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A Summary of Criticisms of the EU Digital Tax

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Key Findings

- The European Commission (EC) has introduced two proposals intending to tax digital companies that have significant activity in Europe.
- The long-term proposal is a framework for establishing taxable digital presence in EU countries.
- An interim proposal would tax the revenues from some digital activities of multinational corporations at 3 percent.
- The 3 percent tax on revenues would operate like a tariff impacting multinational companies not based in the EU.
- Both proposals are likely to have a broad impact despite being intended to target just a portion of the economy.
- Several European leaders have weighed in against the proposals with comments recommending a more global solution rather than a European solution to taxing digital activities.
- The proposals rely on redefining how and where value is created, attributing value creation to users who often interact with digital platforms for free.
- The proposed 3 percent tax on revenues for certain digital activities would hurt companies that operate on thin margins and further undermine the business climate in Europe.

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Introduction

The debate over whether the European Union (EU) should adopt a uniform tax on digital services has been developing for several months since the original proposals from the European Commission (EC) came out in March.[1] Many lawmakers and experts have weighed in with varying levels of criticism. These critiques range in content from countries arguing that the proposals impinge on national sovereignty over tax policy to questioning the logic behind the proposals themselves. These various critiques suggest that there is wide disagreement in Europe about the merits of the proposals and that work being done by the Organisation for Economic Co-operation and Development (OECD) may ultimately provide a solution to the matter. As this debate moves forward it is important to understand these critiques.

Summary of the Proposal

On March 21, 2018, the European Commission (EC) released two proposals regarding taxing multinational corporations that provide digital services—a permanent solution and an interim solution.

The first proposal sets out the commission's preferred permanent solution to taxing digital businesses. In the context of defining a comprehensive tax base for corporate income, this proposal provides a framework establishing taxable digital presence. The goal is to adopt a uniform definition of a "Digital Permanent Establishment" in the corporate tax bases across the EU.

Digital presence is defined as a company having satisfied at least one of the following criteria in a European Union (EU) member state:

- €7 million ($8.1 million) in annual revenues
- More than 100,000 users
- More than 3,000 contracts for digital services with businesses in the EU

The proposal would also establish a new method for allocating profits among countries in which a company has significant digital presence. The EC envisions that this proposal for defining significant digital presence and allocating profits for taxation would eventually be adopted into another one of its objectives of establishing a unified corporate tax base across Europe.

Given the time needed to implement the above proposal, the EC released a second, interim digital tax proposal in March. This proposal sets forth a Digital Services Tax, or DST.

1 European Commission, "Fair Taxation of the Digital Economy, accessed Sept. 4, 2018, https://ec.europa.eu/taxation_customs/business/company-tax/fair-taxation-digital-economy_en.

In contrast to the first proposal, the DST would apply to companies with both:

- Total annual worldwide revenues of €750 million ($868 million)
- Total EU revenues of €50 million ($58 million)

The DST would be a turnover tax levied by individual countries at a rate of 3 percent on revenues derived from the selling of advertising space, digital intermediary activities like online marketplaces, and sales of user collected data. These revenue sources are specifically identified by the commission as "revenues created from activities where users play a major role in value creation."[2] The EC calculates that if the 3 percent DST were adopted, it would generate €5 billion ($5.8 billion) per year in revenues for EU member states. This would represent a revenue increase of approximately 0.08 percent relative to total revenue collected by the 28 EU member states in 2016.[3]

The 3 percent DST is designed in such a way that it could impact a broad swath of companies doing business in Europe, not just a small group of arbitrarily defined digital companies. This is because the true burden (or economic incidence) of the tax would fall on users and companies that purchase online ads and place their products on online marketplaces. Just as the costs of sales taxes are passed on to consumers, the cost of this tax would likely be passed on to a multitude of companies that are trying to sell their products over the internet to a broad set of consumers.[4]

Neither the Digital Permanent Establishment nor DST proposals can be implemented at the EU level without the unanimous support of EU member states, though some EU countries are moving forward with similar individual efforts.

Hypothetical Scenario

The EC bases its argument for a special tax regime for digital companies partially on an assertion that those companies are depriving countries of their fair share of tax revenues.[5] The commission points out that companies based outside of the EU earn profits based on user interactions inside the EU and argues that some of the value that digital companies create is derived from the interactions of users and web platforms. The purpose of the two proposals is to tax income generated from that value in the jurisdiction where the users are located.

Let's say an individual in Austria uses Google to search for vacation spots in the Caribbean and clicks an ad sponsored by a Jamaican hotel. The DST would treat revenues from that ad click as partially attributable to Austria and apply a 3 percent tax on those revenues even though the only transaction is between Google and the Jamaican hotel.

2 Ibid.

3 General government revenues across the European Union were nearly €6 trillion ($6.9 trillion) in 2016. http://appsso.eurostat.ec.europa.eu/nui/show.do?dataset=gov_10a_taxag&lang=en .

4 Dr. Matthias Bauer, "Five Questions about the Digital Services Tax to Pierre Moscovici," ECIPE Occasional Paper, April 2018, http://ecipe.org//app/uploads/2018/06/Five-Questions-about-the-Digital-Services-Tax-to-Pierre-Moscovici.pdf.

5 European Commission, "Fair Taxation of the Digital Economy" accessed Sept. 4, 2018,

When this person returns from their Caribbean vacation, they may want to upload pictures to Facebook. Facebook would then have more data on this user that they could use to marginally improve their algorithms for placing future ads. The DST also envisions taxing the revenue attributable to that extra data at 3 percent.

The DST also differentiates between purchases of goods and services over the internet from using digital platforms that do not require payments from users.

Perhaps that same individual also chooses to purchase shoes from the Italian shoemaker Salvatore Ferragamo using Amazon. The sale of the shoes is already subject to the 20 percent value-added taxes (VAT) in Austria and would not be subject to the DST. Instead, the "service" being provided is the online marketplace itself, and the proposed DST would apply to the user's participation in the marketplace. Because this user is situated in Austria, the revenue from the tax on that user's interaction on Amazon would go to Austria.

In each of these scenarios, the individual interacted with the platforms (Google, Facebook, and Amazon) for free. And in each of the transactions, the hard work in delivering products and setting up the transaction was not accomplished by the user.

There were valuable transactions with set prices between Google and the Jamaican hotel, Facebook and its ad buyers, and Amazon and Salvatore Ferragamo (separate from the sale of the shoes). The user played a role as a beneficiary in the transactions.

The user's data is valuable only to the extent that analysts at Google, Facebook, and Amazon are able to identify ways to target ads or improve their algorithms to create more opportunities for that and other users to get value out of interacting with the platforms.

It is important to note that internet access is subject to VAT in both Austria and Italy. Austria levies a 20 percent VAT on telecommunication services and E-Services while Italy applies a 22 percent VAT on those same categories.[6] Though the VAT on internet access would legally be paid by the service providers, the incidence of the tax falls on the consumer of those services—the shoe company and the Austrian tourist. The DST would apply to gross revenues, net of VAT payments.

As shown in the example, attributing users with value connected to revenues would be technically difficult and likely rely on arbitrary assumptions about what user interactions are valuable. This difficult task is driven by some faulty analysis and assertions about the tax burden faced by digital companies.

The fact that users often interact with digital platforms for free poses a serious challenge to assessing value on those interactions for tax purposes. This makes the proposal to allocate taxable profits to countries based on the value that users contribute even more difficult and expensive to implement.[7]

6 European Commission, Taxation and Customs Union, "National VAT Rules," https://ec.europa.eu/taxation_customs/business/vat/telecommunications-broadcasting-electronic-services/vat-rates_en.

7 Michael P. Devereux and John Vella, "Response to the EU Commission's consultation: Fair taxation of the digital economy," Oxford University Centre for Business Taxation, Jan. 3, 2018, https://circabc.europa.eu/webdav/CircaBC/Taxation%20%26%20Customs%20Union/Results%20of%20the%20open%20public%20consultation/Library/Results%20of%20the%20open%20public%20consultation/Individuals/bc31d10a-b132-41a7-8be1-6f5744bcb9ed_Response_to_EU_Consultation_on_DE_Devereux_Vella_Final.docx.

For some countries the cost of implementing the proposals would likely end up exceeding the revenue collected from the tax.[8]

Faulty Analysis

One of the EC's consistent arguments in favor of a specific policy aimed at digital companies is the assertion that digital businesses face significantly lower effective tax rates than traditional businesses. The data that the EC uses to make this claim does not support the assertion.

In the documents released explaining the proposals, the EC claims that digital corporations face average effective tax rates that are less than half of what traditional business faces. However, one of the authors of the study that the commission cites has directly contradicted the use of the data.[9]

Part of the problem with the analysis is it is based on hypothetical business models rather than real industry data. Analysis by the European Centre for International Political Economy (ECIPE) explores real industry data and finds that digital businesses pay slightly higher average effective rates than traditional businesses.[10]

TABLE 1.

Digital companies do not face lower average tax rates in the EU

Effective average tax rate in the EU for international businesses

	Claim by European Commission (percent)	Finding by European Centre for International Political Economy (percent)
Traditional Businesses	23.2	27.1
Digital Businesses	9.5	29.1

Source: Dr. Matthias Bauer, "Digital Companies and Their Fair Share of Taxes: Myths and Misconceptions," ECIPE Occasional Paper, March 2018, http://ecipe.org/app/uploads/2018/02/ECI_18_OccasionalPaper_Taxing_3_2018_LY08.pdf

Note: The European Commission finding is based on an improper analysis of hypothetical companies with traditional or digital business models. The ECIPE data is based on real industry data covering the EuroStoxx50 and the MSCI Digital Services Companies and the Digital Group Companies. The ECIPE Data reflect tax rates averaged over five years.

8 Finland Finance Minister Petteri Orpo has said this is the case for his country. See Joe Kirwin, "EU Races to Solve Issues Hampering Digital Tax Proposal," *Bureau of National Affairs*, Sept. 10, 2018, https://www.bna.com/eu-races-solve-n73014482428/.

9 Jack Schickler, "EU Study's Author Doubts Digital Transactions Undertaxed," Law360.com, March 6, 2018, https://www.law360.com/articles/1019073/eu-study-s-author-doubts-digital-transactions-undertaxed.

10 Dr. Matthias Bauer, "Digital Companies and Their Fair Share of Taxes: Myths and Misconceptions," European Centre for International Political Economy, March 2018, http://ecipe.org//app/uploads/2018/02/ECI_18_OccasionalPaper_Taxing_3_2018_LY08.pdf. Cf. Scott Hodge, "New Study Debunks European Commission Claims Justifying New Taxes on Digital Companies," Tax Foundation, March 19, 2018, https://taxfoundation.org/european-commission-taxes-digital-companies/.

Inefficient and Anti-Growth

As mentioned previously, the 3 percent DST is structured as a turnover tax meaning that it is a tax on gross rather than net income. Historically, turnover taxes have been rejected as poor tax policy because they are inefficient, create barriers to economic growth, and generally considered to be unfair tax policy. In the 1960s, Europe rejected taxing turnover in favor of VATs, favoring efficiency over multiple layers of taxation.[11] The EC proposal would turn back the clock significantly on that effort and damage the ability for digital companies to grow.

Under a turnover tax like the one being proposed, companies that earn revenue from online interactions in an EU country would pay the tax on the revenue from value attributed to those interactions. The tax would still apply even if those companies were not profitable, ignoring the costs associated with the revenues. This type of tax ignores the economic value of transactions and can create cascading effects as the turnover tax applies at each stage of production—regularly resulting in double or triple taxation of the same activity.[12]

Many companies that have very slim profit margins would be significantly impacted by the tax. The 3 percent tax on revenues could have some companies that operate on thin margins facing effective marginal tax rates of more than 50 percent.[13]

Additionally, because the DST would apply just to companies that cross the worldwide and EU revenue thresholds, growing companies could find themselves suddenly subject to a new tax which would hurt their ability to continue to grow. Some companies might spend resources organizing their businesses in such a way as to stay under the relevant thresholds. Implementing a tax that encourages growing businesses to allocate resources to tax compliance or avoidance is neither helpful nor efficient.

With respect to the EU's trading partners, the digital services tax also has the features of a tariff. The thresholds and definitions in the proposal make it likely that most of the revenues raised by the tax would be from multinationals with headquarters outside the EU. In the United States, where the largest of these multinational companies are headquartered, it is likely that the digital turnover tax would fit into the definition of "unreasonable, discriminatory, or unjustifiable" as laid out in Section 301 of the Trade Act of 1974. That provision of U.S. law allows for an investigation of unfair trade practices and avenues for retaliation against the discriminatory trading partner.[14]

11 Tax Foundation, "Tax Harmonization in Europe and U.S. Business," Tax Foundation, Research Publication No. 16, https://taxfoundation.org/tax-harmonization-europe-and-us-business/, Aug. 1, 1968.

12 Turnover taxes are comparable to taxes on gross receipts. For more analysis of the economic impact of these taxes see Justin Ross, "Gross Receipts Taxes: Theory and Recent Evidence," Tax Foundation, Oct. 6, 2016, https://taxfoundation.org/gross-receipts-taxes-theory-and-recent-evidence/.

13 Julian Jessop, "Why the EU's digital turnover tax is a bad idea," European Policy Information Center, http://www.epicenternetwork.eu/wp-content/uploads/2018/09/Why-the-EU%E2%80%99s-digital-turnover-tax-is-a-bad-idea-1.pdf.

14 Gary Clyde Hufbauer and Zhiyao (Lucy) Lu, "The European Union's Proposed Digital Services Tax: A De Facto Tariff," Peterson Institute for International Economics, Policy Brief 18-15, June 2018, https://piie.com/publications/policy-briefs/european-unions-proposed-digital-services-tax-de-facto-tariff.

Discriminatory Tax

Tax policy designed to target a single sector or activity is likely to be unfair and have complex consequences. The digital economy is not something that can easily be separated out from the rest of the global economy. The European Economic and Social Committee asserts that the entire economy is digitalized,[15] and the OECD has previously noted that it would be impossible to separate the digital economy from the rest of the economy for tax purposes.[16]

For instance, German automakers might be impacted by the tax as more and more vehicles are connected to the internet. Income from value attributed to user data that is transmitted back to manufacturers could be hit by the tax. Fashion houses that purchase ads online could see the costs of those ads increase. Online marketplaces may raise the prices that small businesses face when trying to sell products over the internet.

Even if it were possible to focus a tax on just one portion of the economy, this proposal would run counter to good principles of tax policy. Sound tax policy should be simple, neutral, transparent, and stable. The proposed digital tax would fail on nearly every count.

Undermining National Sovereignty

EU member states maintain a significant amount of autonomy in determining fiscal policy. Because of this, the proposal from the European Commission suggesting a single supranational solution to digital taxation has drawn criticism because it undermines the authority that the individual countries have to set their tax policies.

Legislators from several countries including the Netherlands, Ireland, Malta, and Denmark authored "Reasoned Opinions" on the question of whether the two digital tax proposals violate EU policies against overriding national governments on tax policy.[17] For the majority of legislators in each of these countries the answer to that question is "yes." They argue that the proposal undermines the fiscal sovereignty of individual European states, and they point out weaknesses in the EC's case that policy solutions from individual governments are not enough to address the potential problem.

Even though there are clearly challenges to implementing this tax policy at the EU level, many individual countries are pushing forward with their own efforts in a manner similar to the EC DST proposal.

15 Krister Andersson and Petru Sorin Dandea, "Opinion: Taxation of profits of multinationals in the digital economy," European Economic and Social Committee, July 30, 2018, http://data.consilium.europa.eu/doc/document/ST-11484-2018-INIT/en/pdf.

16 OECD/G20 Base Erosion and Profit Shifting Project, "Addressing the Tax Challenges of the Digital Economy," Sept. 16, 2014, https://www.oecd-ilibrary.org/docserver/9789264218789-en.pdf?expires=1536348782&id=id&accname=guest&checksum=57267A41EF1FC1877444EA2CBE874732.

17 See the letter for the Netherlands at http://www.ipex.eu/IPEXL-WEB/scrutiny/CNS20180072/nltwe.do; for Ireland at http://www.ipex.eu/IPEXL-WEB/scrutiny/CNS20180072/iesea.do; for Malta at http://www.ipex.eu/IPEXL-WEB/scrutiny/CNS20180072/mtkam.do; and for Denmark at http://www.ipex.eu/IPEXL-WEB/scrutiny/CNS20180072/dkfol.do.

Duplicative Efforts

Influential voices in many countries have come out against the digital tax proposals from the European Commission partly because the efforts are duplicative of ongoing discussions at the OECD.[18] The OECD has been discussing issues of the digital economy for several years including during their efforts on Base Erosion and Profit Shifting (BEPS), which is scheduled to release tax proposals on the digital economy in 2020.[19] Some charitable interpretations of the EC's efforts allow that the proposals are a constructive contribution to the broader discussion at the OECD.[20]

Conclusion

The complex debate around the European Commission's digital tax proposal suggests that there is a long way to go before consensus is reached on digital taxes. As many analysts have noted, it is becoming more and more difficult to cordon off part of the economy as "digital" these days. Because of that, a digital tax of this nature is likely not to just tax a group of arbitrarily defined digital companies, but also a much broader set of businesses. It would be unfortunate to have a poorly designed tax become an impediment to growth for innovative businesses and damage the potential for digital services to improve the lives of individuals.

18 Magdalena Andersson, Kristian Jensen, and Petteri Orpo, "Nordic states urge U-turn on EU digital tax plans," euobserver.com, June 1, 2018, https://euobserver.com/opinion/141966.

19 See OECD, "Brief on the tax challenges arising from digitalisation: interim report 2018," https://www.oecd.org/tax/beps/brief-on-the-tax-challenges-arising-from-digitalisation-interim-report-2018.pdf.

20 Cf. Krister Andersson and Petru Sorin Dandea, "Opinion: Taxation of profits of multinationals in the digital economy."