCHAFT

The European Commission's plans for the introduction of a Digital Services Tax (DST) contain serious flaws:

- There is no immediate fiscal need for a short-term interim solution at the European level.
- The alleged discrepancy between tax burdens of digital and traditional business models partly results from preferential tax treatments and, thus, is inadequate to serve as a rationale for additional taxation.
- The DST does not adequately address existing inequity in the taxation of digital business models and related problems of international tax evasion. Instead, it may lead to additional elements of distortion and unfairness with possible adverse effects on innovation.
- Despite generous tax thresholds, the implementation of the DST – in particular the distinction between taxable and non-taxable revenues – is likely to lead to problems and significant additional bureaucratic burdens.
- The DST poses grave long-term risks to export-orientated economies and their tax revenues that clearly outweigh the short-term prospect of a slight increase in tax revenues.

Germany should take a clear stand against the DST instead of succumbing to the temptation of a European “quick fix”, which seems unfit to achieve any of its intended goals. Rather than pioneering the taxation of digital business models, Europe and its member states should focus on creating conditions conducive to digital business models.

BACKGROUND

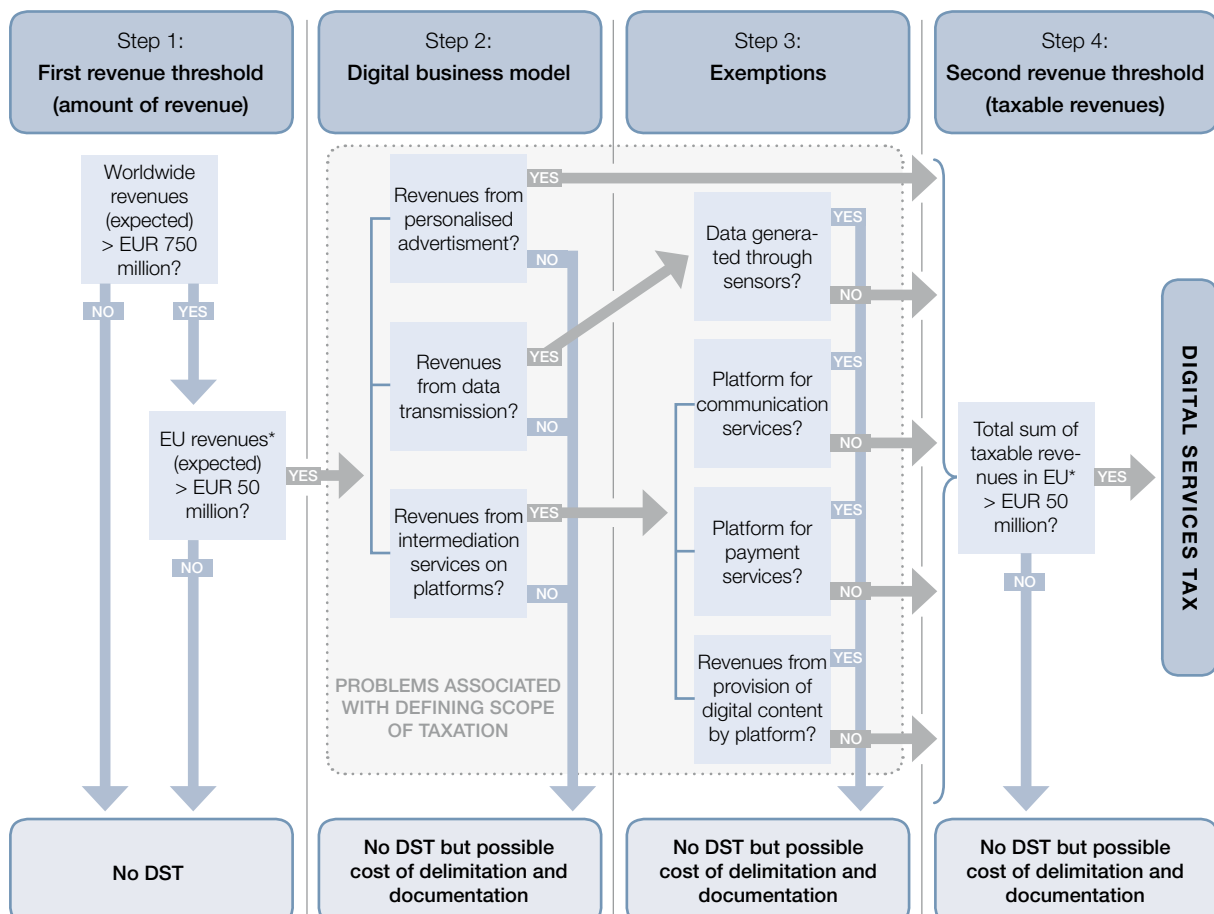
Digitalisation along with new business models, a growing importance of immaterial goods as well as increasing internationalisation pose new challenges to systems of taxation. Current national and international tax rules were not designed to meet most of them and need to be adapted accordingly while preventing aggressive tax evasion. Digital businesses should not be allowed to escape taxation entirely, nor should they be granted an unfair competitive advantage through lower tax levels. Similarly, the European Commission wants to create a level playing field through a stable and modern tax framework, ensuring fair and balanced tax burdens, thus allowing the Digital Single Market to realise its full potential.

In response to these challenges, the European Commission published two proposals for a Council Directive in March 2018. In the short term, the *“Proposal for a Council Directive on the common system of a digital services tax on revenues resulting from the provision of certain digital services”* intends to implement a Digital Services Tax (DST) as an interim solution until a more comprehensive reorganisation of international corporate tax rules is achieved. In the long term, the Commission proposes adopting a “significant digital presence” as a taxable nexus with the aim of closing possible loopholes in the tax system. For tax purposes, the interim solution seeks to put a stronger emphasis on the contribution of users to the process of value creation of digital business models. Those in favour of the proposal aim for an agreement within the European Council by the end of 2018. Due to the unanimity rule in tax law, all member states have to give their consent. The DST is expected to be applied from 2020 onwards.

KEY FEATURES OF THE EU-PROPOSAL FOR A DIGITAL SERVICES TAX

- The tax shall apply to:
 - Revenues resulting from placing personalised advertisements on digital interfaces that refer to any kind of software or application accessible to users;
 - Revenues resulting from intermediation services enabling the interaction of users on multi-sided digital interfaces (in essence online platforms), which may also facilitate the provision of goods and services between users;
 - Revenues from the transmission of collected data about user activities on digital interfaces.
- Exemptions exist for platforms whose main or sole purpose is the provision of communication or payment services as well as for the supply of digital content directly by an online platform (e.g. Netflix).
- The scope of the tax is restricted to companies with total global revenues exceeding EUR 750 million and taxable revenues obtained within the EU in the amount of at least EUR 50 million.
- The tax rate is 3 per cent on the total gross revenues minus the value added tax.
- Both national and cross-border services fall within the scope of the DST. The location of the user is the deciding factor for establishing in which member state revenues are created. The tax is due to that member state and revenues will be distributed according to specific allocation keys.
- A one-stop-shop simplification mechanism allows companies to only register in one member state as a taxable entity and issue a single DST return for the entire EU. An automatic exchange of information will enable the transfer of any relevant information between the member states.
- Pending national legislation, companies will be able to deduct the tax as a cost from their corporate tax base, thus alleviating the risk of double taxation.

Figure: Simplified chart of the EU-proposal



* based on user

NO IMMEDIATE NEED FOR ACTION

- The European Commission has indicated a preference for a long-term comprehensive reform of international taxation rules. However, it also asserts the urgency for immediate additional short-term measures, claiming that member states are faced with the threat of eroding corporate tax revenues until a comprehensive solution is reached. By implementing the DST, the Commission intends to discourage member states from taking uncoordinated unilateral measures, as this would risk further fragmentation of the European Single Market.
- Since the revenues from corporate taxation are stable and even display a slight upward trend, the Commission's concerns over dwindling tax revenues seem unwarranted so far. Hence, from a fiscal point of view, there is no immediate pressure on EU member states to safeguard their revenues by raising additional taxes, in particular in light of changes to international tax rules following the OECD's BEPS initiative and the US tax reform.
- In any case, the contribution of the DST to individual member states' budgets would be negligible given that the Commission expects European-wide annual revenues of less than EUR 5 billion, which is insignificant compared to, for instance, the total German tax revenue of EUR 735 billion in 2017.
- It remains entirely possible that member states resort to their own unilateral measures in spite of the adverse effects on the harmonisation of the European Single Market. The risk of ill-conceived taxes being implemented in some member states, however, cannot justify the adoption of those same taxes on the European level, not least because tax legislation is first and foremost at national discretion.
- Implementing the DST as an interim solution fails to recognise that taxes tend to linger once they have been introduced, irrespective of well-intended sunset clauses.

DOCUMENTED TAX GAP PARTLY THE RESULT OF DELIBERATE PREFERENTIAL TREATMENTS

- The European Commission justifies the DST proposal on the grounds of large discrepancies in tax burdens between digital business models that pay an effective average tax rate of 9.5 per cent and traditional companies bearing an average burden of 23.2 per cent.
- However, this data is not suitable to substantiate the need for a DST. The data does not document an actual disparity in paid taxes but rather the disparity in tax models based on hypothetical structurally different investment projects.¹ To a large extent, the observed discrepancies stem from favourable depreciation rules for intangible assets and existing tax incentives for research and development based on the assumption that digital business models rely more heavily on these incentives.
- The observed discrepancy in tax burdens is thus largely the result of national efforts to promote digital and innovative business models and not an expression of unfair taxation. Those efforts would be negated, if their results were taken as justification for the introduction of additional taxes.
- To the extent that such policies do indeed create unjustified preferential treatment, careful adjustments to depreciation rules and tax incentive schemes would be much more adequate remedies than a flat tax.

FURTHER DISTORTIONS INSTEAD OF COMPENSATION FOR INJUSTICES

- The DST does not apply to income or profits but represents a tax on revenues. Consequentially, it does not take into account whether a company subject to DST is effectively generating profits or whether those profits are subject to an unjustifiably low tax burden. In other words, the DST does not remedy a proven imbalance in tax levels but attempts to fill an assumed tax gap for certain business models.
- This might lead to double taxation and will create further distortions and injustices. Especially businesses with narrow profit margins would be subject to a higher tax burden, among them predominantly young business models in the process of expansion. Likewise, the DST could exert countercyclical effects, given that profit margins tend to decrease during recessions.

¹ For more detail, see Fuest, Clemens et. al. (2018), Die Besteuerung der Digitalwirtschaft – Zu den ökonomischen Auswirkungen der EU-Digitalsteuer, Impulse für die Wirtschaftspolitik, IHK für München und Oberbayern.

- Moreover, the DST may create adverse incentives for companies approaching the threshold values. In order to remain outside the scope of the tax and associated bureaucratic burdens, companies might choose not to scale-up or digitalise their business models.
- European companies that mainly operate in European markets would bear a disproportionate burden of the tax compared to international competitors relying more heavily on other markets.
- The DST fails to address existing unfair imbalances in tax levels resulting from aggressive tax planning and deliberate exploitation of loopholes in national tax laws. It does not solve the main problem of international tax evasion, namely that states allow multinational corporations to evade or escape taxation through preferential tax treatments and deferral to apply taxation rights. Neither is the problem of tax evasion limited to digital business models.
- To alleviate possible double taxation, the DST is intended to be deductible from the corporate income tax base. The implementation of this provision, however, would depend on the compliance of each member state, as the EU, for lack of jurisdiction, can only issue non-binding recommendations.

CUMBERSOME IMPLEMENTATION

- The implementation of any new tax entails significant efforts for taxpayers and administrations alike and must be considered excessive if taxes are only imposed for a limited time.
- This is all the more true in the given case, since the DST requires an entirely new system of taxation to be set in motion, which is contingent on the collection of revenue data on the basis of user activity. Identifying the taxable business models, isolating the associated revenues and applying the exemption clauses correctly are highly complex tasks. As a result, the implementation is likely to be riddled with technical problems and would bring about significant legal uncertainties.
- In order to ascertain whether the thresholds apply, it is necessary to establish the size of taxable revenues. Therefore, the administrative costs of defining taxable revenues and subsequent obligations for documentation would also affect companies that do not even fall within the scope of the DST.
- The additional bureaucratic costs are considerable: the process of taxation entails identification for taxation purposes, definition and determination of taxable revenues, filing of tax returns and automatic exchange of information (whose proper functioning is less than certain, as demonstrated by the administrative failure to process data from the automatic exchange of information on interest earnings). Due to the fact that compliance and audit procedures remain at national discretion, companies will be confronted with a multitude of different procedures, despite the planned one-stop-shop model.

CONSIDERABLE LONG-TERM RISKS

- The Commission stresses the importance of taking the contribution of users to the process of value creation of digital companies into account, in order to be able to tax value creation where it originates. This approach fails to recognise that, for good reasons, not even current international tax rules take into account where value is created. It further implies a shift in taxation towards export markets, albeit to a very limited extent. Nevertheless, such a paradigm shift in international taxation could inflict serious damage on export orientated economies and their tax revenues if export goods were exposed to increasing tax burdens in their designated markets.
- As a barely concealed attempt to target the profits of large US-American multinationals the DST is likely to significantly undermine the prospect of reaching a comprehensive solution in international taxation. Instead, it would most likely be interpreted as a customs tariff and a further stage of escalation in the current dispute over international trade.