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THE EUROPEAN COMMISSION'S PROPOSAL FOR A FAIR AND EFFICIENT TAX SYSTEM IN THE EU FOR THE DIGITAL SINGLE MARKET

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On September 21, the European Commission issued the "*Communication on a Fair and Efficient Tax System in the EU for the Digital Single Market*," a proposal to modernize the international tax framework to account for the digitalization of businesses—or growing tide of new digital business models—in the 21st century.

The proposal, backed by France, Germany, Spain and several other European Union (EU) member countries, aims to ensure "fairer and more efficient taxation" for all companies (EU or non-EU based). Much of the proposal is intended to combat alleged base erosion and profit shifting by multinational companies, including Silicon Valley tech giants, which many proposal supporters believe have not been fairly taxed in the past.

The proposal also supports one of the Commission's priority goals of completing the Digital Single Market, a vision that involves dissolving regulatory hurdles to combine the 28 national markets into a single digital one. The final agreement will need to be unanimously approved by all 28 EU member states.

KEY PROPOSAL HIGHLIGHTS

As the late October meeting between French Economy Minister Bruno Le Maire and U.S. Treasury Secretary Steven Mnuchin and other tech industry lobbyists suggests, the EU's digital taxation plans are still up for discussion—with the September 21 proposal to be one of many options.

The Commission's proposed framework seeks to effectively tax companies on the value created from their digital business models, rather than their reported profits, which are tied to certain jurisdictions. The new tax structure would ideally build on the Commission's Common Consolidated Corporate Tax Base (CCCTB) proposal, relaunched in October

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2016, which "provides an EU framework for revised permanent establishment rules and for allocating the profit of large multinational groups using the formula apportionment approach based on assets, labor and sales that should better reflect where the value is created." This framework could then be updated to also account for organizations' digital activities.

A few of the Commission's more immediate, short-term alternatives to the current tax framework are outlined below:

- **Equalization tax on turnover of digitalized companies:** A tax on all untaxed or insufficiently taxed income generated from all internet-based business activities, including B2B and B2C, creditable against the corporate income tax or as a separate tax.
- **Withholding tax on digital transactions:** A stand-alone, gross-basis, final withholding tax on certain payments made to non-resident providers of goods and services ordered online.
- **Levy on revenues generated from the provision of digital services or advertising activity:** A separate levy could be applied to all transactions concluded remotely with in-country customers where a non-resident entity has a significant economic presence.

THE PROPOSAL'S INTENT: TAKE BACK TAX DOLLARS

The proposal comes at an economically sensitive time, when low public budgets are placing increased political pressure on EU member states to ensure that digital businesses are subject to the same share of tax as traditional brick-and-mortar companies.

According to the Commission, large disparities between tech and non-tech companies and those of different sizes still exist in today's tax framework. For example, the proposal states that domestic digital business models are subject to an effective tax rate of only 8.5 percent, compared to the 20.9 percent tax rate for traditional domestic business models. Digital international business models are similarly subject to lower tax rates of 10.1 percent (B2C model) and 8.9 percent (B2B model), compared to 23.2 percent for traditional international business models.

Supporters of the Commission's initiative point out that this discrepancy comes from the current tax framework, which largely taxes companies on their profits versus their revenues. This allows digital companies—many of which derive their revenue from intangible assets, such as information and data—to minimize their tax burden by limiting their activities in high tax jurisdictions and maintaining the ownership of intangibles and the conduct of non-routine functions in jurisdictions with low corporate tax rates (e.g., Ireland or Luxembourg, in the case of many tech companies).

Under traditional transfer pricing rules, this may result in a geographical disconnect between profits and the location where the customer revenues are sourced, including many of the EU countries where companies do business digitally. The lack of a need for physical offices and activities due to new digital business models has enabled many U.S. tech companies to minimize taxation by host countries without significantly sacrificing or altering critical revenue sources.

IMPLICATIONS FOR U.S. TECH COMPANIES

The implications for U.S. tech companies, should this proposal pass, are significant. Many tech giants, such as Amazon and Apple, have well-publicized tax disputes with the EU and are facing even more pressure of late. In early October, European Commissioner for Competition Margrethe Vestager ordered Luxembourg to collect approximately $294 million in unpaid taxes from Amazon on the claim that the retail giant was taxed at one-fourth the rate of other local companies subject to the same tax rules. This move reflects previous actions undertaken by the Commission to reclaim billions of dollars from other U.S. tech companies.

Reactions to the proposal have varied, and backlash has come from the United States. The American Chamber of Commerce in Europe warned that the EU's plans could potentially hinder the continent's economic growth by dissuading tech companies and investors from entering or expanding into the European market—stating that the initiatives "could both harm the competitiveness of the EU and jeopardize international efforts to tackle tax issues if they are not subject to very broad multilateral agreement."

EFFECTIVE AVERAGE TAX RATE IN EU28

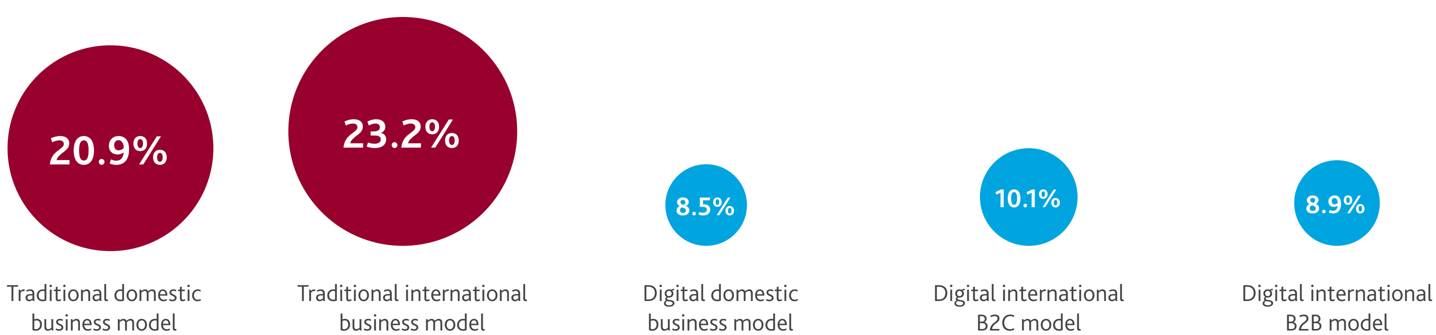

Chart from the European Commission's "A Fair and Efficient Tax System in the European Union for the Digital Single Market"

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Meanwhile, countries with low tax rates like Ireland and Luxembourg, which have been long-favored by tech companies entering the EU market, fear the decision could drive away foreign companies once looking to base their operations in the region.

The late October meetings between U.S. and EU officials in Washington D.C. may help diffuse some of the tension as global leaders seek to find middle ground. During the meetings, U.S. officials continued to emphasize the importance on keeping the attention on the Organisation for Economic Co-operation and Development (OECD)'s current and upcoming global initiatives, including plans to publish a report on digital tax early next year.

LOOKING FORWARD

The Commission's target date for an international agreement on the new tax framework, which it hopes to embed in the general international corporate tax framework, is spring 2018. Until further developments are announced, tech companies are still primarily in a wait-and-see mode as another potential obstacle to long-term planning is conceptualized.

U.S. tech companies should be prepared to face potential increased tax scrutiny from the EU as the proposal undergoes debate. If the Commission does agree on a universal tax framework, they will need to comply with new regulations that will affect not only their annual tax planning but core business decisions.

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