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EXPERT GROUP ON TAXATION OF THE DIGITAL ECONOMY

General Issues

WORKING PAPER

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1. Defining the digital economy

There is no authoritative definition for the *digital economy*. Most definitions refer merely to economic value derived from the internet; some definitions also refer to economic and social activities resulting from other information and communications technologies.

The OECD defined the digital economy as being "comprised of markets based on digital technologies that facilitate the trade of goods and services through e-commerce". The Australian government refers to the digital economy as "the global network of economic and social activities that are enabled by platforms such as the Internet, mobile and sensor networks".

The OECD Action Plan on Base Erosion and Profit Shifting did not define the digital economy per se but rather described vis-à-vis its characteristics: "an unparalleled reliance on intangible assets, the massive use of data (notably personal data), the widespread adoption of multi-sided business models capturing value from externalities generated by free products, and the difficulty of determining the jurisdiction in which value creation occurs".

In simple terms, the term refers to an economy based on digital technologies (sometimes called the internet economy). Increasingly the digital economy has become intertwined with the traditional economy making differences between them less clear.

For the purpose of the expert group, the digital economy can be defined through a more detailed look at the principal business model characteristics of digital economy companies, which often involve:

- Intensive innovation and tendency to make greater use of new sources of finance, e.g. venture capital.
- Emphasis on the importance of intangible assets rather than (traditional) fixed assets e.g. patents, trademarks, copyrights, franchises, licences, etc., in the value creation and of electronic services as final products.
- The emergence of new business models based on network effects, user generated contents, collection and exploitation of personal data, etc.
- Significant cross-border E-commerce including the delivery of traditional forms of commerce through new channels.

This list should be seen as indicative, rather than wholly prescriptive.

The digital economy undoubtedly contributes towards job creation, encourages innovation; and stimulates economic growth within the EU. In the current economic climate, many digital companies are a quite unique success story and the EU wishes to encourage further innovation and economic growth. This makes it important that digital companies are covered by a tax framework that facilitates growth, particularly amongst start-ups and SMEs, so that they are given the opportunity to reach their full potential, while ensuring fair and equitable taxation for all economic sectors. Taxation should not determine business models or "winners" but be neutral as to the business model applied. That seems to be the only way to ensure a level playing field amongst all economic

operators which rewards success, innovation and job creation, whilst ensuring that companies contribute their fair share towards the overall tax base.

2. Digital versus Traditional Economies; relevant tax differences?

Many of the recently publicised cases of corporate tax arrangements of multinational companies which have catalysed the OECD/G20 Project against Base Erosion and Profit Shifting concern leading digital economy companies (e.g. Amazon, Google, Apple). Several of these companies are hugely profitable and generate a significant part of their corporate value on EU markets. This, however, is not always reflected in the share of company taxes paid by these companies in the EU. It has been suggested that this is caused by the fact that digital economy companies are operating outside of regular, traditional, business roles and, by extension, that existing international tax standards designed in the pre-digital age are not properly suited to capture the digital economy. This needs to be considered against the on-going need for governments to raise revenue and ensure fair taxation.

It is indeed true that with the rise of the digital economy specific business models have come to the fore. Examples, as outlined by OECD and others, include:

- **Multisided Business:** whereby two or more user groups benefit from use of the digital platform. For example, search engines are used both by individuals to access information on the internet and by advertisers to access viewers.
- **Outside-In:** where an organisation makes its own resources available to customers. The Amazon EC2 cloud service (a cloud solution sold to third parties) is based on insight developed by Amazon around the cost of maintaining a reliable, scalable infrastructure in a traditional multi-data centre model.
- **Collaborative Consumption:** an economic model based on sharing, swapping, bartering, trading or renting access to products as opposed to ownership. E.g. airbnb.com matches people seeking vacation rentals and other short-term accommodation with hosts who have an unused space to rent.

In addition, the global trend, under which intangible assets such as intellectual property rights (IPRs) and data have become increasingly important to determine the value of a business, i.e. adding value to data and knowledge rather than the production of a physical object.

Many companies that adhere to the models described above are described as platform operators, as they offer services via the internet but do not provide or manage the internet structure needed to access their services. They can be viewed as 'new' business models due to their provision of material, often offering audio-visual content or services, which have emerged with the rise of the internet. Unlike telecommunications operators ("telcos"), platform operators are much more mobile and therefore able to exploit the existence of low and no tax jurisdictions. Moreover, platform operators have the additional (non-tax) benefit that they do not need to maintain the architecture they use to offer their services which is largely met by the telcos.

General question for discussion:

Are there any specific elements or features that are unique to the digital economy, such as intensive use intangible assets and innovation, which allows or even requires the application of a different set of direct tax rules and standards in order to ensure that the sector makes a fair and equitable contribution to the public revenues in the markets where it operates?

3. VAT issues

Value-Added Taxes (VAT) is a revenue raising instrument which taxes the consumption of goods or services in the EU. Tax rates are subject to some partial harmonization but Member States have significant freedom to set their own rates within predetermined ranges.

Digital suppliers, wherever located, are liable for collecting and remitting VAT on supplies to EU consumers. This obligation extends since 2003 to non-EU suppliers to ensure revenue is collected and that EU businesses can operate on a level playing field and are not incentivised to re-locate offshore. Although difficult to prove in practice, these e-commerce tax obligations for non-EU suppliers are considered as having achieved a reasonably high level of compliance. More recently however the evolution of digital economy business models raises questions as to whether these objectives can be sustained. In addition, tax compliance problems have been identified in specific digital economy sectors (*e.g.*, on-line travel agents moving offshore, on-line gaming) which have probably been facilitated by more familiarity with on-line shopping among consumers and a willingness of some businesses to exploit mismatches in taxation. *Consideration needs to be given to how tax fair collection can be assured in the global digital economy.*

In practice VAT rates distinguish between physical goods and services (including digital content). Certain printed material can be subject to a reduced VAT rate (minimum 5%). Digital content attracts the standard rates (15%). This may be perceived as creating inconsistencies where the same content in physical or digital form may sometimes be subject to differing tax rates. Where digital content is not closely comparable with the printed equivalent or has significantly different functionalities, these concerns do not really arise. Consideration should be given to the significance of any distortions and the possible options for addressing them.

General question for discussion:

How does digital technology impact on the charging and collection of VAT as well as other relevant VAT related issues? Does this justify or require a different or particular approach for the digital economy? Which particular aspects and features of the digital economy should be taken into consideration in the on-going elaboration of the definitive VAT system?

4. The role and interests of the EU in the global context

The international debate concerning aggressive tax planning by multinational companies is politically driven by the G20 and – to a lesser extent – the G8. The translation of the political intentions into operational rules, regulations and recommendations is handled by the OECD. The OECD is the authoritative international organisation when it comes to setting international standards regulating the interaction of various domestic tax systems, although the standards are supported not by OECD legislation but by the OECD member states' willingness, or not, to apply the standards.

To address aggressive tax planning by multinational companies, the OECD on request of the G20 has agreed an Action Plan on Base Erosion and Profit Shifting (BEPS) in June 2012. The Action Plan identified 15 actions and was fully endorsed by G20 Leaders in September 2012. The 15 actions address the whole economy. However, it was noted that the digital economy involves specificities that need to be taken into consideration, including in relation to indirect taxes. To tackle these issues a Digital Taskforce has been set-up in the framework of the G20/OECD BEPS Project to address the tax challenges of the digital economy.

Two factors must be taken into account when anticipating the possible results of the Taskforce and its meaning for the EU.

- (a) In the first place, most of the aggressive tax planning schemes that have reached the press concern US based digital companies escaping effective taxation of their non-US profits. This is less of a concern for the US than it is for EU Member States, while the US has a significant influence in the OECD's work.
- (b) Secondly, the existing international tax standards of the OECD are to a great extent about dividing taxing rights between source and residence countries, whereby a company from its residence country makes an investment in source countries and receives income from these investments. The OECD traditionally consists of developed countries that generally act as investors and for that reason the traditional OECD focus has been on protecting the taxing rights of residence (developed) countries, rather than source (developing) countries. The conflict between taxing rights for source and residence countries has been intensified with the growing economic importance of traditional source countries, e.g. BRIC. It is useful to recall that in the digital tax debate, the EU is generally rather a source than a residence country. One therefore should realise that strengthening the taxing rights of the EU in the digital economy, may imply or trigger stronger taxing rights for source countries generally, with potential adverse consequence for the EU's entitlement to tax the revenues of the traditional economy.

General question for discussion:

How can the Expert Group contribute to a protection of EU interest in the global tax debate, in view of different global interests as to the direction of international company tax developments both in general and specifically for the digital economy?