Taxing the digital economy: Is the DST the right solution?

Given the lack of progress on an EU-wide proposal, increasing digitalization of commerce has prompted several Member States to adopt their own Digital Services Tax (DST). Going forward, should agreement be reached at the international level, this would help address some of the unique structural and design challenges associated with DSTs, enhancing the overall efficacy of the tax.

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Abstract: The emergence of digital business models and the differing definitions of taxable presence adopted by countries has led to the significant erosion of tax bases and profit shifting (BEPS) from high-tax countries to low-tax jurisdictions. Although the EU Commission's proposal represents the most advanced and structured attempt to incorporate the concept of a virtual permanent establishment (PE) into the international income tax legal framework, resistance from some Member States has placed it on hold. Consequently, some Member States, including Spain, have introduced their own Digital Services Tax (DST). While implementation issues may be common to many taxes, there are unique structural and design challenges inherent to the DST. In terms of the former, there are issues relating to under which circumstances the DST applies, who would bear the burden of the levy, and the characterization of the equalization tax. The design issues focus on the taxable base, the scope, the rate, and the enforcement of the tax. In light of

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these challenges, an international approach would ultimately be better suited to achieve a multilateral and long-term solution to the international tax issues raised by the digital economy.

Introduction

In recent years, new digital business models have emerged, which have made many of the traditional criteria for identifying a taxable presence in a certain jurisdiction – *i.e.,* residence and permanent establishment (PE) – outdated, as they imply a physical connection to the country. With this in mind, several multinational enterprises (MNEs) have designed their supply chains in such a way that limits their taxable presence in high-tax countries (Allevato, 2019). Relatedly, certain jurisdictions have enacted and granted MNEs extremely favorable tax treatments – especially through advance rulings (Allevato, 2018).

All of this has resulted in the significant erosion of tax bases and profit shifting (BEPS) from high-tax countries (*i.e.,* the source and market countries of most of the digital businesses) to low-tax jurisdictions (OECD, 2013). To address the growing importance of the digital economy and its related tax challenges, most OECD countries have developed responses in an attempt to preserve or re-establish their taxing power.

In particular, over the last decade, the tax policy-making discussion, at both the domestic and international level, has revolved around two main sets of countermeasures, which, in principle, contradict each other. On the one hand, there is the attempt to restructure the existing international corporate income tax legal framework, and on the other hand, there has been the development of a completely new international tax legal framework to tax the digital economy.

The first option would implement substantial adjustments to the existing corporate income tax framework. Such adjustments would enable source countries to exercise their taxing powers over multinational companies that have a significant market presence within their territory. Such changes would re-align the taxable presence to the market presence, without ring-fencing multinational digital firms from other traditional businesses. To achieve the realignment of taxable and market presence, some scholars have advocated the continued use of the corporate income tax with the introduction of a new concept of virtual PE, which would apply whenever there exists a significant digital presence in the source country.

Prominent scholars advanced the proposal for a virtual PE to solve the BEPS issue (see Collin and Colin, 2013). In 2018, the OECD also discussed it in its Interim Report (OECD, 2018) and, most importantly, since then it has been the subject of the EU Commission's directive proposal (European Commission,

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2018b). All these proposals maintain that source countries should be entitled to tax cross-border business income anytime a foreign enterprise has a significant digital presence within their territory. [1] By now, the EU Commission's proposal represents the most advanced and structured attempt to incorporate the concept of a virtual PE into the international income tax legal framework. [2]

However, this proposal encounters two feasibility problems. First, the introduction of the virtual PE requires unanimous consensus to be effective, at least among all the jurisdictions that are part of a certain economic and geographical region, which, in the case of the EU Commission's directive proposal, includes all EU member countries. Otherwise, the effectiveness of the virtual PE would vanish or be weakened, similar to the amendments to the treaty concept of PE in the Multilateral Instrument (MLI), [3] which are currently impaired by the fact that certain key-jurisdictions, such as the United States, have not signed it or made reservations on certain measures. Second, the significant digital presence threshold would not apply to European-sourced income derived by corporations that are resident of an extra-EU country with which the EU source country has entered into a Double Tax Treaty (DTT). In such cases, the traditional PE threshold would continue to apply.

Implementing a new tax paradigm

Although the adoption of the virtual PE can theoretically represent a technically appropriate systematic solution to the BEPS issue, its practical implementation could actually prove ineffective and extremely time consuming to adopt. The question thus revolves around what can be done in the meantime. An increasing number of scholars, policy makers, and governments have considered implementing new types of taxes, which would enable source/market countries to collect tax revenues based on where the users of the digital firms are located (Kofler, Mayr and Schlager, 2017). On this subject, the public debate has reached an advanced stage, with some countries having already adopted their own new taxes. Among these new levies, the so-called "Digital Services Tax" has currently gained most of the attention of policy-makers and governments. While implementation issues may often accompany the introduction of many new taxes, there are specific challenges inherent to the implementation of a DST. Therefore, the next paragraphs will be dedicated to the main features and challenges related to the implementation of such a levy.

The Digital Services Tax

The Digital Services Tax (DST) belongs to the category of taxes defined as "equalization levies", since, as stated by the OECD in the BEPS Action 1's Final Report, this levy represents a type of excise tax on digital transactions aimed at compensating for the "lost" profit taxes whose effectiveness is impaired by the development of new business models (see Collin and Colin, 2013). The ultimate policy aim of the DST is to tax large non-resident taxpayers, which have a significant economic and market presence in a source/market country but do not meet the PE threshold.

India was the first country that unilaterally adopted and concretely implemented the DST. Such a levy, which corresponds to a 6% tax rate applicable to revenues from digital transactions, is a withholding tax on payments to foreign companies for online advertising services provided to Indian businesses, or to PEs of other non-resident enterprises. [4] Being a withholding tax, it poses a significant compliance burden on the Indian client, although the actual taxpayer is the non-

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resident advertiser. The significant economic presence threshold for the application of the equalization tax is met if the annual aggregated value of the payments exceeds USD 15,000.

In March 2018, the EU Commission released a directive proposal for an EU-wide DTS (European Commission, 2018a) along with the already-mentioned directive proposal for the adoption of a significant digital presence concept. Both proposals are part of a plan drawn up by EU institutions to cope with the tax challenges associated with the digital economy.

According to the EU Commission's proposal, the DST will apply to gross revenue, net of value added tax arising from the provision within the EU territory for the following categories of digital services:

- Placing a digital interface of advertising targeted at users of that interface;
- Making a multi-sided digital interface available to users, which allows them to find other users to interact with, and which may also facilitate the provision of underlying supplies of goods or services directly between users; and,
- Transmitting data collected about users and generated from users' activities on digital interfaces.

The common feature of these services is the strong reliance on user participation and data obtained from users.

Due to the mounting opposition from Ireland and the Nordic Member States in the ECOFIN meeting of May 2019, the project for the implementation of an EU-wide DST is currently on hold and, most likely, will not be concluded anytime soon. [5] Hence, the scenario is fragmented with some Member States unilaterally going ahead and introducing their own DST, while others have refused any action at all. As of October 2020, Austria, France, Hungary, Italy, Poland, and Spain [6] have adopted a DST, while Belgium, the Czech Republic, and Slovakia have published proposals for the enactment of a DST (Asen, 2020). Although most of these implemented or proposed DSTs substantially attempt to mirror the EU Commission proposal, they differ significantly in their structure.

In the following paragraphs, several structural and design characteristics of Member States' DSTs will be discussed, with a particular focus on the Spanish DST.

Structural issues

The first structural characteristic concerns the circumstances under which a DST applies, namely only to digital service transactions. This contravenes the economic concept of tax neutrality [7] and would thus ring fence the digital economy industry. This may end up unduly favoring firms operating in other industries, *i.e.,* those whose core business does not fall under the umbrella of the digital economy. Indeed, as some scholars rightly argue, nowadays, even traditional businesses rely on intangible assets, data collection, and digital platforms to offer their products and services remotely. It is therefore unclear why only fully-fledged digital businesses' transactions should be tax liable (see Olbert and Spengel, 2019).

An additional element which may influence the effectiveness of equalization levies is

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whether the burden of such a levy would ultimately be borne by the service provider or by other weaker players. Indeed, the fact that large businesses will be legally subject to the tax does not necessarily imply that such a tax will ultimately be borne by them or by their shareholders. There is plenty of evidence showing that businesses with strong market power – which is the case for the large MNEs targeted by the DST – are able to pass on the tax burden to consumers. [8] Some authors have even warned that part of the tax burden can be borne by suppliers (Dyreng *et al.,* 2019) or employees (Fuest, Peichl and Siegloch, 2017). Making the DST deductible from the corporate income tax would help avoid such risks.

Finally, the general concern among scholars is the characterization of the equalization tax. Although the aim is to re-establish source countries' taxing power over business income generated within their territories and compensate for corporate income tax revenue losses, there is a consensus that this would not qualify as an income tax because the taxable base is derived from gross revenues rather than profits. Also, the Spanish DST is expressly characterized by law as an indirect tax, which places the equalization tax outside of the scope of the existing tax treaties. From a policy perspective, the advantage would be that the application of such a tax would not be in violation of the DTTs (*i.e.,* Article 7 or Article 5 of DTTs). The disadvantage would be that countries of residence of multinationals would not have a duty to grant relief (*i.e.,* tax credit or a deduction) for the equalization tax paid in the source countries. This would constitute a serious double taxation issue if the equalization taxes were to be levied on tax-payers resident in high-tax countries. [9]

Design issues

The main design questions concerning the DST center on the determination of the taxable base, the scope, the rate, and the enforcement of the tax (see Kofler, Mayr and Schlager, 2017).

The first design issue is constituted by the fact that, since the DST applies to gross revenues, loss-making businesses would in principle also be subject to the payment of the tax. However, if loss-making businesses were tax liable without any relief (*e.g.,* tax losses carryforward or tax losses carryback), this could distort investments (Bethmann, Jacob and Müller, 2018), put start-up firms at a disadvantage, discourage entrepreneurship (Cullen and Gordon, 2007), and even create additional profit shifting incentives (De Simone, Klassen and Seidman, 2017). According to proponents of the DST, the only cost which should be deductible from its taxable base is the VAT. As such, no other business expenses would be tax deductible from gross revenues. Such a feature may trigger cascade effects from the DTS not just on intra-group transactions (unless such transactions were excluded from

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the DST, as most governments and policy makers advocate), but also on transactions between independent platforms (Di Tanno and Marchetti, 2019). Therefore, appropriate mechanisms should be introduced to prevent such risks.

As far as the scope of the DST is concerned, an issue that has been extensively discussed is whether such a tax should apply only to cross-border transactions or whether it should also apply to purely domestic transactions. As argued so far, it is clear that the ultimate target of such a tax should be to tax cross-border digital transactions due to the misalignment between the market presence and the taxable presence of MNEs in the source countries. However, narrowing the scope of the application of an equalization levy to the revenues arising from cross-border digital transactions would likely raise WTO law and EU law issues because of the discriminatory nature of such a choice (see Kofler, Mayr and Schlager, 2017). This is the reason why both the EU and most Member States which have recently adopted a DST – including Spain – have opted to extend the scope of application to purely domestic transactions.

Other sensitive aspects entail the definition of "digital transactions" and the criteria to determine the threshold for the application of the tax, *i.e.* the significant economic presence. One of the biggest problems arising from the fragmentation of the various EU Member States' unilateral initiatives after the failure to approve the EU Commission-proposed EU-wide DST is the fact that each country made different choices in regard to the definition of digital transactions falling within the scope of application of their DST. Some of them – like Italy and Spain [10] – tried to strictly mirror the scope as defined in the Commission's proposals. Others, deviated significantly. [11]

Furthermore, most policymakers claim that the DST should be paid only in regard to services rendered by businesses that have a significant economic presence. For example, in its proposal for the implementation of a EU-wide DST, the EU Commission has established that the tax is due only by those businesses which, in a given fiscal year, have reached at least 750 million euros of total annual worldwide revenues and 50 million euros of annual intra EU revenues arising from digital transactions. Most of the EU Member States which have so far unilaterally introduced the DST have adopted the same revenue thresholds as the EU Commission's proposal (although they have adapted the internal market threshold to the size of their domestic market). In particular, the Spanish DST will apply to service providers featuring more than 750 million of total annual worldwide revenue and 3 million euros of total annual revenue arising from digital activities in Spain. Special rules for corporate groups are also set forth.

In order to determine whether an entity surpasses the thresholds, the entire group turnover will be considered. If such turnover meets the two thresholds, any entity belonging to the group will qualify as a potential taxpayer. While such thresholds provide firms with certainty about the applicability of the DST, they could also provide firms with incentives to report or manipulate revenues by keeping revenues just below the thresholds triggering the tax. This opportunistic behavior (*i.e.,* so-called "bunching") would not be surprising – since firms respond to incentives – as has been extensively documented in the prior literature (see Almunia and Lopez-Rodriguez, 2018). Such threshold issues are exacerbated when MNEs, which by definition operate in multiple jurisdictions, report their financial information using different accounting standards (Balakrishnan *et al.,* 2019).

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As for the tax rate, there is the risk that countries may start competing with each other by setting lower tax rates. Indeed, prior experience with the corporate income tax have shown that countries compete with each other over mobile tax bases by setting lower tax rates (Devereux and Loretz, 2013). It therefore follows that countries could even engage in tax competition over the equalization tax, and this would raise tax arbitrage and base erosion issues. Such problems have already materialized, with Poland setting its rate at 1.5% compared with France, Italy, and Spain who set their DST rate at 3%, Austria and the Czech Republic who adopted a 5% tax rate, and Hungary's 7.5% rate (see Asen, 2020).

With respect to the enforcement of the DST, there is the question of whether countries adopting this levy should rely on the client of the digital services to act as a withholding agent, similar to the Indian equalization tax, or whether the compliance burden should be placed on the service provider. Choosing one option over the other is particularly relevant for cross-border transactions. With the withholding mechanism, the source country would collect the tax, which is in line with the policy rationale of the equalization levy. However, this solution would impose a compliance burden on the client of the digital services, which could be particularly burdensome for business-to-customer transactions. Conversely, placing the compliance burden directly on the service provider would provide relief to clients but it could also prove extremely complex and require significant monitoring activities. This latter policy option has been chosen by the EU Commission and by all of those Member States that have unilaterally introduced a DST, including Spain, whose DST would require service providers to file periodic returns for the computation of the required tax amount, and would also impose on providers not established in Spain the appointment of a tax representative.

Either way, since the policy rationale of the equalization tax is to re-establish the taxing power of the source countries over digital transactions, the application of an equalization tax will always require setting forth clear rules to determine where an online service takes place. This is not an easy task at all for policy makers, since various rules may be available and choosing between them may lead to extremely different consequences and results. [12] And different countries may choose different rules and criteria, therefore creating room for international tax fragmentation and thus excessive compliance burden or tax arbitrage.

Finally, there are inconsistencies among countries about whether the DST should follow cash or accrual accounting to identify when the tax is due. Choosing one option over the other may have significant practical implications.

As far as the Spanish DST is concerned, digital services falling within the scope of its application are deemed to be connected to the Spanish territory, and thus taxable, when their users are located in Spain. Importantly, specific rules have been developed for each type of digital service. These rules are centred on the place where the electronic devices of the users have been utilized, which is determined by means of their internet protocol address (IP) or other means such as the devices' geolocation. [13]

It is also worth noting that, according to the relevant Spanish law and its Explanatory Memorandum, the DST will be triggered when the user is deemed to be located within the Spanish territory at the time of the digital

interaction, regardless of whether a monetary payment takes place. [14]

Final remarks

The aforementioned paragraphs have illustrated how, in deciding whether and how to implement a DST, a government should take many structural and design questions into consideration. The response to such policy challenges is multifaceted, and its implementation and implications are difficult to plan and estimate due to the borderless nature of the digital economy's businesses.

Such complexity and uncertainty is exacerbated if, instead of proceeding in a multilaterally coordinated way, countries belonging to the same market region end up resorting to unilateral measures, as is the current trend.

The EU Commission argues "divergent national approaches within the EU can fragment the Single Market, increase tax uncertainty, destabilize the level playing field and open new loopholes for tax abuse." (European Commission, 2017) In this regard, longstanding literature on tax competition dating back to the seminal works of Wilson (1986) and of Zodrow and Mieszkowski (1986), along with the policy recommendations of the EU and the OECD against "harmful tax competition" (*i.e.,* the so-called "race to the bottom"), shows that countries strategically compete over mobile tax bases (European Commission, 1997), and this eventually raises tax arbitrage and base erosion issues.

Given the aforementioned challenges, an international approach would be preferable to achieve a multilateral and long-term solution to the international tax issues raised by the digital economy.

In particular, the international community – specifically, the OECD and the G20, which have established the OECD/G20 Inclusive Framework on the Base Erosion and Profit Shifting project (BEPS) – agreed on a Programme of Work leading to the enactment of substantial adjustments to the current international tax legal framework, aimed at resolving the tax challenges arising from the digitalization of the economy (OECD, 2019). The Programme of Work is based on two pillars:

- The revision of the profit allocation and rules, in order to achieve an apportionment of taxing powers between the jurisdictions involved by the MNEs' businesses which could be deemed to be more consistent with the actual digital and economic presence and the value creation (Pillar 1).
- The design of a system aimed at ensuring that MNEs – in the digital economy and beyond – pay a minimum level of tax (Pillar 2).

For both Pillars, the OECD has released consultation documents advancing technical solutions, [15] which require coordinated changes to domestic law and tax treaties. This Programme of Work returns to the idea of cooperative multilateral actions aimed at revitalizing the effectiveness of the corporate income tax and the achievement of its revenue-raising, redistributive and regulatory purposes on a global scale, rather than shifting to a new international tax paradigm and framework based on new taxes. On October 12th, 2020, two reports on the state of the discussion on the implementation of Pillar 1 and Pillar 2 (so-called "Blueprints") have been released, and the Inclusive Framework on BEPS now aims at reaching political agreement by mid-2021. [16] This aim has been confirmed also during the G20 meeting of November 22, 2020. [17] This makes it worth postponing, where it is still possible, the implementation of the DST.

Notes

[1] For an in-depth analysis of the EU Proposal for the introduction of the "significant digital presence" concept, please see Escribano (2018).

[2] Specifically, a foreign enterprise should be deemed to have a "significant digital presence" in the source country anytime it: (i) generates over €7 million annual revenues from digital services; or, (ii) has more than 100,000 users accessing their digital services; or, (iii) concludes over 3,000 business contracts for digital services in the member country.

[3] Multilateral Convention to Implement Tax Treaty Related Measures to Prevent Base Erosion and Profit Shifting, available at https://www.oecd.org/tax/treaties/multilateral-convention-to-implement-tax-treaty-related-measures-to-prevent-beps.htm

[4] This tax was introduced in 2016. For more details, please see Wagh (2016).

[5] 'Nordic countries oppose EU plans for digital tax on firms' turnover', Reuters, 1 June 2018, available at https://www.reuters.com/article/us-eu-digital-tax/nordic-countries-oppose-eu-plans-for-digital-tax-on-firms-turnover-idUSKCN1IW337

[6] Spain's DST has been introduced by means of Law No. 4/2020, approved by the Spanish Congress and Senate, and published in the *Spanish Official Gazzette* on October 16th, 2020. The DST will apply from January 16th, 2021.

[7] A central theme in the design of corporate tax systems is the neutrality of taxes with respect to investment decisions (*e.g.,* tangible and intangible assets). See, Sandmo (1974) and Auerbach, Devereux and Simpson (2008).

[8] As Fullerton and Metcalf write "the standard assumption about the corporate income tax that the burden falls 100% on capital is commonly believed to be false." (Fullerton and Metcalf, 2002).

[9] The OECD has suggested that the levy be structured "to apply only to situations in which the income would otherwise be untaxed or subject only to a very low rate of tax". However, the OECD does not provide detail as to how such an alignment between the corporate income tax and the equalization tax should be concretely achieved. See OECD (2018) 115 and 364.

[10] According to the legislation ultimately approved by the Senate, Spain's DST, like the proposed EU-wide DST, should apply to: *a)* Online advertising services targeted at users; *b)* Online intermediary services; and, *c)* Data transmission services. Furthermore, most of the digital transaction excluded from Spain's DST would coincide with those situations noted in the EU's proposed directive.

[11] For example, the Austrian and the Hungarian taxes target exclusively online advertising transactions. See Asen (2020).

[12] For example, in cases of transactions leading to data transfer, the Spanish draft law set forth a legal presumption that the location of any digital device corresponds to the IP address.

[13] More specifically, in the case of targeted advertisement, the amount of times the add appears on the device of users located in Spain during the relevant tax period will be taken into account. Regarding the intermediary services, the connection to the Spanish territory shall be assessed based on the number of users involved in such operations during the tax period, using a device in Spain. As to the transmission of users' data, the allocation of taxable revenues to Spain will correspond to the number of users located in Spain who are involved in the generation of the data transmitted during the tax period in question. See Explanatory Memorandum, Section VI.

[14] Explanatory Memorandum, Section VII.

[15] "OECD invites public input on the Secretariat Proposal for a "Unified Approach" under Pillar One", available at https://www.oecd.org/tax/oecd-invites-public-input-on-the-secretariat-proposal-for-a-unified-approach-under-pillar-one.htm; "OECD secretariat invites public input on the Global Anti-Base Erosion (GloBE) Proposal under Pillar Two", available at https://www.oecd.org/tax/oecd-secretariat-invites-public-input-on-the-global-anti-base-erosion-proposal-pillar-two.htm

[16] *OECD/G20 Inclusive Framework on BEPS invites public input on the Reports on Pillar One and Pillar Two Blueprints,* available at https://www.oecd.org/tax/beps/oecd-g20-inclusive-framework-on-beps-invites-public-input-on-the-reports-on-pillar-one-and-pillar-two-blueprints.htm.

[17] G20 Summit: G20 leaders united to address major global pandemic and economic challenges, 22 November 2020, available at https://www.consilium.europa.eu/en/press/press-releases/2020/11/22/g20-summit-g20-leaders-united-to-address-major-global-pandemic-and-economic-challenges/

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