**Joint position of the Institute of Financial Services Practitioners and the Malta Institute of Taxation on the European Commission's proposals concerning the Fair Taxation of the Digital Economy**

## Introduction

The Institute of Financial Services Practitioners and the Malta Institute of Taxation recognise the tax challenges of the digital economy and the role of the European Commission and all Member States in addressing these challenges.

Digitalization is a major driver of innovation and economic growth. Policymakers can and should view digitalization as an overall accelerator for growth, with taxation as a potential and significant restraint if it is not done appropriately. The conclusion of the OECD in its Action 1 Final Report was that the economy is the digital economy and the "digital economy" cannot be ring-fenced. However, we do recognise the need for action to adapt current international corporate tax rules toward the modern global economy, albeit in a comprehensive manner.

To this end, we believe that any proposals should:

- be globally agreed as far as possible;
- be as simple as possible to apply for tax administrations and taxpayers;
- create certainty for all parties going forward;
- not create double taxation, non-taxation, or undue administrative burdens;
- not create a drag on the development and diffusion of digital technology;
- not distort commercial decisions; and
- ensure in particular that they do not create a burden for small and start-up businesses.

## 1. General comments

### *1.1 Digitalisation is an accelerator for growth, and taxation should not inhibit that more than it does with traditional business*

The declared intention of the proposals is to address the perceived misalignment between the place where the profits are taxed and the place where value is created. However, it would appear that the extent of profit shifting through the use of intangibles, as well as the role of specific digital business models in profit shifting strategies, has not been researched. Besides the tax-

motivated allocation of patents (which is not a major driver of digital economy as other intellectual property, and predominantly software, is), there is currently no evidence of the tax-motivated allocation of key functions (in particular people) or profits in the digital sector. We question if any studies have been carried out which show that offshore digital services reduce the local tax take – or whether do they actually increase it via efficiencies. Against this background there is both a risk of overstating and of understating the respective tax challenges.

***1.2 There is a need to better understand how value is created in digitalised business models and whether this is different from traditional businesses, and in particular, how 'user data' is accounted for and assigned a value, before it is brought within the taxation net.***

We note that the BEPS Final Reports were issued at the end of 2015; that the Multilateral Convention (MLI), which will make significant changes to the operation of tax treaties is not yet in effect; that the first country-by-country reports have only just been filed; the focus on 'value creation' in the context of transfer pricing (which should ensure alignment of profits with the key functions performed by people in the area of intangibles) is still being digested with several questions coming to the fore; and that generally the BEPS implementation process is still in the early stages and is ongoing.

***1.3 Unilateral action and potential solutions will have a negative impact overall (including particularly on growth).***

Multiple sets of rules may reduce global growth, trade and investment because of friction between different systems; alternatively, multiple sets of rules may create new opportunities for BEPS as the different responses to the tax challenges create new gaps that may be exploited. Obviously, the lack of a coordinated or systemic approach may bear the risk of arbitrary taxation and market distortions between local companies versus MNEs and digital companies versus traditional companies. To avoid such barriers to innovation and healthy competition, tax policy makers should place a premium on achieving tax certainty and the principle of tax neutrality.

The problem with unilateral action is replicated on a global scale – with unilateral action by the EU on these matters threatening to destabilize the existing international tax system. Therefore, the EU should wait until the final OECD report on digital economy and ensure a global approach, which should not jeopardise its competitiveness in this important area (for example since its unilateral action in this area, Hungary has already experienced a loss in location attractiveness for digital businesses). The EU will benefit from a bigger pot even if the tax share is smaller (not to mention the additional non-financial benefits to consumers and societies that increased digitalization can bring).

1.4 ***Time should be taken to consider the perceived problems, the real challenges, their impact, and potential solutions that could attract multilateral consensus.***

Rebalancing residence and source-based taxation rights is a significant endeavour that requires global consensus which is likely to be reached only through a thorough and inclusive global process. This will require time and further research into expected implications for cross border trade and investment. Proposals to shift the balance of taxing rights towards source-countries and away from the country of residence represent a fundamental shift in international tax policy and theory as agreed by countries over the past decades. The BEPS project represented a broad multilateral agreement on revised standards to minimize perceived abuses of the historic international tax policy, but expressly did not address the existing rules on the balance of taxing rights between source and residence states. The EU, and the European Commission, should be

very clear in assessing the implications if the intention is to propose a shift in this underlying policy.

The magnitude of the work to be done is once again reflected in the OECD's interim report (published on March 16, 2018). While the interim report is a step forward in terms of understanding the different business models in the context of the digital economy, it does not offer or recommend any measures at this stage. The report, while providing a summary of unilateral measures taken world over, concludes that significant work is yet to be done before global consensus can be achieved on the mechanism to tax profits arising from the digital economy (and on associated questions relating to user data).

## 2. Comments on the specific aspects of the legislative proposals

With respect to the specific EU proposals, as already highlighted, there is no research / evidence to support the mismatch indicated as justification for the EU action. Particularly, the importance placed by the proposals on the user value creation: a declared objective of taxing profits of digital businesses where value is created, which is not supported by a clear and globally accepted definition of value and determination of where such value is created.
Furthermore, the proposals indicate that the solution would improve the perception of fairness for citizens, however perception should not be a driving force for policy changes with far reaching implications for the EU.

### 2.1 Significant Digital Presence

- Defining the geographical location of value creation first requires agreeing on splitting value creation between the different functions. For example, where a digital business derives profits from the exploitation of data, how much value is created when the data is collected, how much value is created when the data is processed and how much value is created when the data is made available to third parties against a remuneration? The major challenge lies in understanding how collected data is monetized and which functions are involved to do so. Thus there are several questions in attributing value to user data with many believing that the value of data is rather created by processing and analysing the information.

- Further, in this context, presently there is no international accounting standard which provides guidance on the accounting for 'data' / 'user data' (should data be accounted for as intangible assets?) and its valuation. Generally, tax follows accounting, and until such guidance is available at an international level, any unilateral action on the taxation front may still leave open opportunities for tax avoidance.

- Without addressing the fundamental question of splitting value creation, no proposal will be able to function properly and would inhibit economic growth. The impossibility of clearly formulating any policy without addressing this issue is clearly demonstrated by the profit allocation rules of the comprehensive solution which are lacking substantial detail (for example personnel expenses might be an appropriate allocative factor for assigning profits more than advertising revenue). While it is acknowledged that the concept of 'significant people functions' would not serve the

purpose when attributing profits to a digital presence (significant digital presence), no solid alternative has been provided in the EU's proposal. Rather, the concept of DEMPE has been resorted to with the argument that the DEMPE functions would be typical to a significant digital presence. Unless companies are able to track expenses associated with intangibles attributed to different significant digital presences separately, which is quite unlikely, it is hard to envision this allocation key being informative.

- Without substantial work in the area of transfer pricing (at a global level) and digital business models, any proposal will create uncertainty and will not be possible to be quantified at an EU level.

- The proposal is based on the Authorized OECD Approach as an underlying principle, however assuming that the AOA is commonplace in the EU may not be accurate. Furthermore, technologies are fast evolving and businesses are quick to absorb such changes in technology into their operational models. Therefore, any suggested measures to tax profits arising from digital businesses should be comprehensive enough to cover such future technologies which may presently be at a nascent stage (example: artificial intelligence).

- The proposal highlights that the comprehensive solution should be quite broad and flexible in order to avoid clashing with an eventual global agreement, however the same goal is better achieved by ensuring that global agreement is reached at an OECD level first and the EU only subsequently decides its policy, without creating a substantial risk of reducing the EU competitiveness.

- In the meantime, further analysis on the proposal should be undertaken, the definition of digital services falling under the comprehensive solution is key and should ensure that it does not create selectivity (for example the definition includes the supply of film, software, music and data warehousing, while the sale of goods or services which is facilitated by using the internet is excluded).

- The criteria established for the creation of significant digital presence are quite broad and should be cumulatively met [for example, where not all users are customers that contribute in the same (financial) manner to a platform's value, would the location of the conclusion of contracts affect the digital PE? Has the potential for abuse that using the prevailing IP address as a proxy been explored? How are cases of double counting proposed to be resolved (and possibly double taxation)?). Would the absence of a group size threshold impede the access of SMEs to the market in view of compliance costs? The measure could increase the regulatory and compliance burden, which may have a larger negative impact on cross-border SMEs.

- Further, additional analysis is required on the compatibility of the comprehensive tax proposal with the General Data Protection Regulation (GDPR) which in a broad sense gives control of their personal data back to the users. For example, has it been considered whether users who opt out of permitting a company to process their data be counted within the user base for the digital presence?

## 2.2 Digital Services Tax

- The fact that the tax would, in effect apply, for the most part, to US companies may raise issues from the viewpoint of the prohibition of de-facto discrimination under international trade law. This approach could be inconsistent with World Trade Organization obligations as discriminatory, since Member States would only apply the new interim tax to situations involving third countries and not to intra-EU situations. This concern should be addressed before a decision can be made, especially in view of the importance of adhering to WTO obligations, if the EU were to invoke this argument against the recent US tax reform (including the tariffs on steel and aluminium).

- While the Digital Services Tax (DST) is advocated as an interim solution, should there be a lack of global consensus on the comprehensive solution, this 'interim measure' could be applied indefinitely. Should the US not accept the comprehensive solution, no matter what consensus is achieved extra-US it would be wrong to assume that there is global consensus – so where does that leave the application of the sunset clause? The risk is that the DST would continue to apply to US companies.

- The interim solution is effectively a gross basis sales tax which will inevitably result in double taxation and cascading tax liabilities. Since the tax will fall outside the scope of tax treaty networks, thereby leaving such a tax ineligible for double tax relief, market distortions and inequities would particularly arise (particularly as this tax will be a cost passed to EU taxpayers).

- Whilst some relief has been proposed in the form of a deduction of the DST as a cost from the corporate income tax base, this is a mere suggestion without being required by the proposal. That said, any measure should not discriminate against non-resident businesses, and the potential distortion of location considerations that could ensue cannot be ignored.

- The monitoring and enforcement of this tax will be simply based on the obligation to declare, which should be analysed in more detail in order to ensure proper enforcement.

- This tax, which will also be imposed in loss-making situations of the digital business model, is likely to have a significant impact on businesses with smaller or no margins. It is clear that significant work remains to understand any unintended consequences of the proposals, with a view to introducing measures (e.g. profitability threshold) to address such consequences.

- The threshold for the tax appears to have been intended to partially mitigate the disincentive to start ups. However, the fact that it does not apply to all companies may raise a state aid issue.

- The interim proposal rightfully recommends to leverage existing VAT mechanisms, and the potential efficiencies and practical advantages of such an approach, and are noted. However, whilst we agree that requiring taxpayers to fulfil administrative obligations in each Member State is a preferred approach, the practical difficulties of running the VAT and DST collection systems in parallel should not be ignored. Likewise, the costs for national tax administrations of implementing this new system (which will be disproportional to smaller Member States) for a measure which is declared to be interim.