Copenhagen Economics

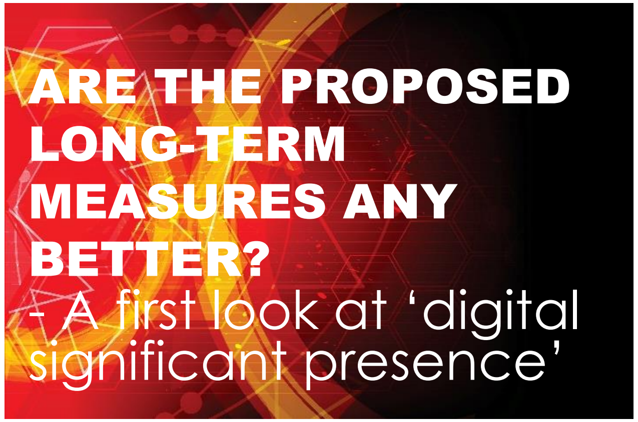
CHALLENGES IN TAXING THE DIGITALISING ECONOMY

Designing robust national and international tax system for the future

24-10-2018


THE CONTEXT
- What are the challenges?


DOES INTERIM MEASURES ADDRESS CHALLENGES?
- No solid arguments for the EU DST


ARE THE PROPOSED LONG-TERM MEASURES ANY BETTER?
- A first look at 'digital significant presence'

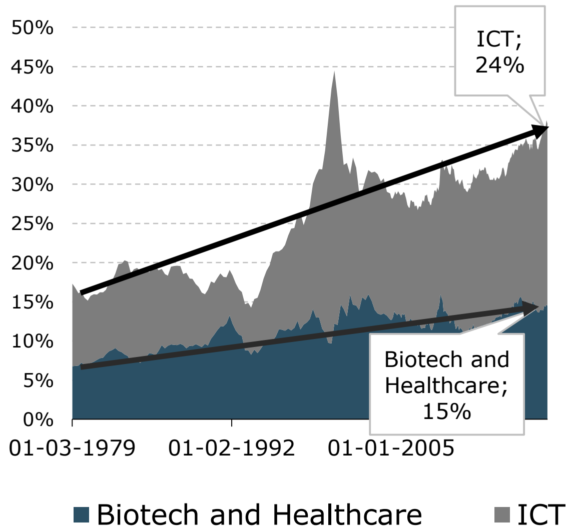
THE CONTEXT

- WHAT ARE THE CHALLENGES?

Challenges in corporate taxation for high-tech industries

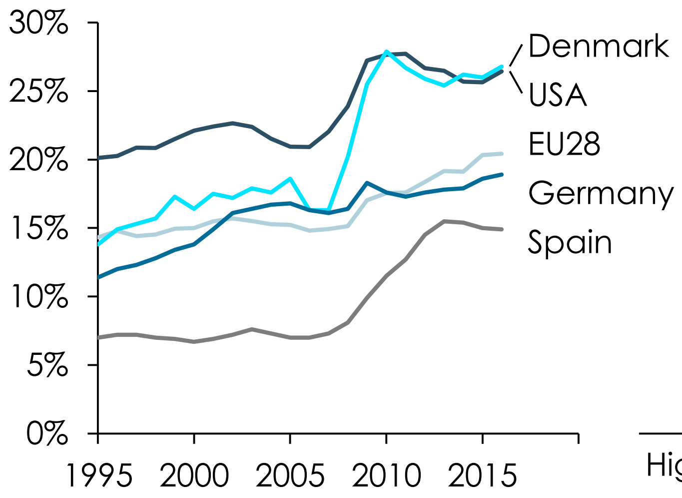
1 High-tech industries growing in importance…

Sector weighting S&P 500 Index



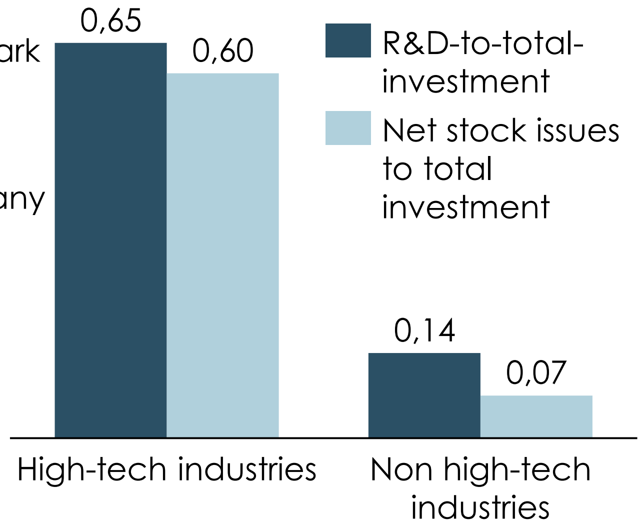
2 …shares of intangible investments rising

Intangible fixed assets share of gross fixed capital formation



3 Risk capital essential: risks high, collateral values small

Dependence for the median firm, 1980-2005



Conclusions

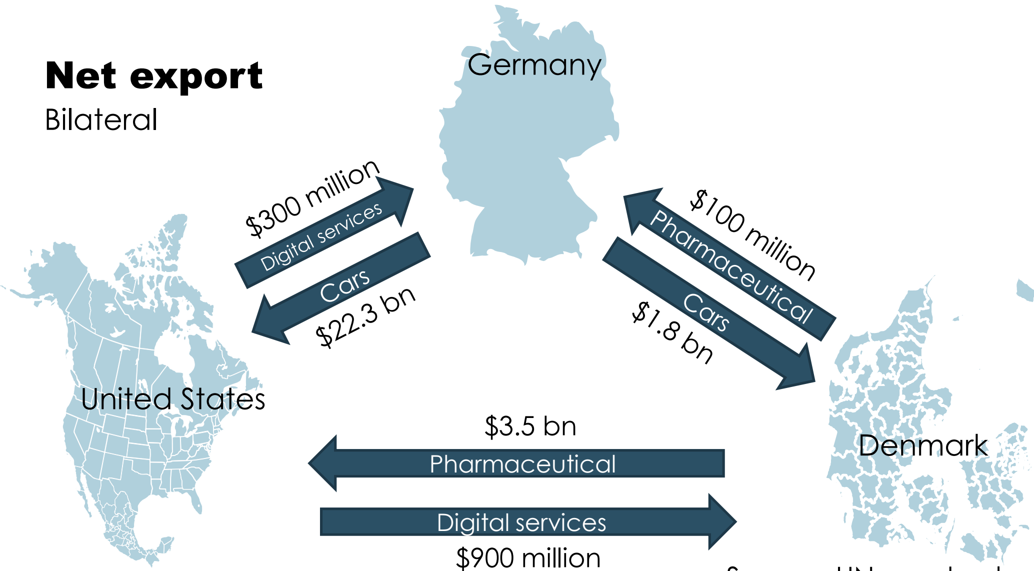
1. Debt bias in tax systems increasing problem (and lack of deep risk capital markets in EU)
2. A case for "good" tax treatment of R&D expenditure (on input or output side)
3. Transfer pricing becomes more challenging depending on business model

Transfer pricing and business models in high-tech sectors

DST: What is it stake for different countries with different comparative advantages?

Net export

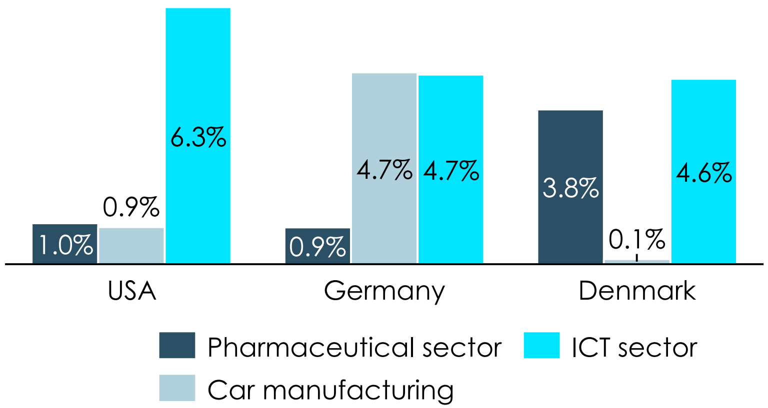
Bilateral



Source: UN comtrade

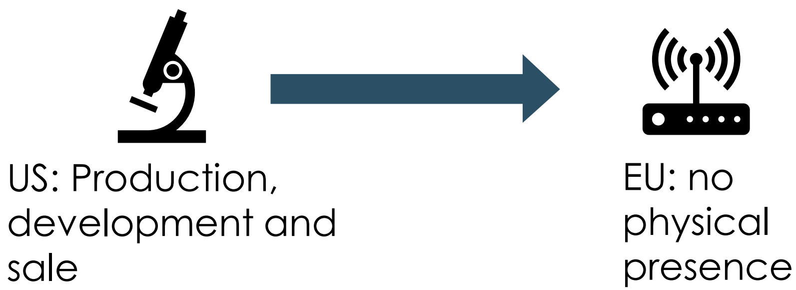
Industry size

Share of Gross Value Added

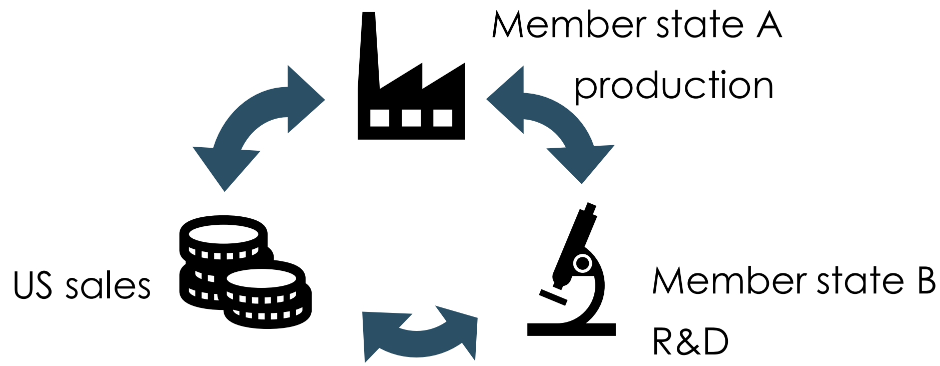


From a transfer pricing perspective: 'Easier' to tax digital businesses than other high-tech industries

Simple to apply transfer pricing rules for purely digital businesses ("critical mass without local presence")



Complex transfer pricing rules for pharmaceuticals



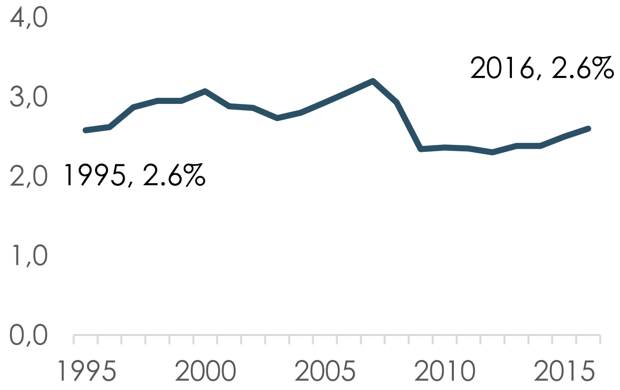
DO INTERIM MEASURES ADDRESS CHALLENGES?

No solid arguments for the DST

1

Digitalisation does not erode corporate tax base

Tax on corporate profits
% of GDP

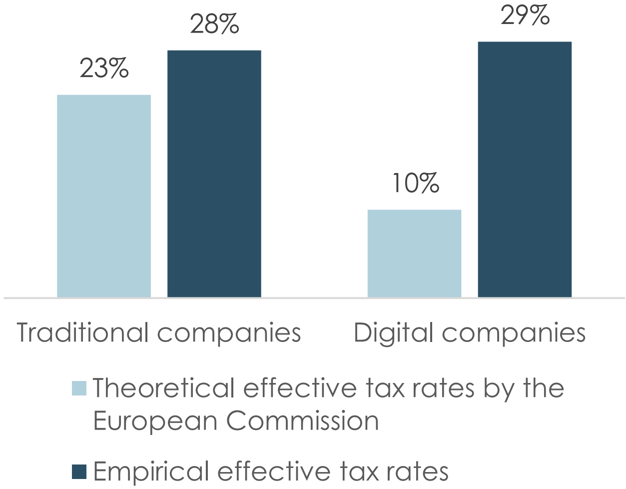


Corporate tax base has remained stable for two decades

(If target companies are outside EU then EU countries cannot be losing corporate taxes in pure digital models)

2

No evidence of under-taxation in digital companies



Tax records show that average tax rates are the same

(come back to calculation in a minute)

3

Proposed concept of user contribution not meaningful

How to measure value? Time? A click?

The ringfencing approach fails to capture the nature of digital economy

Proposed tax base has no link to risk taking activity which is the essence of a corporate tax base

User contributions in a corporate tax perspective difficult!

Proposal does not really help us

DST design also creates wide range of distortions

Any attempt to change within narrow DST framework just move around, does not really reduce distortions

1 Distortion to digital vs non-digital platforms and services

In scope:
Online intermediary platforms & digital advertisement

Outside scope:
Brick & mortar stores and non-digital consumption (e.g. CDs vs streaming)

2 Distortion to above vs below the thresholds

In scope: Platform above thresholds:
More than €750 million worldwide revenue
More than €50 million EU digital service revenue

Outside scope:
Platform below thresholds e.g. large platform with limited EU presence

3 Distortion to third-party vs own sales

In scope:
Third party sellers using online intermediary platforms to reach customers (often SMEs)

Outside scope:
Own sales by businesses with mixed business models (e.g. online intermediaries)

4 Distortion to EU exporters vs non-EU competitors for exports via online platform

In scope:
EU businesses exporting to non-EU buyers via online platforms

Outside scope:
Non-EU user selling similar goods and services to non-EU buyers via the same online platform

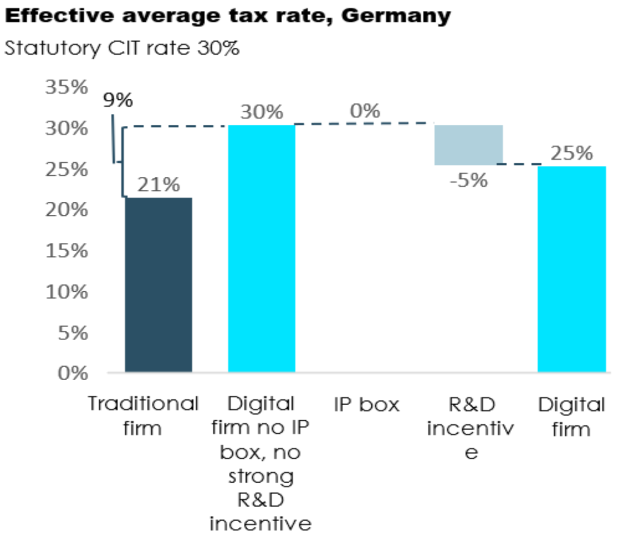
5 Distortion to compliant vs non-compliant businesses

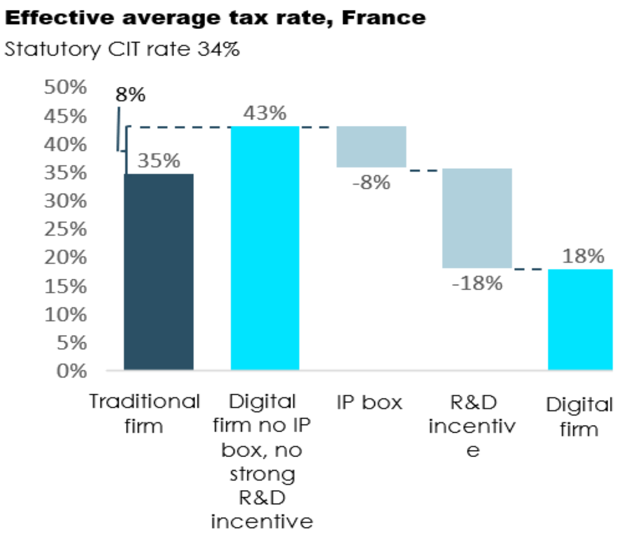
In scope:
Compliant businesses, e.g. businesses with presence in the EU where enforcement is relatively more feasible

Outside scope:
Non-compliant businesses, e.g. businesses without EU presence and hence difficult to enforce against

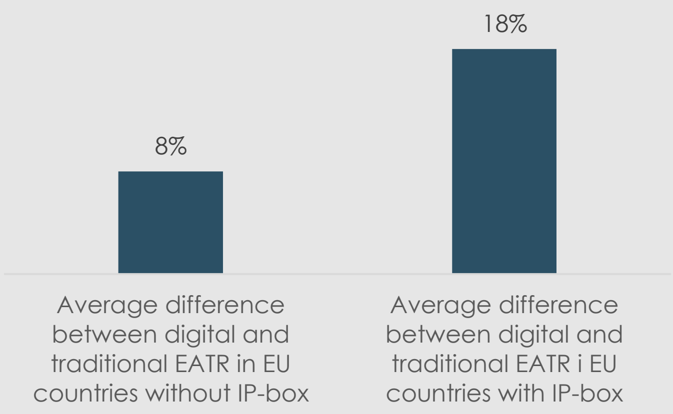
Should Germany (EU) compensate for aggressive R&D incentives & patent boxes in (some) other Member States?

The German and French tax systems: the story in a nutshell!





IP boxes are driving most of the difference in EATR between traditional and digital companies in EU



Four lessons:

I: In the absence of specific incentives, debt bias punishes digital (and pharma) in Germany
II: If EU is concerned about too aggressive R&D incentives, modify!
III: OECD BEPS and US tax reform helping reduce real abuse
IV: Illogical that Germany should introduce a DST to correct for patent boxes & R&D incentives in some (EU) countries

DST especially non-sensical in Germany

1

German digital businesses already have the highest effective average tax rate according to 2016 study by ZEW / PwC

2

The DST is tax on top of existing corporate taxation – equivalent to a 20% CIT rate for a median digital business

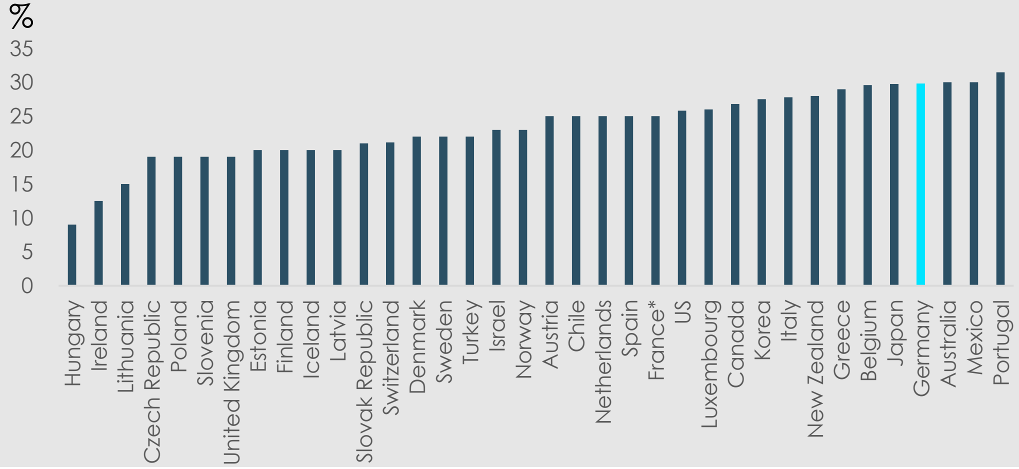
3

Germany has an unreformed corporate tax system with one of the highest statutory CIT rates in the OECD (cuts in US and France)

US tax reform with lower rate and exemption principle gives incentives to US in-sourcing ***and*** choice of low rate EU countries

Effective average tax rates for digital businesses in Europe, 2017

Statutory corporate income tax rate in OECD, 2018



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* For France the 2022 corporate income tax rate is displayed

ARE THE PROPOSED LONG-TERM MEASURES ANY BETTER?

- A FIRST LOOK AT ‘DIGITAL SIGNIFICANT PRESENCE’

Significant digital presence does not really solve profit allocation issue

Very limited impact:

1

Significant digital presence only affects the right to tax – not the amount

2

Transfer pricing rules still apply

Allocate the taxable profits to the place of value creation

(user contributions are not part of guidelines)

3

Potentially a significant administrative burden for businesses (and tax administrations)

Illustration: Corporate tax system today in comparison with future with 'significant digital presence' implemented

Today

US
R&D, production and sales force

Rest of the world
No physical presence and no taxable nexus

Conclusion: Corporate tax paid in the US. No transfer pricing needed.

Future with significant digital presence

US
R&D, production and sales force

Rest of the world
Significant digital presence and hence taxable nexus

Conclusion: Corporate tax still paid in the US. Transfer pricing rules would allocate all profits to the US

There are many unresolved issues when combining significant digital presence with the CCCTB

What is the Common Consolidated Corporate Tax Base? (2016 proposal)

1

A harmonised set of rules applied to MNEs operating in multiple Member States to calculate the taxable profits (or tax base) (CCTB)

2

An allocation mechanism (Formula Apportionment) for allocating taxable profits to individual Member States:

$$Share\ A = \frac{1}{3}\frac{Sales_A}{Sales_{group}} + \frac{1}{3}\left(\frac{1}{2}\frac{payroll_A}{payroll_{group}} + \frac{1}{2}\frac{No\ of\ employees_A}{No\ of\ employees_{group}}\right) + \frac{1}{3}\frac{Assets_A}{Assets_{group}}$$

3

The 2016 CCCTB proposals also include a whole bundle of other policies, including: R&D incentives, Allowance for Growth and Investment (AGI) and further transfer pricing measures

Proposed solution: Add 'user contribution' term to the formula...

Key issues

1. How to ring-fence digital activity: All actors increasingly using digital tools to interact in the value-chain.
2. What weight to put on user contributions?
3. How to measure value: A click, number of users, input time?

Conclusion

- Many of the issues with DST is essentially not resolved in long-term solution
- User contribution principle: hard to believe in it from a practical or economics perspective

More fundamental concern with the CCCTB + new PE definition: Are we moving away from taxing value creation?

Today:

- According to globally agreed, long-established principles, business profits are allocated to the country where **value is created**

With CCCTB:

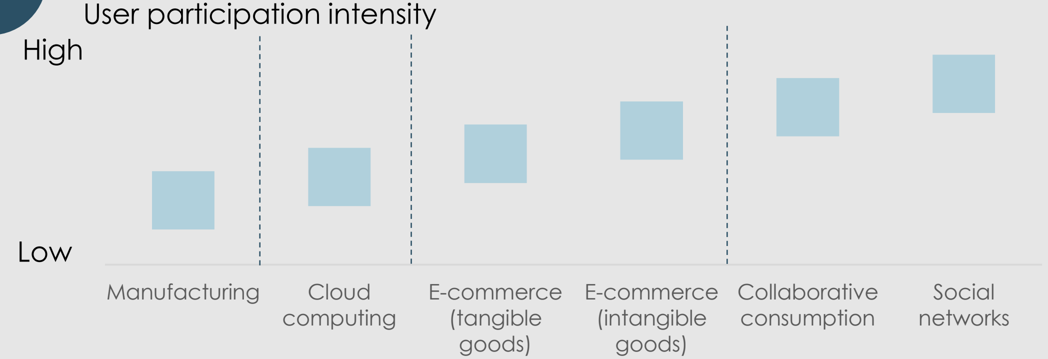
- In contrast, under the CCCTB, business profits *would be allocated to the countries where the firm merely has a local presence*
- The amount of allocation would be calculated using a fixed formula – by definition not aligned with value creation

Implications:

- Introducing the proposed Formula Apportionment would **provide fewer incentives for Member States** to increase productivity e.g. by investing public funds to boost research, development and innovation at national level
- Is that what Europe needs?

The inherent challenges with user contributions

1 User intensity varies greatly across business models



Source: OECD (2018) Tax Challenges Arising from Digitalisation – Interim Report 2018

2 … furthermore, value creation and user intensity are two completely different things

"Just having a large number of loyal customers in a given jurisdiction who receive a firm's product (either via online channels or conventional shipping) is not enough to justify unfettered source-based taxation"

Source: Becker & Englisch (2018) Taxing Where Value is Created: What's "User Involvement" Got to Do With It?

3 The whole economy is digitising: what, where and who should be taxed?

Car manufactures are collecting data to improve their product (e.g. for predictive maintenance or improvements to new generations). Should they start allocating profits to where users are?

"we do not believe that it is sensible to attempt to "ring-fence" the digital economy as if it were distinct and separate from the rest of the economy"

Source: Devereux and Vella (2017) Implications of digitalisation for international corporate tax reform

"Neither the work by the OECD nor related literature provides a definition of "economic activity" or "value creation" as the new mantra of international tax policy. This is particularly critical when considering digital business models. The digital economy is not an exclusive group of multinational IT companies that engage in tax planning. Digitalization rather entails new types of transactions and business models across all sectors"

Source: Olbert & Spengel (2016) International Taxation in the Digital Economy: Challenge Accepted?

4 Conclusion:

- User contributions don't seem aligned with taxing corporate profits where the risk taking activity is taking place…
- … are users really exposed to any risks?

Policy objectives and tax policy instruments (some reflection)

Globally:

- Tax policies to support growth of knowledge intensive industries: debt bias a key problem
- Transfer pricing:
  1. Defining tax base focusing on risk taking activities in a corporate tax perspective
     1. Risk taking activities rather than depth or stability of customer interaction
  2. Digital business models with limited local presence not really problem, i.e. DST barking up the wrong tree
- CFC and Minimum tax rates:
  1. CFC meant to ensure that parent companies cannot reduce their domestic tax burden by shifting activities to low tax jurisdictions
  2. Defining minimum tax rate regimes can be used to determine when to apply CFC
  3. Less clear minimum tax rates will / should have any role with respect to delivery of services that does not require any local risk bearing presence (transfer pricing versus global levelling playing field)
  4. No tax revenues are being lost

National tax policies with a German perspective:

- With US and French tax reforms, German is challenged!
  1. Top statutory rate and weak R&D incentives: challingen for knowledge intensive industries
  2. US reform with lower rate and exemption principle also implies that US firms will have large incentive to shift production to US or alternatively to EU jurisdictions with low rates (Ireland)
  3. Can Germany avoid a genuine corporate tax reform with much lower effective and statuary rates: growth and profit shifting

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