# Taxing permanent establishments in digital economy (2/34/18)

The European Commission has issued several proposals aimed at setting up a fair and effective tax system for the digital single market after the OECD published an interim report on tax challenges arising from digitisation on 16 March 2018. This article provides a summary of the proposals.

The proposals

The first proposal aims to reform corporate tax rules so that profits are registered and taxed where businesses have significant interaction with users through digital channels. This is the Commission's preferred long-term solution.

The second proposal responds to calls from several member states for an interim tax covering the main digital activities that currently go untaxed in the EU.

Background

A taxation policy that specifically targets the digital economy has been a hot issue in the EU due to the recent boom in digital businesses, such as social media companies, collaborative platforms, and online content providers. Today's global tax systems have not been designed to administer virtual companies or companies with no physical presence.

Unlike traditional-economy businesses, companies that are part of the digital economy are able to generate significant revenues in foreign countries without the need to establish entities, set up offices, or employ staff. The existing international taxation policy assumes the need for a certain level of physical presence (e.g. an office, a factory or a workshop) in a foreign country before any significant or stable revenues can be generated. Only a company with a physical presence, i.e. a permanent establishment (PE), is usually subject to taxes levied in the foreign country.

As for the Commission's proposals, member states seek permanent and lasting solutions to ensure a fair share of tax revenues from online activities.

The main issues

- An unfair system. Traditional companies carry a heavier tax burden than digital ones do.
- Diminished tax revenues. Member states are unable to recognise the place of the actual revenues of digital companies.
- The need for a stable and competitive environment for digital companies. The EU needs modern, fair and growth-friendly tax rules to support the growth of the digital single market.

Reforming corporate tax rules for digital activities

This proposal would enable member states to tax profits a company generates in their territory even if it does not have a physical presence there. New rules would ensure that digital companies contribute to public finances at the same level as traditional companies.

A digital platform will be considered to have a taxable digital presence (or a virtual PE) in a member state if it fulfils one of the following criteria:

- It exceeds a threshold of EUR 7 million in annual revenues in that member state;
- It has more than 100,000 users in the member state in a tax year;
- Over 3,000 business contracts for digital services are created between the company and business users in a tax year.

The new rules would also change the way profits are allocated to member states in order to better reflect the way companies can create value online, e.g. depending on where the user is based at the time of consumption. Thus, the new system would secure a real link between where digital profits are made and where they are taxed.

Interim tax on certain revenues from digital activities

The interim tax would ensure that any activities that are currently not effectively taxed would begin to generate immediate revenues for member states.

Unlike the EU reform of the underlying tax rules, this indirect tax would apply to revenues arising from certain digital activities that escape the current tax framework. This system would apply only as an interim measure until the comprehensive reform is implemented, and it has inbuilt mechanisms to minimise the possibility of double taxation.

The tax would be applied to revenues generated from activities in which users play a major role in value creation and which are the hardest to capture with current tax rules, such as revenues generated by –

- selling online advertising space;
- digital intermediary activities that allow users to interact with other users and can facilitate the sale of goods and services between them;
- selling data gathered from user-provided information.

Tax revenues would be collected by the member states in which the users are located and would only apply to companies with total annual worldwide revenues of EUR 750 million and EU revenues of EUR 50 million. This would help ensure that smaller startups and scale-up businesses remain unburdened. Member states are expected to generate an estimated EUR 5 billion in revenues a year if a 3% tax is applied.

Recommendations

The Commission recommends that member states should enter into double tax treaties with non-EU countries in line with the proposed changes. The Commission also suggests amending the existing double tax treaties as follows:

- Change the PE definition to take account of situations where a company has a significant digital presence in a given jurisdiction;
- Include rules for attributing profits to a significant digital presence in line with the Commission's proposals.