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The possibility of taxation based on the destination principle

The European Commission ('EC'), with the support of several EU Member States, wants to adapt EU taxation rules in order to adequately cover the digital market, and is trying to find measures to achieve a fair taxation of digital businesses, which currently pay very little tax in comparison to non-digital companies. The EC published a communication 'A Fair and Efficient Tax System in the European Union for the Digital Single Market' (the 'Communication'), on 21 September 2017, and in this article, Andras Salanki and Julija Saduikyte, of PwC, assess the current EU tax landscape for digital businesses and analyse the changes being explored by the EC.

Based on the current EU taxation system, digital companies pay very little tax in comparison to other non-digital companies. The effective tax rate for digital business models lies between 10-25%. On average, digital business models are taxed at a rate of 10.20%, which is 11.73 percentage points lower than traditional business models[1]. According to the EC, current EU taxation rules do not cover the digital market. Therefore, there is an increasing need to close this gap and create a tax system in which digital and 'brick and mortar' companies would be taxed more equally.

Recently, the EC published a communication in which it said that the fair taxation of the digital market is an important issue for the whole of the EU. This was a key subject of the Digital Summit attended by European leaders, held in September 2017 in Estonia. The two questions which the EC raised and which the EC seeks to answer in early 2018 are: where to tax (nexus) and what to tax (value creation) in regards to the digitalised companies[2].

In the Communication, the EC proposed several long term and short term solutions. As a long term solution, the EC anticipates an EU corporate tax reform (common consolidated corporate tax base or 'CCCTB'). Based on the CCCTB, the EC is considering changing the definition of a 'permanent establishment,' i.e. moving from the current definition based on the fixed establishment of the business to a virtual establishment; the company would then be taxed where the value has been created and not where it is established. This would also influence changes in transfer pricing and profit allocation fields, as another formula would be used for allocating profit (based on assets, labour and sales). The EC is of the opinion that it would be beneficial to have an international long term solution. Therefore, the EC hopes that some changes in this regard will be also decided by the Organisation for Economic Cooperation and Development ('OECD')[3].

In the interim, the EC is considering the following short term alternative options, which should be implemented sooner, in order to adapt to the digitalisation of the market:

- Equalisation tax on turnover of the digitalised companies - a tax on all untaxed or insufficiently taxed income generated from all internet-based business activities, including business-to-business and business-to-consumer activities, creditable against the corporate income tax or as a separate tax.
- Withholding tax on digital transactions - a standalone, gross-based, final withholding tax on certain payments made to non-resident providers of goods and services ordered online.
- Levy on revenues generated from the provision of digital services or advertising activity - a separate levy could be applied to all transactions concluded remotely with in-country customers where a non-resident entity has a significant economic presence[4].

The question about the taxation of digital companies was initially raised by France, which just lost a case against Google regarding the definition of 'permanent establishment' in the French Administrative Court[5]. France supports the first option - implementation of an equalisation tax on turnover - which is also supported by some other EU Member States (Germany, Italy, Spain, Greece, Romania, Portugal, Slovenia, Austria and Bulgaria).

The low-tax countries (i.e. Ireland and Luxembourg) that host the major

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internet giants are strongly opposed to such plans and argue that such an approach is not in line with OECD guidelines. However, should the changes described become effective, these countries might face bigger issues if the digital companies cease to see tax advantages in being based in these countries, since they would no longer be taxed according to Luxembourg's or Ireland's tax law provisions, but in the countries where their services have been consumed/sold the most. Some other EU countries raised concerns about this approach of the EC as well (e.g. Malta).

US business organisations are also concerned about these proposed changes. According to the American Chamber of Commerce, the turnover or 'equalisation' taxes proposed by some EU Member States might substantially reduce the amount of company profits available for investment and reinvestment, with negative effects on jobs and growth. They penalise startups, low-margin companies and loss-making companies because the proposed measures do not seek to tax the value created[6].

A precedent for such a turnover tax was created through the adoption of a so-called IRAP in Italy, which was imposed at the regional level in 2005. The EC claimed that this violated EU VAT laws. The European Court of Justice ('ECJ') ruled, however, that the IRAP did not violate any EU VAT laws. Nevertheless, there were a lot of discussions, even after the decision of the ECJ, about whether the IRAP is really compatible with EU law from a legal, not an economic, perspective[7].

Of course, it is questionable how fast such 'quick fixes' could be applied in practice, as implementation would require time. Supplemental rules and guidance would have to be created and implemented in order to avoid negative consequences for business, such as double taxation in several countries. Plus, in the field of taxation, the EU requires a unanimous decision from all 28 EU Member States, including those low-tax jurisdictions. Nevertheless, it is a sign that the EU would like to change the main principles of taxation in the EU and introduce the destination principle in place of the permanent establishment principle.

Extension of the Mini One Stop Shop ('MOSS') for VAT

Another remarkable development arising from the EU's taxation reform efforts are the planned changes to indirect taxes. Interestingly, a successfully implemented measure of the B2C taxation of electronically supplied services may also be implemented for the physical trade of goods by also implementing the destination principle for the cross-border trade of goods within the EU.

At the beginning of October 2017, the EC announced a legislative proposal for the definitive VAT system for cross-border EU trade[8], i.e. a proposal that would change the EU VAT system. One of the aims of these changes would be to minimise the administrative burden of business and reduce VAT fraud. Among other things, the EC proposes extending the MOSS Scheme to all cross-border supplies of goods and services. This Scheme is already applicable in the field of cross-border supply of electronic services to private individuals in the EU.

According to the EC, the VAT definitive system for intra-EU trade will be based on the principle of taxation in the Member State that is the destination of the goods and services being supplied. According to the EC's proposal, the sellers would have to apply the VAT rate of the country of destination to cross-border transactions. The EU anticipates that the VAT on cross-border sales would be collected by the tax authority of the originating country and transferred to the country where the goods or services are ultimately consumed. Businesses would be able to make their declarations and payments for cross-border VAT via a single online portal and in their own language[9]. This would mean establishing a MOSS for the companies, as they would not have to be VAT-registered in all the relevant countries. Moreover, the companies would be able to report and pay the VAT to the country where the sale is made.

The EC would like to have this new system in place by 2022[10].

Businesses should take these plans of the EU into consideration and observe how they development, as they might strongly influence their financial and tax situation. If the planned changes in connection with the destination principle become effective, businesses might have to revise their business models and restructure their economic activities in line with the consequences for tax.

If we put the above initiatives in the context of other measures that are already in place in some countries (e.g. country-by-country reporting, (near) real-time provision of transactional data to the tax authorities, Standard Audit File for Tax and similar requirements to provide data in a structured electronic format), we can see that transparency will increase and authorities will be able to carry out more comprehensive assessments based on analysis of the data collected. This also means that tax fraud will be easier and faster to detect.

1. PwC and ZEW, Digital Tax Index 2017: Locational Tax Attractiveness for Digital Business Models, page 6, https://www.pwc.de/de/industrielle-produktion/executive-summary-digitaliiserungsindex-en.pdf
2. Communication from the Commission to the European Parliament and the Council of 21 September 2017, page 7, https://ec.europa.eu/taxation_customs/sites/taxation/files/1_en_act_part1_v10_en.pdf
3. Cf. footnote no. 1, page 10.
4. Ibid.
5. Tribunal Administratif de Paris, No. 1505113/1-1, 12 July 2017; http://paris.tribunal-administratif.fr/Actualites-du-Tribunal/Communiques-de-presse/La-societe-irlandaise-Google-Ireland-Limited-GIL-n-est-pas-imposable-en-France-sur-la-periode-de-2005-a-2010
6. http://www.amchameu.eu/media-centre/press-releases/digital-tax-unilateral-eu-action-threatens-growth
7. http://www.empcom.gov.in/WriteReadData/UserFiles/file/2007-60.pdf
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9. http://europa.eu/rapid/press-release_IP-17-3443_en.htm
10. Cf. footnote no. 6.