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Digitalization and taxation: Beware ad hoc measures

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Digitalization and taxation: Beware ad hoc measures

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Digitalization expands the possibility for corporations to reduce taxes, mainly, but not exclusively, by allowing improved planning where profits can be shifted. The reasons are manifold.

First, to deduct a value added tax you need some sort of transaction of money between two parties. For most internet services such a transaction simply does not exist. Using an internet search engine, for instance, provides the private user with a service and the operator with a commercial advantage either by having higher advertising revenues or by using the data that the user indirectly provides by her query. This disclosure of personal data or the consideration of advertisements constitutes the "payment" that the providers receive in return for their service. It may be seen as a barter trade. No value added tax on the consumers' "payment" is due. Quantitatively, the tax revenue shortfalls produced by these barter trades should be very limited, as the marginal willingness to pay for most internet services is small and internet providers that try to change the business model towards a monetary fee struggle severely.

Potentially more important, digital services can easily be offered across borders without having a permanent establishment in the respective country of destination, heretofore the connecting factor in cross-border business taxation.

Against this background, the European Commission and several countries emphatically demand and design new tax instruments. Italy is the forerunner in that respect who already drafted a bill, proposing a so called "web tax". According to the initial proposal, Italian companies would be subject to a six per cent flat tax when they buy digital services, such as online advertising, from internet companies like Alphabet (Google) and Facebook. Private persons and small amounts below €30 would be excluded. Shortly before the turn of the year, the Italian budget commission approved the proposal, but halved the flat tax rate to three percent.[1] The market volume of the Italian internet market amounts to about

[*] SAFE policy papers represent the authors' personal opinions and do not necessarily reflect the views of the Research Center SAFE or its staff.

[1] Reuters, 19 December 2017: https://www.reuters.com/article/us-italy-tax-digital/italian-budget-commission-approves-web-tax-on-digital-services-idUSKBN1ED14F.

€2.5 billion. Thereof, Google accounts for around €1.8 billion, Facebook for €0.2 billion and the national internet companies for approximately €0.5 billion[2]. Hence, with a tax rate of three percent the expected tax income amounts to less than €75 million. If you wanted to finance a basic income out of these tax revenues for each individual, this would yield a yearly basic income of less than €1.25 per capita.

Currently, the German market for online advertising is estimated at around €6.5 billion, implying a per capita tax revenue of a 3 percent flat "web tax" of about €2.40. Clearly, the tax revenue losses from not introducing such a web tax are minor. Conversely, the introduction of the tax would be a considerable departure from generally accepted tax principles.

The underlying reasoning behind most of the arguments to push for special tax regimes can be summarized as follows: [3] Because of digitalization the tax can only hardly be deducted at the source where the actual value was created. Therefore, the current international tax rules may only be applicable to the traditional industries, but not to the digital industry of the 21st century. In the era of digitalization, it is not only possible to export physical products without having a subsidiary in the import country; it also makes possible to offer cross-border digital services that are intangible by nature. Furthermore, the current system regarding the digital economy is often perceived as unfair as the profits should be taxed where the value has been created. Thus, the advocates of an adaption find it necessary to account for these developments. The EU should preempt the national endeavors to tackle the risks for taxation associated with digitalization. Furthermore, a common approach is necessary to counteract uncoordinated national efforts and diverging approaches that would fragment the common market. With reference to a recent study,[4] the EU Commission points out that the effective taxation of digital business models is far less than the one from traditional business models.

The additional challenges for taxation in the course of digitalization cannot be denied and the points made above seem valid. At the same time, an important dilemma even of EU-wide action prevails. On the one hand, the EU Commission argues that it gets more difficult in a digitalized economy to determine where the income has been generated. On the other hand, this source principle of taxation, which requires the determination of location of value creation, is perceived as particularly fair. Essentially, this admits that the preferred (fair) concept is not practicable.

There are demands that EU taxes should apply on the basis that European markets are used in international firms' business models, even if these firms have no physical presence in the EU. The mere

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[2] James Politi and Rochelle Toplensky, Financial Times, 20 November 2017, online https://www.ft.com.

[3] See for example EU Commission, COM(2017)547 final, A Fair and Efficient Tax System for the Digital Single Market.

[4] PWC, 2017, Steuerliche Standortattraktivität digitaler Geschäftsmodelle.

existence of a domestic market is perceived as a postulate to make profits. Again, this would be a deviation from the applied value-oriented concept. The problem with this argument becomes apparent by considering old-fashioned exports of goods. The argument that the domestic market creates a value would also imply that the domestic corporate tax rate has to be applied to all foreign exporters of physical goods.

Certainly, the term fairness in international taxation is a difficult concept that has been discussed intensively and multifariously since the end of the 19th century.[5] From a fairness perspective, one can for example ask whether a foreign company is using domestic public resources. A question that has to be widely negated for most pure exporters and may well be negated for foreign internet service providers.

A selective turning away from internationally accepted principles of international taxation will bring up more questions than solutions. Hence, such a departure should not be frivolously implemented just for the sake of some extra tax euros per capita. So what are driving forces for the thirst of action?

As a central bureaucracy in Europe, the EU Commission for quite some time is suspected of promoting centralization, even if the economic arguments are highly questionable in many cases. By this time, many local issues without any obvious European connection are regulated by central legislation, for example concerning the fine dust pollution in cities or regional water quality. Against this background, it seems fair to ask whether the concern about the European corporate tax base is only a pretense to promote further centralization and harmonization of taxation in Europe. The unanimity required in tax matters is certainly a major concern for the Commission. In the recent past, the Commission has increasingly used a powerful tool, the state aid control, to reign into national tax policies. In this area, decisions of the EU Commission are only subject to the control of the European Court of Justice, not the Council or the EU Parliament. The unanimity requirement is absent.[6]

The argumentation that the mere provision of a domestic market for American internet corporations justifies a corporate tax may serve as a rationale to create additional tax bases on a limited scale. However, also German and other European firms considerably benefit from the existence of foreign markets. With a similar line of argument, China could for instance claim the taxation of European

[5] Georg Schanz, 1892, Zur Frage der Steuerpflicht, Finanzarchiv 9(2).

[6] When considering the application of state aid control to tax matters it is hard to detect a clear consistency. For instance, Italy was denied the right to charge smaller social security contributions in branches of production in which mainly female employees work, as it may potentially distort trade within the EU. In contrast, the Commission approved the use of a Spanish patent box, under EC Treaty state aid rules, that allows to tax income from intellectual property less (EU Commission, IP/08/216), as in principle every company is free to generate such income. For an extensive discussion of this issue, see Beirat beim Bundesfinanzministerium, 2017, *Steuervergünstigungen und EU-Beihilfenaufsicht - Problematik und Ansätze zur Lösung des Kompetenzkonflikts mit der Steuerautonomie.*

exports for companies without any physical presence in China. In unstable times, Europe should remain level-headed and not initiate international trade wars.

Instead of selectively looking for new tax concepts targeting purely digital business models, there are many good arguments that one should rather concentrate on repressing the design of generous tax constructions in some EU member states. The study by Pricewaterhouse Coopers that the EU Commission uses to demonstrate the low taxation of digital business models, rationalizes the low taxation with targeted investment incentives and exception regulations (patent boxes). It is no empirical evidence for the role of tax havens in this area, probably playing a similar role in nearly all research-intensive sectors. Instead it is rather an illustration of diverging national tax policies. The example Germany, with a relatively high effective tax rate on such business models, shows that countries can partly resist the trend. A wide set of measures that relies on the OECD action plan against profit shifting and base erosion is currently implemented by national legislation and should help to curb corporate tax revenue losses both in the digital economy and in more old-fashioned industries.

Alternatively, one could move on to tax systems that account for the difficulty to determine where taxable value has been created. One suggestion is a formula based profit apportionment of corporate profits within Europe, considering different factors such as sales, capital or labor within each member state. A Common Consolidated Corporate Tax Base (CCCTB), a proposal re-launched by the Commission in 2016 (EU Commission, COM(2016) 683) would apply such a system. However, a CCCTB, although it would tie the hands of national policy makers for better or for worse, will also not be the be-all and end-all of all discussions, as it does not regulate profit shifting outside the EU. A promising corporate tax system that would also solve the third-country problem is the destination-based corporate tax system that was also behind the initial Trump-plan for the US corporate tax reform.[7] As in the case of the value added tax, in such a system the taxation would be dependent on where the consumers reside and not where value is created. While this may be felt "unfair" by some, it leaves considerably less opportunity for corporate tax planning and avoidance.

While there are good reasons to think about a fundamental regime switch in international corporate taxation, there are also good arguments for not turning to ad hoc measures that selectively target the relatively small market of Google and Facebook and raise only negligible tax revenues.

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[7] See Auerbach, Alan J. and Devereux, Michael P. and Keen, Michael and Vella, John (2017), Destination-Based Cash Flow Taxation, Oxford University Centre for Business Taxation WP 17/01.