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MIT MASTER CLASS SERIES

Digitalisation – is it a catalyst for International tax reform?
October 2018

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Introduction

The Malta Institute of Taxation launched its Master Class Series on 25th July 2018, with the first session focusing on the proposals and policy discussions around the taxation of the digital economy. The session was presented by Dr John Vella.*

This paper outlines the various issues raised by Dr. Vella which were discussed with the participants, and sets out the Malta Institute of Taxation's views on some of the key points.

The below complements the views already expressed in the Position Paper on the European Commission's proposals concerning the Fair Taxation of the Digital Economy issued jointly by the Malta Institute of Taxation (MIT) and the Institute of Financial Services Practitioners (IFSP) [the "Joint IFSP-MIT Position Paper"].

What has the impact of digitalisation on taxation been?

Taxation of the digital economy is at the forefront of both the international tax policy agenda and the general political agenda. Digitalisation has brought international corporate tax to a turning point, and the common view is that it exacerbates problems in international corporate tax.

The period between 2015 and 2017 saw BEPS addressing the digital economy, specifically in Action 1, which can be said to have been prompted primarily by the tax affairs of the US digital giants.

However, whilst the main focus of BEPS has been to address profit-shifting activities to tax havens, the issue with digitalisation is the allocation of taxing rights among jurisdictions. In fact, whilst Action 1 did propose targeted measures, there were no specific proposals addressing the taxation of the digital economy.

Interestingly, Action 1 concluded that it **is impossible to ring-fence the digital economy** because the whole economy is in effect being digitalised. This view does not, however, reconcile with the approach being proposed by the EU Commission, and the drive in certain jurisdictions for unilateral measures to be adopted.

What is evident is a common concern, at both a jurisdictional and institutional level, about the low level of taxation borne by digitalised companies, and about the inadequacies of the current

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international corporate tax system in its adaptation to a digitalised economy.

This has prompted dialogue at a global level on the future of the international corporate tax system, with the debate amongst the G7 countries and the Inclusive Framework (116 countries) resulting in the development of 3 schools of thought (OECD 2018 Interim Report):

1. The view that Digitalisation poses a challenge for the international Corporate Tax system which is best addressed through **reform targeted at highly digitalised business**. Countries should be allocated jurisdiction to tax businesses on a destination basis, i.e. where its market is located. The justification for this claim is the taxation of profit where value is created.
2. The view that Digitalisation poses a challenge for the international Corporate Tax system which is best addressed through a more **general reform of the tax system, as a whole**.
3. And the view that after BEPS and ATAD, there is **no immediate need for reform**.

The concept of 'value creation'

It has become an accepted belief that the international corporate tax system is based on the principle that the profits of a business should be taxed in the countries in which it creates value. However, it is recognised that this principle is being challenged by business models, in particular digital business models, for which value creation depends to an extent on the engagement and participation of users. The alignment between the taxation of profits and the notion of 'value creation' was adopted by BEPS as the driving principle. The OECD, the Commission in its recent proposals, and certain jurisdictions via their unilateral measures, continue to confirm it as such. Value creation, that is, the taxation of profits where value is created, has evidently been adopted as the principle to address the challenges brought about by digitalisation. But are 'efficiency' arguments being confused with 'fairness', the ability-to-pay and the benefits principles?[1]

Notwithstanding claims to the contrary, it is contended that 'value creation' is not in fact a principle of the current system of international taxation. Although it is undeniable that, over time, we have seen a shift from a worldwide to a territorial system of taxation, this of itself does not mean that there has been a shift in policy. Furthermore, it is arguably illogical to build an international tax regime on a principle if there is no global agreement as to its conceptual application.

[1] *"The normative claim, that profit should be taxed where value is created, is also questionable. It cannot be easily justified on fairness grounds—whether formulated along the lines of the benefit principle (profit is not commensurate with benefit, and benefit is provided by countries other than those where value is said to be "created", including the market country) or the ability to pay principle (which is generally thought to justify world-wide residence based taxation). It certainly cannot be justified on efficiency grounds because it is conducive to real distortions and, therefore, economic inefficiency."* Michael P. Devereux and John Vella, *'Taxing the Digital Economy: Targeted or system-wide reform'*, British Tax Review, Issue 4, 2018, p. 393.

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Taxation of digital businesses at the location where value is created is at the core of the proposed Digital Sales Tax. Critics of the proposed tax are of the view that it is based on a principle which is descriptively wrong, normatively questionable and practically very hard to implement.[2]
What has become clear is that the notion of value creation is difficult to define. From a practical perspective, the determination of value, its quantification and its location are not easy to identify. These complexities cannot be ignored, and arguably, are brought to light by the proposals to tax profits on the basis of value creation. The lack of definition, and the issues with quantification of 'user' value creation, is the main criticism of the Commission proposals.[3]

There is a view that taxation of profits on the basis of value generated at destination is as justifiable as taxation on the basis of location of activities. However, it is debatable whether the profits adequately represent the benefits received (in Dr. Vella's view, it would not be reasonable to link the profitability of a business to the level of benefits received from a State since in effect loss-making businesses are likely to place a heavier burden on State resources than highly profitable businesses that tend to make limited use of them).

Value creation: supply vs demand – Under the current system of taxation, the allocation of taxing rights focuses on activities conducted on the supply side. This common understanding of 'value creation' is reflected in the Commission proposals for the taxation of the digital economy, arguably disregarding the role of consumers in the creation of value. As explained by Dr. Vella, this approach clearly conflicts with the economics principle of supply and demand, and in particular, the impact of demand on profitability.[4]

According to Dr. Vella, the fact that specific taxes are already levied in the context of the 'demand' side (for example, VAT), should not alter the notion of value creation, and in particular the recognition of the role of consumers in the creation of value. Whilst politically, states may not want to appear to be taxing profits on the same basis as they tax consumption, conceptually there is no basis to distinguish between the notion of value creation as applied in the context of profits taxes and consumption/sales taxes. This begs a further question, is international corporate tax the appropriate system of taxation to address the demand side?

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[2] Ibid. p 393
[3] The absence of a clear and globally accepted definition of the notion of value creation is, in fact, a primary point of criticism of the Commission's proposals raised in the Joint IFSP-MIT Position Paper.
[4] *"From a standard economic perspective, it is simply incorrect to state that consumers are not "factors that produce the income". The income being allocated among countries owes as much to the market as it owes to the various parts of a supply chain. Income depends on the price charged at the point where supply and demand meet; it simply would not have arisen in the absence of a market. It is not entirely clear why the international corporate tax system should depart from a simple and uncontroversial economic understanding of value creation.*" Devereux & Vella, fn 1, p. 394

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What is unclear is **the link between value and profit** – are the two synonymous? BEPS Action Point 1 refers to 'economic activity' as interchangeable with profit, however it must be acknowledged that the fact that a business does not derive a profit does not necessarily imply that no value is created. The OECD Interim Report suggests that countries are in agreement that local scale without local mass, and a significant reliance by businesses on intangibles create problems for the international corporate tax system. However, there does not appear to be consensus on the degree of relevance of 'data' and 'user participation'. Value may be said to be created wherever any 'contributor', whatever the extent of the contribution, is located. However, is the context of value creation being distorted with a view to altering the fundamental principles around the taxation nexus? There appears to be a gradual shift from the original concept of 'value creation' toward the concept of 'value created by demand', which arguably has no link with value creation and which cannot be controlled.

In support of a system that allocates jurisdiction to tax on the basis of the location of users it could be argued that **users and their data are a natural resource** and thus 'owned' by the state in which they are located. However, how does this reconcile with a widely accepted view, especially amongst digital businesses, that the processed data is of more value to a business than the raw data? – on this basis it would not be accurate to conclude that 'value' is created by the user.

Ring-fencing the digital economy

The recent EU proposals, with a 'short-term' turnover tax targeting certain digitalised activities and a long-term solution modifying the definition of Permanent Establishment, essentially reflect the first approach – the ring fencing of the digital economy and the introduction of measures which allocate jurisdiction to tax based on 'market'. Whilst it is recognised that this may not be an optimal approach, these proposals, in particular the 'short-term' measure, seek to address the possibility of unilateral measures being adopted by Member States that may distort the Single Market. That said, this has not stopped Member States from already adopting unilateral measures to tax certain digital businesses. On a broader scale, there is a concern that such unilateral measures by Member States may endanger Double Tax Agreements.[5]

The suggested interim nature of the Digital Sales Tax is also questionable, and, with no determined end-date, the possibility that the measure may be retained indefinitely and/or of the broadening of its scope cannot be ignored.[6]

[5] The imprudence of unilateral measures by certain Member States, as well as more broadly at a consolidated EU level, was highlighted in the Joint IFSP-MIT Position Paper.
[6] As mentioned in the Joint IFSP-MIT Position Paper, should there be a lack of global consensus on the comprehensive solution, or even consensus from the US, this could result in the 'interim measure' being applied indefinitely.

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The proposal for a 'long-term' measure (Significant Digital Presence - Digital PE) attempts to adapt the traditional PE concept to generate a nexus between a digitalised business and a territory in which users and consumers are located. One of the concerns with this proposal is the absence of clear rules and parameters for quantifying the value being created, so as to enable to, in turn, quantify the profit to be allocated to the country in which the user is located.[7]

A number of different approaches to the splitting of value-creation for profit attribution purposes have been put forward for discussion in various fora, such as, the EU Commission's proposal to adapt existing profit attribution rules to take 'value' into account. However, the proposed 'profit-split' approach, in effect, is arguably more akin to fractional apportionment, thus undermining Transfer Pricing principles. On the other hand, the UK is proposing a computation based upon an allocation of profit to routine activities, extracting a proportion of the residual profit which is attributable to value created by users, and apportioning that amount among countries in which the users are found. This methodology, however, ignores the fact that different users create different levels of value. Arguably, this approach can equally be applied to brick-and-mortar business.

Whilst there may be merit in a system which allocates a proportion of profits to routine activities and at least part of the residual profits to 'destination' countries, even where there is no Permanent Establishment, thus harnessing part of the benefit obtained from the destination country, this rationale should logically result in an attribution of residual losses to the destination country. Ultimately, the risks taken by the entrepreneur should not be ignored, and in particular, the impact of these risks on what value is.

The application of the proposed long-term measure requires clear and appropriate profit attribution rules, which not only cater for current digital business models, but which recognise ongoing technical innovation and further digitalisation of business and which can be adapted accordingly.[8]

Taxation of profit where value is created – looking beyond digital businesses

The proponents of a targeted reform for digitalised businesses are of the view that users create value for highly digitalised business in a way that is not mirrored with traditional businesses, and in particular, not in the same way that consumers do. There is a view that countries should be allocated

[7] As also referenced in the Joint IFSP-MIT Position Paper, the profit allocation rules in the Commission's proposal lack substantial detail, and, in the absence of an appropriate and comprehensive approach to the splitting of value creation, the likelihood is that the measure would inhibit economic growth.
[8] See Joint IFSP-MIT Position Paper, section 2.1

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taxing rights on the basis that there are 'users' located therein but not on the basis that there are consumers, trying to draw a distinction between the two.

However, it is difficult to distinguish (both conceptually and practically) between the importance of users for highly digitalised business and for non-highly digitalised business, and this will only become harder over time. For example, user fora (including digital ones), are widely used in the context of all businesses, not only digitalised ones.

Whilst there appears to be a widely accepted view that the scope of a single jurisdiction's right to tax businesses based on 'value' generated within their territory by users and/or consumers, there is clearly a lack of consensus on the manner in which this objective is to be achieved, or may be successfully achieved. There is a view that different rules should be applied for different business models – however such an approach, which disregards the reality of continually emerging business models, is not future-proof.

What is clear is the complexity which any rules which require a determination and quantification of user value would entail, and the difficulty of enforcement in the absence of significant resources.

Is broader tax reform the answer?

There is a growing view that ongoing digitalisation of the economy undermines the stability and viability of the system as a whole. Can therefore these proposals to address the challenges posed by the digital economy be said to be gradually changing the international tax system as a whole? If so, would not a broader reform to the system be the more logical approach?

It is argued that digitalisation does not create new problems but exasperates existing ones, distorting real economic activity. The existing international corporate tax system, as evidenced from the outcome of the BEPS project, creates opportunities for countries to shift profits to low tax countries, with many of the problems arguably stemming from the basis of the tax system itself. We have seen a steady increase in complexity of profit shifting practices over time, and of the measures intended to address such practices. The risk that the system is rendered **too complex to enforce** cannot be ignored – whilst the rules should act as a deterrent to profit-shifting practices, over complication could, in effect, enable customisable outcomes.

Over the past two decades we have seen a gradual reduction in overall corporate tax rates and the recent years have seen a fresh spell of tax competition amongst industrialised countries.

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Tax competition has pushed tax rates down, with countries looking to attract investment. Should we be concerned? Is this reduction in rates justified by a broadening of the tax base? It is argued that the BEPS measures, while effectively increasing the tax base, will incentivise the tax rate race to the bottom due to positive economic spill-overs. As is already becoming evident, we may reach a point where turnover taxes are considered preferable (they potentially generate more revenue and are arguably less complex, albeit less stable). Whilst the benefits and necessity of tax competition are acknowledged, there is a view that this could be a race to the bottom. However, it is our view, as also shared by the Master Class Participants, that competition would not necessarily lead to 'destruction' and could be the route to efficiency between the level of activity in a state and its taxation, and is arguably healthy.

The perceived problem with the international corporate tax system, and the fundamental principles that have been and remain at the core of it, is mobility. Under the current system of taxing businesses on the basis of residence and physical presence, the issues is that these are fairly mobile. A customer-base on the other hand is less mobile. Is there therefore scope for a destination-based tax and a sales-based formulary apportionment?

Is reform at all necessary?

Critics of a system which would levy income tax on profits by reference to user value creation are concerned that this could result in a second VAT system running in parallel. VAT is gradually moving to a full destination system of taxation, and a profits tax levied on the same basis, besides being 'unfair' to smaller-market states, is likely to add to the already existing enforcement issues which arise with the one-stop-shop in VAT (such as, requiring Member States, including the smaller ones with limited resources, to collect taxes on behalf of consumer/user States).

Furthermore, it cannot be ignored that a 'market' or 'destination' approach protects revenue of the larger jurisdictions, and, at least, within an EU context, the focus on user value creation under the guise of 'fairer taxation' would in effect operate to the advantage of larger markets.

It may be said that the European Commission, with its proposals targeted at the Digital Economy, is attempting to reinvent the wheel rather than to build upon existing established concepts of tax law. States should be examining the effects of the BEPS measures before attempting to revolutionise the international corporate tax system. Any proposals to shift the balance of taxing rights towards source-countries and away from the country of residence arguably represent a fundamental change to international tax policy. Whilst an agreement to reform the tax rules exclusively for digital businesses

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as defined would alter the notion of 'source' as understood traditionally, on the other hand, a broader reform of the international corporate tax system, will effectively alter the fundamentals of taxation.

Any change to the fundamental principles requires global consensus which is likely to be reached only through a thorough and inclusive global process.[9]

It is acknowledged that achieving a harmonised EU-wide (as opposed to global) approach is likely to be problematic, in particular, where the success of the measures depends upon compliance by non-EU jurisdictions. Of course, the risk cannot be ignored that, in the absence of a broader agreement on the way forward for the International Corporate Tax System, jurisdictions will adopt unilateral measures.

*Dr John Vella is Associate Professor of Taxation in the Faculty of Law at the University of Oxford, a Fellow of Harris Manchester College and a Programme Director at the Oxford University Centre for Business Taxation. John studied law at the University of Malta (BA and LLD) and the University of Cambridge (LLM and PhD). His recent research has focused on the taxation of multinationals, financial sector taxation, and tax compliance and administration.

This Master Class was held on the 23rd July 2018 at the Westin Dragonara Resort. The Rapportuer for the event was Dr. Trudy Marie Muscat.

[9] See Joint IFSP-MIT Position Paper, Section 1.4

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