INSIGHT: Why Taxation of Digital Services Continues to Occupy Center Stage

By David Klass
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The fiscal response to the Covid-19 pandemic might be said to be entering its next phase.

In the first instance, as the economic impact quickly became clear, the onus on government was to react decisively to support businesses in circumstances of almost unprecedented challenge.

Now that those support measures are in full swing, governments may feel better placed to consider how the funds will be raised to finance them.

In this context the recent announcement by the European Commission that they too are now proposing a form of digital services tax (DST) is significant. It represents further evidence of how the digital services economy is being seen as a potential source of valuable tax revenue, at a time when more traditional sources have ceased to play that role, without any prospect of a robust return in the foreseeable future (particularly if losses incurred now can be carried forward and set off against future taxable profits, should they arise).

This has now been followed by an announcement by the U.S. government—in the form of the U.S. Trade Representative (the USTR)—that it is launching an investigation into the proposed EU DST along with several DSTs variously implemented or proposed in several other jurisdictions.

The list of dramatis personae continues to grow.

Digital Services Taxes as Vital Sources of Revenue

Enter the European Commission

In its release dated May 27, 2020 entitled "Financing The Recovery Plan For Europe," the Commission proposes to borrow up to 750 billion euros ($848 billion) in order to make loans and grants to businesses struggling due to the effect of the Covid-19 pandemic and that, in order to aid the repayment of that debt, it may introduce a DST.

No detail is provided as to the form that such a tax may take, except for a statement that this will be a tax on "companies with a global annual turnover of above EUR 750 million to generate up to EUR 1.3 billion per year."

This is not the first time that the EU has proposed a DST—but objections raised by a number of countries meant the proposal was not taken forward. Now, however, circumstances are materially different.

Providers of services via digital platforms are increasingly being turned to as profitable success stories of the pandemic, on the basis that they are among the few winners in an otherwise gloomy economic picture. The immediate reaction to the announcement by German MEP Manfred Weber was instructive: “The big winners of the crisis are the digital giants.”

Role of the OECD

It is likely this development will have raised eyebrows at the Organization for Economic Cooperation and Development (OECD), perhaps more so than would have been the case following an announcement of another national-only DST.

The OECD has been campaigning hard for the need to reach a global consensus on how to address the digital services taxation issue: the European Commission’s proposal represents a high-profile departure from the OECD’s preferred plan of action, whereby all countries would focus on developing a united approach.

Work has admittedly begun in the form of certain OECD proposals, but there appears a long way to go from this point to ultimate agreement among all of the 135+ member states of the OECD’s Inclusive Framework on BEPS (base erosion and profit shifting), on what is a particularly thorny issue where the interests of participants are not all aligned.

The Covid-19 pandemic was in itself a hurdle on the path to global agreement, as the attention of governments was rapidly diverted to addressing the economic chaos engendered by the pandemic, as opposed to fixing faults in the global tax system.

There is now the risk that the Commission proposal could distract European countries still more from the OECD’s efforts to keep everyone focused on agreeing the single over-arching solution.

The ambitious target of a final agreement by the end of 2020 remains, however, the OECD’s declared aim.

From the perspective of individual countries, one can see the appeal of DSTs at the current time: a national DST can be implemented quickly, in the manner the relevant country sees fit without having to wait for the consent of 135+ other countries. And although the European Commission tax would need to be agreed by EU member states, such agreement would nevertheless appear to be within easier reach than one at the level of the OECD.

DSTs represent an attractive way of countering the problem of plummeting tax revenues and hugely costly Covid-19 rescue packages.

Despite this, and although the stakes are high and the political background fraught, it is far from impossible that the OECD will manage to secure agreement before the end of the year. For one thing, the OECD’s recent track record stands it in good stead: one needs only to look to the recent past at the agreement reached on the BEPS Project, which was achieved in what many regarded as an extremely ambitious and optimistic timeline.

Much focus will therefore be placed on the next meeting of the OECD to discuss the issue scheduled for October, at which significant progress will need to be made if there is any possibility of the December 31 deadline's being met.

Enter the USTR

Days after the European Commission unveiled its proposal for a DST, on June 6 the U.S. Trade Representative announced that it was initiating a [Section 301 investigation] into a number of DSTs already announced, and in some cases still at the proposal stage, in Europe and beyond—including that of the Commission.

Section 301 empowers the USTR to take action in circumstances where "an act, policy, or practice of a foreign country is unreasonable or discriminatory and burdens or restricts United States commerce."

We have been here before—when the USTR investigated the French DST in 2019, France being one of the first countries out of the blocks in this respect. That investigation resulted in the threat of U.S. tariffs on imported French goods, which was ultimately averted thanks to the French government's subsequent decision to postpone the collection of the DST until 2021.

So the USTR's announcement is not a surprising development, bearing in mind the issues are very similar.

The DSTs under investigation now are those in Austria, Brazil, the Czech Republic, India, Indonesia, Italy, Spain, Turkey, the U.K. and, as noted above, the European Commission.

The three areas of focus are alleged discrimination against U.S. companies, retroactivity, and the question of unreasonable tax policy.

With regard to tax policy, the potential issues that have been identified by the USTR are that the DSTs may diverge from norms reflected in both the U.S. and the international tax systems "in several respects."

These departures are stated by the USTR to include extraterritoriality, the taxation of revenue rather than income, and a purpose of penalizing particular technology companies for their commercial success. (It is interesting to note the reference to extraterritoriality, in the context of certain provisions of the U.S. tax code which could be described as having such an effect.)

Comments from interested parties are requested by July 15, and possible outcomes include the imposition of tariffs on goods imported into the U.S. from the countries concerned.

There has already been some debate as to whether DSTs could be illegal, on the basis that they infringe the terms of bilateral treaties aimed at preventing double taxation, or because they infringe free trade agreements protecting against discriminatory taxation, but this discussion has largely been confined to the academic arena and has not been tested yet. The USTR's investigation puts questions of DST legality and discrimination directly in the spotlight.

Indeed, it would seem fairly likely that the USTR's conclusions regarding the legality and alleged discriminatory nature of the DSTs currently under investigation will mirror those reached with regard to the French DST, to the extent that they share similar characteristics.

The key findings of the USTR's investigation into the French DST were that the French DST discriminated against U.S. digital companies "due to the selection of services covered and the revenue thresholds," and that the proposed taxation of revenue rather than income was in contravention of prevailing tax principles, and was "particularly burdensome for covered US companies."

It is difficult to see why, if the USTR judged those tests to be failed in respect of the French DST, similar features of the DSTs currently under investigation would be viewed differently.

Further to the USTR's decision to launch its investigation, on June 17 the U.S. Treasury announced that the U.S. would be stepping back from discussions at the OECD "while governments around the world focus on responding to the Covid-19 pandemic and safely reopening their economies."

Whilst the initial reaction from some quarters was one of strong disappointment (French finance minister Bruno Le Maire referring to the U.S. stance as a "provocation"), the OECD itself has striven to remain upbeat. Pascal Saint-Amans (Director of the Centre for Tax Policy and Administration at the OECD) has claimed the situation was still on course for a global agreement by the end of 2020 and that some of the U.S. reluctance to engage now is merely a function of the upcoming presidential elections—after which there will be one less hurdle in the way of final agreement.

Next Steps

Arguably the need for international agreement has never been greater; but there is the risk that tax administrations will be inclined to focus on immediate revenue-raising solutions to shore up domestic finances, rather than take a longer-term, more international perspective.

The immediate question is how the USTR investigation will pan out.

In response to the wider question whether the proposal of an EU-wide DST, combined with the intervention of the USTR, makes international consensus by the end of 2020 an even more unlikely prospect, the answer is: "not necessarily."

There are grounds for hoping that the prospect of tariffs and trade wars may ultimately prove sufficient to motivate governments to develop a consensual approach.

And, provided such an approach is maintained, discussions between the U.S. and the jurisdictions whose DSTs are under investigation could in fact have the effect of moving the debate forward. This would have a positive knock-on effect on subsequent discussions at the OECD level.

There may (yet) be a happy ending to this.

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