# Taxing the digital economy in Europe: The proposed EU legislation for corporate taxation of significant digital presence

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Shafi U Khan Niazi

Monash Business School, Monash University

**Abstract:** The article examines the proposed EU legislation on issues concerning the "taxable presence" of businesses in the arena of the digital economy. Traditionally, the concept of permanent establishment (PE) has long remained - and still is - a significant tool of international tax rules in determining the economic and taxable presence of businesses in a jurisdiction. The traditional PE notion (e.g., Art. 5 of the OECD Model Convention) draws mainly on the physical-existence indicators of the enterprise in a jurisdiction for allocation of taxing rights to that jurisdiction. The existing PE concept, however, does not consider the digital environment where cross-border economic activities may take place without the physical presence of enterprise, raising tax issues as foreseen under Actions 1 and 7 of the OECD/G-20 BEPS plan.

The EU initiative focuses on this realm by presenting two legislative drafts, one as a long term solution by introducing the concept of significant digital presence, and the other a temporary measure seeking to levy a 3% digital service tax until the long term solution is adopted. The draft laws aim at addressing the rising challenges to taxing the digital economy in the European single market. The draft law views that the existing international tax rules conceived some hundred years ago are largely based on the concept of physical presence of traditional "brick and mortar" business models that fail to capture the taxable existence of the digital enterprise. The proposed law attempts to provide a solution to the challenges posed by the rapidly changing business models of the digital arena in the EU single market.

The proposed legislation on significant digital presence considers new indicators to determine the taxable presence of digital enterprise that otherwise does not require physical existence to carry out transnational business. In this context, the draft law sets out new rules to establish the taxable nexus of cross-border digital companies and offers a concept of "significant digital presence" to extend the definition of PE in the European Member States. In order to determine the attribution of profits, the proposed rules take into account the functional analysis and consider the economic activities performed by the significant digital presence incidental to the development, enhancement, maintenance, protection, and exploitation of the intangible assets of the enterprise. This article examines some of the key provisions of the EU initiative and offers certain comments with a particular focus on the EU single market.

## 1. The Context

In recent years, challenges raised by the problems of taxing the digital economy has attracted an increased amount of attention of public finance analysts and those dealing with the corporate tax reforms worldwide. The issue is central to the global tax agenda foreseen under the base erosion profit shifting (BEPS) project of the OECD/G-20,[1] and lies at the heart of Action Plan 1 of the project on the tax challenges of the digital economy.[2] The global efforts to seek a multilateral solution are ongoing as indicates the OECD 2018 interim report on the tax challenges arising from digitalisation concerning international tax reforms on the concept of permanent establishment (PE) and the incidental matters.[3] However, since the global consensus has so far has proven challenging in this domain, unilateral solutions contemplated by nations are on the rise.[4]

The European Union (EU), which is long striving to institute a digital single market in Europe, has adopted a proactive approach and taken an ambitious position on addressing the challenges of fair and optimal taxation of the digital economy. In September 2017, the European Commission published a powerful foundational document on the taxation of digital economy.[5] The document highlights the rationale behind an increasing need to move rapidly towards finding solutions to the tax-related problems surrounding the digital economic arena.

The Commission stresses an ever-increasing need for a change in the paradigm of the taxable presence of digital business entities triggered by the structure and function of the rapidly transforming cross-border digital business model. It underpins the exponential growth of digitalised business in the EU by offering a periodical comparison: while in 2006, there existed

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[1] OECD, *Addressing Base Erosion and Profit Shifting* (Paris: OECD Publications, 2013); OECD, *Action Plan on Base Erosion and Profit Shifting* (Paris: OECD Publications, 2013).

[2] OECD, *BEPS 2015 Final Reports*, Action 1 (2015), at http://www.oecd.org/tax/addressing-the-tax-challenges-of-the-digital-economy-action-1-2015-final-report-9789264241046-en.htm.

[3] OECD, *Tax Challenges Arising from Digitalisation – Interim Report 2018* (2018), at https://read.oecd-ilibrary.org/taxation/tax-challenges-arising-from-digitalisation-interim-report_9789264293083-en#page1.

[4] See, e.g., Nana Ama Sarfo, "Finding Middle Ground over Unilateral Digital Taxation" (2018) 72(4a) *Bulletin for International Taxation* 1–4.

[5] European Commission Communication on a Fair and Efficient Tax System in the European Union for the Single Digital Market, *COM(2017) 547 final* (21 September 2017).

only one digital company (worth 7% of the market capital) in the top 20, which grew sharply to 9 (worth 54% of the market capital) of the top 20 companies in 2017.[6] Likewise, compared to average revenue growth of 1% per year during the period 2008–2016 in the entire retail sector, the revenue growth for the top five e-commerce retailers was voluminous, recording a sharp increase at the rate of 32% per year for the same period.[7] Alongside the exponential growth in the number and size of digital firms, the Commission, at the interface of growing digital business phenomenon and tax incidence, also notes a sharp disparity in the taxation of digital and traditional firms. It observes that the digital business model is subject to an effective tax rate of 8.5% that is less than half of the effective tax rate of the traditional business model.[8]

Against the above backdrop, the foundational document of the Commission sets out the key issues of the taxation of the digital economy and growing needs to address these issues in EU. The Commission, foremost, raises questions on the compatibility of traditional international tax rules to the concept of transnational taxable presence of businesses. The Commission notes that the old rules were designed almost a century ago keeping in view the "brick and mortar" businesses and are now unable to capture the economic activities of digital companies that creates a disconnect between the place of value creation and place of taxation.[9] Consistent with the operation of digital models where businesses are conducted transnationally without physical existence in across various jurisdictions, the Commission underscores increasing need to review the concepts of "where to tax" and "what to tax" as envisaged under the existing international tax rules.[10] The current notion of "where to tax" and "what to tax", conceived under the international tax rules on PE and attribution of profits are anchored in the notion of a physical presence of businesses and adopt traditional approaches to determine the value creation processes. The Commission views that owing to the digital business model, a firm can have significant economic presence in a taxing jurisdiction without being present there physically; likewise, intangible assets such as the data

[6] Ibid, at 4 (citing Global top 100 companies by market capitalisation PWC, 2017; Financial Times Global 500 database, 2016).

[7] Ibid (citing Bloomberg and Eurostat databases, accessed on 13 September 2017).

[8] Ibid, at 5 (citing Digital Tax Index of PWC and ZEW, 2017).

[9] Ibid, at 5.

[10] Ibid, at 7.

on habits, demand, and choices of users are the new value drivers of the digital economic activities, challenging the existing framework of cross-border tax system.[11]

In addressing these challenges, the Commission is of the view that it acknowledges the ongoing OECD/G-20 work on addressing the tax challenges of digital economy as the ultimate long-term holistic solution; however, the Commission argues that it is also conscious of the challenges posed by the lack of global consensus in that policy realm.[12] The Commission, therefore, commits itself to explore all possible options at the EU level until a global agreement is achieved in the long run. The Commission is of the view that any EU level action in this area should focus on bringing more fairness in the taxation of digital businesses, maintaining the competitiveness of European firms, preserving the integrity of the EU single market and sustaining the corporate tax system in the digital arena.[13] To that end, the Commission suggests three possible alternative options: the introduction of (1) an equalisation tax on the turnover of digitised companies, (2) a withholding tax on digital transactions, or (3) a levy on the revenue generated from providing the digital services or advertising activity.[14]

In October 2017, the European Council, which consists of the Head of States of EU nations, acknowledged the Commission's efforts and emphasised an increasing need to ensure "an effective and fair taxation system fit for the digital era."[15] In December 2017, the Economic and Finance Council (ECOFIN Council), which comprises of the Finance Ministers of EU Member States, highlighted the need to revisit the international tax rules to explore an appropriate nexus between the digital PE and related changes in the rules on transfer pricing and profit attribution that better capture the business activities of the digital era.[16] The ECOFIN Council also stressed a need for an interim EU level action in this policy area until a

[11] Ibid, at 7, 9.
[12] Ibid, at 7, 8.
[13] Ibid, at 8.
[14] Ibid, at 10.
[15] Conclusions of European Council Meeting, doc EUCO 14/17, 19 October 2017, P. 7, available at https://www.consilium.europa.eu/media/21620/19-euco-final-conclusions-en.pdf (last accessed 10 September 2018).
[16] ECOFIN Council conclusions on responding to the challenges of taxation of profits of the digital economy, doc 1545/17 (5 December 2017), para 17, available at http://data.consilium.europa.eu/doc/document/ST-15445-2017-INIT/en/pdf (last accessed 10 September 2018).

broader consensus is achieved at the international level.[17] Amid these developments, the Commission undertook a public consultation on the "fair taxation of the digital economy"[18] before presenting a package on the taxation of digital economy including the draft legislation at hand, examined in the following section.

## 2. The EU Initiative on Taxation of Digital Economy

Growing on its foundational document discussed in the previous section, the Commission, on 21 March 2018, presented a package on the taxation of digital enterprises in EU which includes:

- a legislative proposal in the form of a draft directive on significant digital presence (SDP Directive),[19] termed as a comprehensive long term solution for determining the taxable presence of digital firms;
- a legislative proposal in the form of a draft directive to levy a digital service tax (DST Directive) as an interim measure;[20]
- a communication explaining the context of above proposals;[21] and
- a recommendation (a non-binding soft law measure in EU parlance),[22] inviting the Member States to integrate the concept of a significant digital presence as foreseen under the SDP Directive into the residency-related clauses of the bilateral treaties on the avoidance of double taxation.

In what follows, this paper first examines the draft law on the significant digital presence and then examines some main points of the remaining components of the EU package on the taxation of digital economy.

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[17] Ibid, paras 23, 24, 25.

[18] https://ec.europa.eu/info/consultations/fair-taxation-digital-economy_en (last accessed 18 November 2018).

[19] European Commission proposal for a Council Directive laying down rules relating to the corporate taxation of a significant digital presence, *COM(2018) 147 final - 2018/0072 (CNS)* (21 March 2018) (hereinafter SDP Directive.

[20] European Commission proposal for a Council Directive on the common system of a digital service tax on revenues resulting from the provision of certain digital services, *COM(2018) 148 final - 2018/0073 (CNS)* (21 March 2018) (hereinafter SDT Directive).

[21] European Commission Communication on time to establish modern, fair and efficient taxation standard for the digital economy, *COM(2017) 146 final* (21 March 2018).

[22] European Commission Recommendation relating the corporate taxation of a significant digital presence, *COM(2018) 1650 final* (21 March 2018) (hereinafter Recommendation).

### 2.1. The European Commission proposal on significant digital presence (SDP Directive)

The SDP Directive is a concise yet significant piece of legislation that once in force inherits far-reaching tax implications for the transnational digital business activities in Europe. The crucial provisions of this short draft law are embedded in two clauses.

The first key provision advances a new concept of taxable residence in the form of a significant digital presence[23] that departs from the traditional PE notion available under the international tax rules. Unlike conventional PE principles that mainly build on the premise of the physical existence of business entities for taxing rights of foreign jurisdictions (e.g., Article 5 of OECD Model), the proposed clause provides new standards to capture the economic activities of cross-border digital businesses in locations where users or recipients are located. According to these standards, a significant digital presence of a business entity will be deemed to exist in an EU Member State if that entity supplies services in a tax year and satisfies one or more of the following conditions:

> (a) the proportion of total revenues obtained in that tax period and resulting from the supply of those digital services to users located in that Member State in that tax period exceeds EUR 7 000 000;
> (b) the number of users of one or more of those digital services who are located in that Member State in that tax period exceeds 100 000;
> (c) the number of business contracts for the supply of any such digital service that are concluded in that tax period by users located in that Member State exceeds 3 000.[24]

A user of digital services shall be considered to be located in the jurisdiction of an EU Member State in which the user operates the device that is meant for a digital interface for the supply of services.[25] The IP address of the advice shall determine the jurisdiction of a user's device, or, if superior to the IP address, any other method of geolocation.[26]

The second key provision of the proposed law deals with the attribution of profits of a business entity concerning its significant digital presence.[27] The clause provides that the

[23] Proposed SDP Directive, above n 19, art. 4

[24] Ibid, art. 4(3).

[25] Ibid, art. 4(4). The expression "digital interface" had been defined as "any software, including a website or a part thereof and applications, including mobile applications, accessible by users"; SDP Directive, above n 19, art. 3(2).

[26] Proposed SDP Directive, above n 19, art. 4(6).

[27] Ibid, art. 5.

profits attributable to the digital PE "shall be those that the digital presence would have earned if it had been a separate and independent enterprise performing the same or similar activities under the same or similar conditions, in particular in its dealings with other parts of the enterprise, taking into account the functions performed, assets used and risks assumed, through a digital interface."[28]

The provision also envisages that in order to determine these profits, those economic activities performed by the digital PE shall be taken into account which relate to "the development, enhancement, maintenance, protection and exploitation of the enterprise's intangible assets."[29] The clause further elaborates that economic activities performed by the digital PE through digital interface shall comprise any digital service including in particular "(a) the collection, storage, processing, analysis, deployment and sale of user-level data; (b) the collection, storage, processing and display of user-generated content; (c) the sale of online advertising space; (d) the making available of third-party created content on a digital marketplace".[30] For determination of profits attributable to or in respect of the digital PE, the law makes it obligatory for taxpayers to use the profit split method unless a taxpayer demonstrates that an alternative method is more suitable in a given case.[31]

In its final segment, the SDP Directive lays down provisions to institute an advisory committee, named as the DigiTax Committee, comprising of representatives of Member States and headed by the Commission representative, to examine the questions surrounding the implementation of the proposed law.[32] Furthermore, the proposal also requires the Commission to evaluate the implementation of new law after five years of its adoption and report it to the Council of EU.[33] As regards the data collected from users in relation to the application of the SDP Directive, the law provides that such data will be confined to the Member State where users are located without disclosing the users' identification.[34] Finally,

[28] Ibid, art. 5(2).
[29] Ibid, art. 5(4).
[30] Ibid, art. 5(5).
[31] Ibid, art. 5(6).
[32] Ibid, art. 7.
[33] Ibid, art. 6.
[34] Ibid, art. 8.

it lays down a provision that the new law on taxation of digital entities will become effective in the EU from 1 January 2020.[35]

### 2.2. The changes proposed by the European Parliament in the draft law

The SDP Directive would take the form of binding legislation only if it receives a unanimous vote of approval from all (currently 28) Member States in the Council. On 21 April 2018, the Council, following the special legislative procedure, submitted the draft law for consultation of the Parliament.[36] The European Parliament, the most democratic organ of the EU, recently on 5 December 2018, has proposed certain amendments in the Commission's draft.[37] Although the amendments proposed by the Parliament are not binding on the Council under EU constitution, the changes so suggested bear significance in the sense that the Parliament, the most representative institution of EU citizens, reflects the public sentiments of the majority of European people. Some of the key amendments proposed by the Parliament in the contextual (recital) part of the draft include:

- Emphasis on the fact that the digital age has shifted economic resource form conventional-based to data based;[38]
- Addition to highlight the urgency of the matter pursuant to slim chances of global consensus in near the future. Also contextualises the need to legislation in line with earlier work of the Parliament's inquiry committees on Panama Papers and Luxembourg Leaks;[39]

[35] Ibid, art. 9.

[36] The "special legislative procedure" is set out in *the Consolidated Version of the Treaty on the Functioning of the European Union* (TFEU), art. 289(2) where either the Council of EU or the European Parliament is vested with the power to adopt legislation after consulting the other institution. For the draft law in question, TFEU, art. 115 serves as the legal basis for the draft legislation, and according to this clause, the Council of EU is empowered to proceed on the draft under the "special legislative procedure" after consulting the European Parliament. The changes, if any, proposed by the EU Parliament are, however, not binding on the Council in such cases.

[37] For a fuller version of proposed amendments, see European Parliament Report on the proposal for Council directive laying down rules relating to the corporate taxation of a significant digital presence, 2018/0072 (CNS), 5 December 2018, at http://www.europarl.europa.eu/sides/getDoc.do?type=REPORT&reference=A8-2018-0426&format=PDF&language=EN (last accessed 10 September 2018).

[38] Ibid, recital 1(a).

[39] Ibid, recital 2.

- Insertion of a provision that the proposed law needs to integrate the proposal with pre-existing work on the proposal for a common consolidated corporate tax base in EU;[40]
- Addition of provision that the EU states should be urged to include the significant digital presence clause in tax treaties with non-EU states where necessary. Also urges the Commission to develop a Union model to that effect;[41]
- Insertion of a provision that the concept of significant digital presence should also become part of a pre-existing Commission proposal on the common corporate tax base and common consolidated corporate tax so as to bring coherence in the tax base framework for companies.[42]

Alongside these suggestions in the introductory part of the draft law, the Parliament also proposed certain significant changes in its substantive part, as shown in Table-1.

**Table-1**: Certain changes proposed by EU Parliament in the main body of draft rules relating to the corporate taxation of significant digital presence

| **Provision** | **Commission's proposal** | **Amendments proposed by the Parliament** |
|---|---|---|
| Article 4(3)(ca) | Does not exist in Commission's proposal. | Adds to the definition of "significant digital presence" by inserting "the volume" of data in the form of digital content collected by the taxpayer in a taxable year exceeds 10% of the group's overall stored digital content." |
| Article 4(6) | The device of the user shall be identified with reference to the IP address of the device, etc. | Adds that data protection law of EU should apply in parallel so as not to personal identification of the user should preserve. |
| Article 4(7a) | Does not exist in Commission's proposal. | Emphasises that the Member States to retain the right to apply a tax rate of their choice on revenues collected from digital service in their territorial jurisdiction. |
| Article 5 | Provides that the profits attributable to the digital PE "shall be those that the digital presence would have earned if it had been a separate and independent enterprise performing the same or similar activities under the same or similar conditions, in particular in its | Amends the provision as follows:<br>"The profits attributable to or in respect of the significant digital presence shall be *proportionate to the economic reality* of *the business activity in the corresponding Member State*." |

[40] Ibid, recital 4.

[41] Ibid, recital 5.

[42] Ibid, recital 8a.

| | | |
|---|---|---|
| | dealings with other parts of the enterprise, taking into account the functions performed, assets used and risks assumed, through a digital interface." | |
| Article 5(6) | Provides for the use of profit split method for determination of attributable profits unless the taxpayer satisfies the tax authority that an alternate method suits best in the taxpayer's case. | Deletes the text in relation to the taxpayer's alternate option. |
| Article 5(6) | Does not exist in Commission's proposal. | Member States are made responsible for allocating budgets for training and enhancing the expertise of the relevant staff engaged in determining the attributable profits from digital business activities. |
| Article 5a | Does not exist in Commission's proposal. | Commission to issue guidelines on the methodology for companies to self-assess as to which of their activities are caught by the clause on digital PE. |
| Article 6(1) | The commission to evaluate the implementation of this law after five years. | The commission to evaluate the implementation of this law after three years. Also adds that the Commission, during the review process, should examine the administrative costs of the significant digital concept notion on SMEs. |
| Article 6a | Does not exist in Commission's proposal. | Confers powers to the Commission to adopt delegated legislation in relation to Article 4 on the significant digital presence (and that the Council having the authority to revoke these powers). |
| Article 6b | Does not exist in Commission's proposal. | Adds right of appeal to companies on the decision that their services are digital in nature. |
| Article 6d | Does not exist in Commission's proposal. | Adds that the Member States to delegate powers to mandate for the Commission to negotiate on their behalf tax treaties with non-EU counties in relation to the definition of significant digital presence. |
| Article 7(4)(1a), (4a) | Does not exist in Commission's proposal. | The DigiTax Committee shall prepare an annual report of its findings and share with the legislature. The Committee shall oversee the implementation of this law and facilitate national tax authorities with a view to mitigate double taxation. |

From the amendments proposed in the SDP Directive, it is evident that the EU Parliament lays greater emphasis on the worth of use of data in the form of digital content in determining the value creation process of digital business activities. The Parliament is rather more attentive on catching the taxable transactions having nexus with the significant digital presence and recommends broader criteria to define the concept of significant digital presence. At the same time, the Parliament is also watchful of the fact that the new law may not adversely impact the SMEs. The Parliament's amendments, for example, require the Commission to review the law after three (instead of five) years after the adoption of law together with a change in the proposal which requires the DigiTax Committee to oversee the implementation of SDP Directive highlight its cautious approach to the possible gaps in legislation. In the same vein, the Parliament, in a bid to enhance fairness and transparency in tax treatment, also suggests an additional clause to grant the digital businesses a right of appeal on the decision that the services in questions are digital in nature. Another significant amendment proposed by the Parliament concerns the delegation of power to the Commission to negotiate tax treaties with non-EU counties on behalf of Member States in relation to the definition of significant digital presence. It will certainly be very difficult, if not impossible, to retain such a clause or seek its approval at the ECOFIN Council where Finance Ministers of Member States often take a hard stance on issues incidental to the national sovereignty in fiscal and tax matters.

Since the Parliament's amendments are non-binding in nature, only the time will tell on how the Council of EU, the institution ultimately responsible for deciding the final fate of tax legislation, responds to the Parliament suggestions on the draft SDP Directive.

### 2.3. The adoption of a soft law measure in relation to significant digital presence

As noted at the start of section 2, the EU package on the taxation of digital economy, alongside the proposed SDP Directive, also includes adoption of a non-binding, soft law measure in the form of a Recommendation related to the corporate taxation of a significant digital presence.[43] The recommendation at the outset underscores the need to revise the PE rules (article 5 OECD Model Tax Convention), the profit attribution rules (articles 7, 9 OECD Model

[43] European Commission recommendation, above n 22.

Tax Convention) and the OECD transfer pricing guidelines so as to integrate the contribution of users data into the value creation concept.[44]

To that end, the Recommendation urges the Member States to revise relevant rules in double tax treaties concluded between themselves and with the non-EU nations in the light of provisions of the SDP Directive.[45] This soft law measure in effect is an advisory call to the Member States, endorsing them to negotiate adaptations to the double tax treaties with non-EU jurisdictions to make the treaties consistent with the EU approaches. In doing so, the Member States have been in particular urged to incorporate the rules on significant digital presence and on the attribution of profits of digital firms operating cross-border in accordance with the articles 4 and 5 of the SDP Directive.[46] Furthermore, the measure also stresses upon the Member States to adopt a consistent and uniform approach at the time of application of these rules at the international level.[47]

### 2.4. The European Commission proposal for a digital service tax (DST Directive)

Another important measure integral to the EU package of 21 March 2018 on the taxation of digital economy includes a draft law on the introduction of a digital service tax.[48] The primary objective underpinning the proposal is to adopt in an interim measure to address the crucial gaps in taxing the digital activities until a comprehensive long-term solution foreseen under the draft SDP Directive is achieved.

Fundamentally, the draft DST Directive is targeted in nature and seeks to capture *only* those digital businesses which cannot exist without the user participation. It envisages levying a 3% digital service tax[49] on revenues originating *only* from the provision of following services:

> (a) the placing on a digital interface of advertising targeted at users of that interface;
>
> (b) the making available to users of a multi-sided digital interface which allows users to find other users and to interact with them, and which may also facilitate the provision of underlying supplies of goods or services directly between users;

[44] Ibid, recital 4 and art. 1.
[45] Ibid, recitals 5, 6 and art. 1.
[46] Ibid, art. 2.
[47] Ibid, art. 3.
[48] Proposed DST Directive, above n 20.
[49] Ibid, art. 8.

(c) the transmission of data collected about users and generated from users' activities on digital interfaces.[50]

Further, the draft law also imposes two thresholds to make a digital business providing the above services liable to the proposed tax. A digital business will be caught by the provisions of new law if its annual worldwide turnover exceeds EUR 750 million and its turnover within the EU for those activities in that year exceeds EUR 50 million.[51]

The text of SDT Directive was discussed in a recent ECOFIN Council meeting on 4 December 2018 but it failed to gain a unanimous approval of all Member States,[52] an act that is a constitutional obligation for the adoption of tax legislation. The lack of unanimity then was immediately followed by a French-German announcement to bring an amended version of the digital service tax – a move that is being viewed as akin to the demise of the existing proposal on DST Directive.[53] The Franco-German joint declaration calls upon the Commission and the Council for a new legislative proposal on an urgent basis and aims at its EU-wide adoption by March 2019.[54] Despite the foregoing developments that indicate that the proposed DST Directive is no longer "alive", this paper will touch upon some of its major features in the overall analysis of new EU initiatives in the following section because the Franco-German approach to initiate an alternate EU legislation in the near future is likely to build on some of the fundamentals foreseen under the SDT Directive.

## 3. Comments on the EU Legislative Proposals on Taxation of Digital Economy

As noted earlier, the taxable presence of multinational business under the existing international tax system is governed by the PE rules that draw largely on the physical

[50] Ibid, art. 3(1).

[51] Ibid, art. 4(1).

[52] Main results of the ECOFIN Council meeting of 4 December 2018, available at https://www.consilium.europa.eu/en/meetings/ecofin/2018/12/04/?utm_source=dsms-auto&utm_medium=email&utm_campaign=Economic+and+Financial+Affairs+Council%2c+04%2f12%2f2018# (last accessed 5 December 2018).

[53] Bjarke Smith-Myer, "Paris, Berlin to propose new tech tax to save face" (4 December 2018) *Politico*, available at https://www.politico.eu/article/paris-berlin-to-propose-new-tech-tax-to-save-face/ (last accessed 5 December 2018).

[54] For a full text of the Franco-German joint declaration, see https://g8fip1kplyr33r3krz5b97d1-wpengine.netdna-ssl.com/wp-content/uploads/2018/12/FR-DE-Joint-Declaration-on-the-taxation-of-digital-companies-final.pdf (last accessed 5 December 2018).

existence premise.[55] The proposed EU legislation in question, on the other hand, builds on the rationale that the current PE rules do not catch business activities of digital models which do not need a physical presence in the markets despite their significant economic presence, rooted in the data-driven value creation in market jurisdictions.

There are several aspects of political, economic, legal and technical nature accompanying the proposed laws that need close attention both at the academic and policy level. Then broadly, these aspects need to be viewed through a three dimensional lenses in that some of these have general international implications, while others are EU-specific in nature and some of these overlap both.

In the political context, for example, the fundamental tension lies in the fact that the proposed legislation prompts a change in the taxing rights of origin versus market jurisdictions in favour of the latter. A unilateral EU measure intervening in taxing rights of nation states without having a broader consensus at the international level may trigger political fallout.

Another political dimension that needs closer attention lies in the fact that most of the tech giant businesses to be ultimately caught by new rules are headquartered in the USA which may give rise to the perception that the proposed rules may disproportionately target US digital firms.[56] To that end, a unilateral EU action may further worsen the situation already being labelled by tax commentators as something akin to "brewing an EU-US tax war" in the post-Apple Ireland case where the Ireland branch of the US tech giant was charged with a EUR 13 billion tax bill for infringing EU competition rules.[57]

Then, although the literature exploring the possibility of incorporating the significant digital presence in existing PE rules as one of the most viable long-term solutions is on the rise,[58] yet,

[55] e.g. OECD Model Convention, art. 5.

[56] KPMG's comments submitted in response to the European Commission's public consultation process on the fair taxation of the digital economy (19 December 2017), pp. 1–2, available at https://ec.europa.eu/info/consultations/fair-taxation-digital-economy_en (last accessed 18 November 2018).

[57] In the aftermath of the European Commission decision to charge Apple with a hefty EUR 13 billion tax bill for breaching EU tax competition rules in the European single market, the edition of Tax Notes International (Volume 83, published 29 September 2016) brought the title: *Is an EU–U.S. Tax War Brewing?* See also Frans Vanistendael, "Are the EU and U.S. Headed for a Tax War?" (2016) 83 *Tax Notes International* 1057.

[58] See, e.g., Dale Pinto "Options to Address the Direct Tax Challenges Raised by the Digital Economy – A Critical Analysis" (2017) 65(2) *Canadian Tax Journal* 291, at 314–320; "Yariv Brauner and Pasquale Pistone "Some Comments on the Attribution of Profits to the Digital Permanent Establishment" (2018) 72(4a) *Bulletin for*

the fundamental concern raised against such measures on "ring-fencing" of the digital economy is largely unresolved. The businesses, for example, argue that the digital models should not be treated differently from the wider economy.[59] It is also argued that the differential treatment would be difficult to sustain with the increasing digitalisation as it is creeping into all corners of the physical economy.[60] The OECD is also vigilant of these issues and acknowledges that since "… the digital economy is increasingly becoming the economy itself, it would be difficult, if not impossible, to ring-fence the digital economy from the rest of the economy for tax purposes."[61] The issue, however, is global in nature and could be better dealt with after taking on board all global players through multilateral efforts at the OECD, where similar issues are part of the ongoing work on the BEPS action 1 on the tax challenges of digital economy, likely to be presented by the OECD Task Force on the Digital Economy in its next report by 2020.[62]

Likewise, the proposed legislation also inherits contentious issues of diverse nature alongside the political dimensions. For example, in relation to the proposed EU digital service tax (3%) on specified services of certain digital enterprise foreseen under the DST Directive, the legal basis for the legislation derives sanctity from a constitutional clause that is meant for indirect taxes.[63] The tax base for this levy is not net income but gross revenues. The levy is therefore not a corporate income tax but is an indirect tax on certain services of digital firms.[64] The 3% tax on digital services thus arguably suffers from an inherent contradiction. That is, on the one hand, the fundamental governmental rationale behind proposing such taxes is to capture untaxed profits of digital firms, but, on the contrary, the very tax base is not net profits. The

*International Taxation* 1–3; Peter Hongler and Pasquale Pistone, "Blueprints for a New PE Nexus to Tax Business Income in the Era of Digital Economy" (2015) *IBFD Working Paper*.

[59] David Stewart, "Silicon Valley Concerned about OECD Digital Economy Draft" (2014) *Tax Notes* (21 April); Christiana H.J.I. Panayi, *Advanced Issues in International and European Tax Law*, p. 55 (Hart Publishing, 2015).

[60] PricewaterhouseCooper's comments submitted in response to the European Commission's public consultation process on the fair taxation of the digital economy (3 January 2018), p. 13, available at https://ec.europa.eu/info/consultations/fair-taxation-digital-economy_en (last accessed 18 November 2018).

[61] OECD, above n 2, at 11.

[62] OECD, above n 3.

[63] TFEU, art. 113; the constitutional clause is the legal basis for all legislative acts of the EU in force on VAT and excise taxes. The legislative acts on direct taxes in EU are based on the constitutional clause TFEU, art. 115, which is not the case with SDT Directive.

[64] Fred van Horzen and Andy van Esdonk, "Proposed 3% Digital Service Tax" (July/August 2018) *International Transfer Pricing Journal* 267–272, at 269.

distortionary effects of such taxation therefore cannot be ruled out as it is a matter of conventional tax economics wisdom that the ultimate burden of such indirect taxes, instead of firms, often passes on to the consumers. Since the tax has no direct relationship with the net income, it would therefore not only fail to recognise loss-making businesses but, unsurprisingly, might also increase the cost of (goods or) services.[65]

Another issue with this type of taxation can be explored in its complex relationship in terms of its compatibility with the existing bilateral tax treaties concluded under the public international law. Although the fundamental rationale underpinning the proposed law is to capture and tax the profits that are otherwise being viewed as going untaxed in cross-border markets; however, the tax, as a distinct levy, is being kept out of the purview of traditional tax codes so as to avoid its potential conflict with the tax treaties concluded under the international law.[66] This is similar to the case of equalisation tax of 6% on certain digital services introduced in India which is a distinct legislation outside the conventional income tax code.[67] The question as to whether such taxes override the international commitments made under the tax treaties or, whether it falls within the ambit of treaties might rise as a contentious question that requires a closer look at the interface of the economic analysis of taxation and international obligations under the tax treaty law.

In so far as the extension of the concept of significant digital presence to the PE regime (under the SDP Directive) is concerned, it is being viewed as relatively acceptable form of a long term solution to address the issue.[68] Nonetheless, in the context of EU-specific legislative mechanism in tax matters, a number of complexities surround the proposal that merit consideration. Foremost, the EU has a torturous history of adoption of legislation on direct taxes in terms of time span from the issuing of proposals to the final adoption as binding laws. For instance, in several important legislative acts adopted in the area of direct taxes to date, it took over a decade on average to adopt each legislative act since its first presentation by

[65] American Chamber of Commerce to EU's comments on European Commission's public consultation process on the fair taxation of the digital economy (5 December 2017), p. 4, available at https://ec.europa.eu/info/consultations/fair-taxation-digital-economy_en (last accessed 18 November 2018).

[66] van Horzen and van Esdonk, above n 64, at 270.

[67] Sarfo, above n 4, at 3.

[68] e.g. Brauner and Pistone, above n 58.

the Commission.[69] Likewise, the pending proposal on common consolidated corporate tax base (CCCTB) which was first presented by the Commission in 2001[70] failed to attain the consent of all EU nations until it was withdrawn and an amended version was re-launched in October 2016,[71] that still awaits the unanimous approval. In the case of the SDP Directive, it appears from the momentum of developments in the corridors of EU institutions that efforts are underway to achieve a political consensus before the next EU Parliament elections take place in May 2019. Yet, given the troubling history of tax legislation in terms of years often needed to attain unanimity, the proposed date of 1 January 2020 for the adoption of the law on significant digital presence seems rather challenging.

Another dilemma that further adds to the complexity lies in the lack of concurrence between the SDP Directive and the pre-existing proposal on the CCCTB.[72] Unlike the DST Directive, the original CCCTB draft takes the traditional PE rules. Although the EU Parliament, on 1 March 2018, proposed extensive changes to integrate the digital nexus of PE into the CCCTB plan[73] but, as noted earlier, these are not binding on the Council nor is the proposed amendment on the definition of digital PE identical to the one foreseen under the SDP Directive.[74] No doubt the Commission is aware of these challenges and has also committed itself to work

[69] Despite the momentum seen in avoidance-related EU tax legislation in recent years, the history of adoption of directives in the field of direct taxes in EU had mostly been a cumbersome and lengthy process. For example, the following two pieces of tax legislation adopted in the form of directives in in 1990 were initially proposed by the Commission in 1969: *Council Directive 90/434 ECC on Common System of Taxation Applicable to Mergers, Divisions, Transfers of Assets and Exchanging concerning Companies of Different Member States*, 1990 O.J. L 225/1–59; *Council Directive 90/435 ECC on Common System of Taxation Applicable in the Case of Parent Companies and Subsidiaries of Different Member States*, 1990 O.J. L 225/6–9. Likewise, the following two tax directives adopted in 2003 were initially presented as proposals in around 1989: *Council Directive 2004/48/EC on Taxation of Savings Income in the Form of Interest Payments*, 2003 O.J. L 157/38–48 (subsequently repealed in 2015); *Council Directive 2004/49/EC on the Common System of Taxation Applicable to Interest and Royalty Payments Made between Associated Companies of Different Member States*, 2003 O.J. L 157/49–54.

[70] European Commission Communication towards an Internal Market without obstacles: a strategy for providing companies with a common consolidated corporate tax base for their EU-wide activities, *COM(2001) 582 final* (23 October 2001).

[71] European Commission proposal for a Council Directive on a Common Corporate Tax Base, *COM(2016) 685 final - 2016/0337 (CNS)* (25 October 2016); European Commission proposal for a Council Directive on a Common Consolidated Corporate Tax Base (CCCTB), *COM(2016) 683 final - 2016/0336 (CNS)* (25 October 2016).

[72] Ibid.

[73] European Parliament Report on the proposal for a Council Directive on a Common Corporate Tax Base COM(2016)/0685 – C8-0472/2016 – 2016/0337 (CNS) (1 March 2018); in particular see ibid, Amendments 8, 15, 29, 35, 38–40,

[74] The indicators of taxable digital presence are not the same under the two regimes; compare, e.g., ibid, Amendment 40 with the SDP Directive, above n 19, art. 4(3).

closely with the Member States and the Parliament to address the problems,[75] yet, it can prove an additional impediment in achieving the consent of all Member States in the Council.

Another potential EU-specific issue with both directives may arise in question of their compatibility or vires with the EU constitution. The legal basis to adopt the DST Directive is a constitutional clause that empowers EU to "harmonise" indirect taxes of Member States to the extent which is necessary for the establishment of a single European market.[76] A segment of tax law scholarship puts question mark on the constitutionality of the DST Directive arguing that the clause acting as legal basis for the proposal could be invoked only to harmonise the pre-existing national laws.[77] On the contrary, however, at the time of presentation of the proposal only 10 out of 28 Member States had either implemented or planned such measures.[78]

The same line of argument could also question the SDP Directive which derives constitutional power from another clause that authorises the EU to act "… for the approximation of such laws, regulations or administrative provisions of the Member States [that] directly affect the establishment or functioning of the internal market."[79] As indicated by the text of this clause, the mandate to legislate at EU-level measures is, again, confined only to "approximate" those pre-existing national laws which directly affect the institution of EU single market. Given that authority, one might raise the question of constitutional validity rather more forcefully against the SDP Directive since hardly any measure comparable to the digital PE exists at the level of Member States that would call for an EU-level intervention.

Equally, a range of counter arguments could also be offered against the above constitutional question. First, the proposal on significant digital presence, in a stricter sense, for example, is an anti-avoidance measure that Member States would have to transpose into existing tax rules. And, EU competence to act in the anti-tax avoidance regime is already fully established

[75] SDP Directive, above n 19, Explanatory Memorandum, pp. 3–4.

[76] TFEU, art. 113: "The Council shall, acting unanimously in accordance with a special legislative procedure … adopt provisions for the harmonisation of legislation concerning turnover taxes, excise duties and other forms of indirect taxation to the extent that such harmonisation is necessary to ensure the establishment and the functioning of the internal market and to avoid distortion of competition."

[77] van Horzen and van Esdonk, above n 64, at 270–271.

[78] Ibid, citing European Commission Staff Working Document accompanying the proposed legislation, available at https://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:52018SC0081&from=ES.

[79] TFEU, art. 115.

as EU-level legislative measures in this realm have been frequently adopted over the past few years.[80] Secondly, an argument on the lack of EU authority merely for non-existence of laws of Member States might sound illogical in that it would imply the EU to first wait for the 28 national governments to adopt independent solutions and only then act despite strong indications of the looming diverse national measures that could fragment the single market. Indeed, the Commission has been mindful of the current status of national measures similar to the digital service tax and notes that "[i]t is not possible to concretely anticipate not yet specified unilateral measures, but there is a clear risk that unilateral measures will keep expanding in the near future."[81] Third, and perhaps more fundamental, argument against the lack of EU mandate to act in this policy regime lies in the premise that the EU legislative powers are "mobile in nature and emerge over time" pursuant to the ever-evolving level of integration attained by the European single market.[82] Nonetheless, the question of EU mandate is certainly open to academic debate though it is less likely that the European Court of Justice would disapprove any such legislation if it is referred to the Court.

## 4. Conclusion

The paper examined the proposed EU legislation aimed at addressing the tax challenges of the digital economy. On 21 March 2018, the Commission presented a package on the taxation of digital economy that included two key legislative proposals. The first one, the SDP Directive, seeks to offer a long term solution of the issue by introducing the concept of significant digital presence. The second, the DST Directive, proposes a 3% digital service tax as a temporary measure until the comprehensive solution is adopted. The paper explored provisions of the SDP Directive at length together with the amendments proposed by the EU Parliament (these suggestions are not binding on the Council in tax legislation; however, these were discussed to reflect the public sentiment as the Parliament is the most democratic organ in EU).

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[80] See, for example, the *Council Directive (EU) 2016/1164 laying down rules against tax avoidance practices that affect the functioning of the internal market*, 2016 O.J. L193/1–14. Similarly, there have been frequent amendments in EU tax legislation on cooperation that are primarily led by the anti-avoidance drive; for details, see https://ec.europa.eu/taxation_customs/business/tax-cooperation-control/administrative-cooperation/enhanced-administrative-cooperation-field-direct-taxation_en (last accessed 18 November 2018).

[81] European Commission Staff Document, above n 78, at 53.

[82] See, e.g., Shafi U. Khan Niazi, "Emergence, Growth and Mobility of European Competence on Direct Tax Regime: An Analytical and Evolutionary Review" (2016) 11(1) *Journal of the Australasian Tax Teachers Association* 103–137.

The DST Directive has been almost abandoned following the lack of consensus at the ECOFIN Council meeting on 4 December 2018. Yet, the paper touched upon the proposed 3% tax on digital services and offered some comments since a Franco-German declaration has vowed to soon come up with an alternate legislation for adoption by March 2019.

The study acknowledged that the existing PE concept does not consider the digital environment where cross-border economic activities may take place without the physical presence of enterprise. It is also conceded that the existing international tax rules conceived some hundred years ago are largely based on the concept of physical presence of traditional "brick and mortar" business models that fail to capture the taxable existence of the digital enterprise. Nevertheless, the unilateral measures, in particular, temporary measures like 3% digital service tax that falls beyond the tax treaty ambit may inherit several legal, political, economic and technical implications as discussed in section 3.

In relation to the taxable presence of digital firms, the SDP Directive considers new indicators to determine the taxable presence and attribution of profits of the digital enterprise. Undoubtedly, given the multilateral nature of issues, an ideal and comprehensive solution to the issues surrounding the digital taxable presence could be better sustained if developed multilaterally through the ongoing efforts on Action 1 of the OECD/G-20 BEPS project. This is rather more relevant when the concerns raised on the ring-fencing of the digital economy are considered. At the same time, however, given that the chances of global consensus are slim in the near future and the EU-specific needs to institute the single market are compelling, the SDP Directive could be a way forward. To head in this direction, the EU would have to first have to deal with the political and institutional hardships within its borders. If it succeeds, the European tool on significant digital presence may then also serve as a broader template for a multilateral solution to address the challenges of the taxable presence of firms in the digital space.