Copenhagen Economics

AN APPRAISAL OF THE PROPOSED DST

A study commissioned by CCIA
20 September 2018

DST: What, why and the two problems

What

- A new 3% tax on certain digital activities: i) Online advertising revenues, ii) Fees on online intermediaries, iii) Revenues from sale of user data
- Only applying to firms above certain thresholds

Why

- Digital companies are undertaxed
- Mitigating tax losses resulting from digitalisation
- Users key contributors to value creation

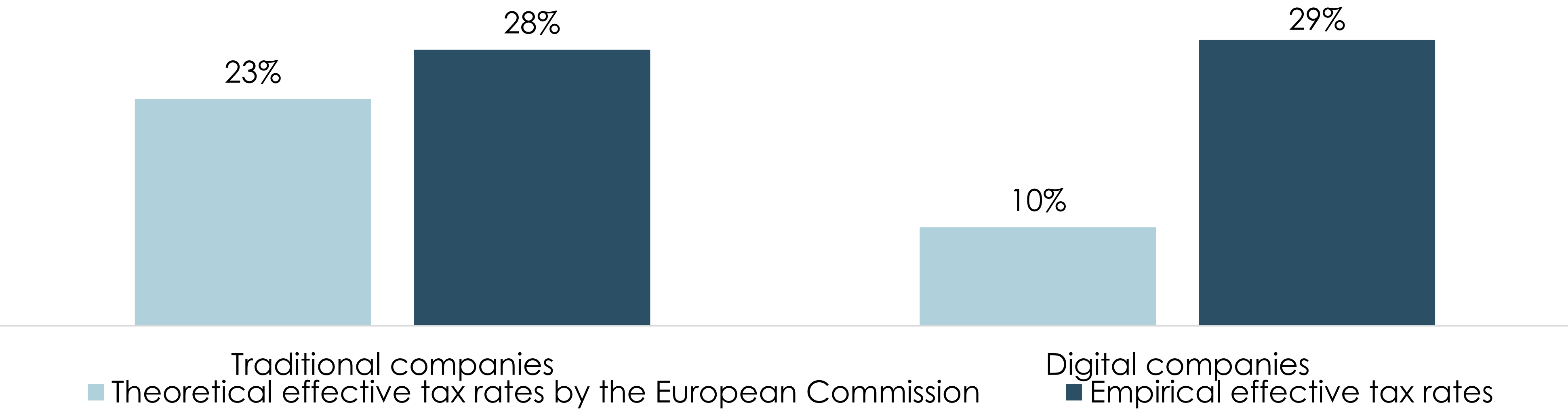
The two problems with the DST

- Argumentation not backed by evidence or solid tax analysis
- DST creates a range of new distortions to the tax system

NO GROUNDED ARGUMENTS FOR A DST

IA calculations at odds with observed tax record

IA states: Traditional companies pay 13 % point more in average tax rate than digital companies….
…. However, a real world sample of tax records suggests that they pay about the same



What explains this massive difference between theoretical and actually recorded average rates of taxes across industries?

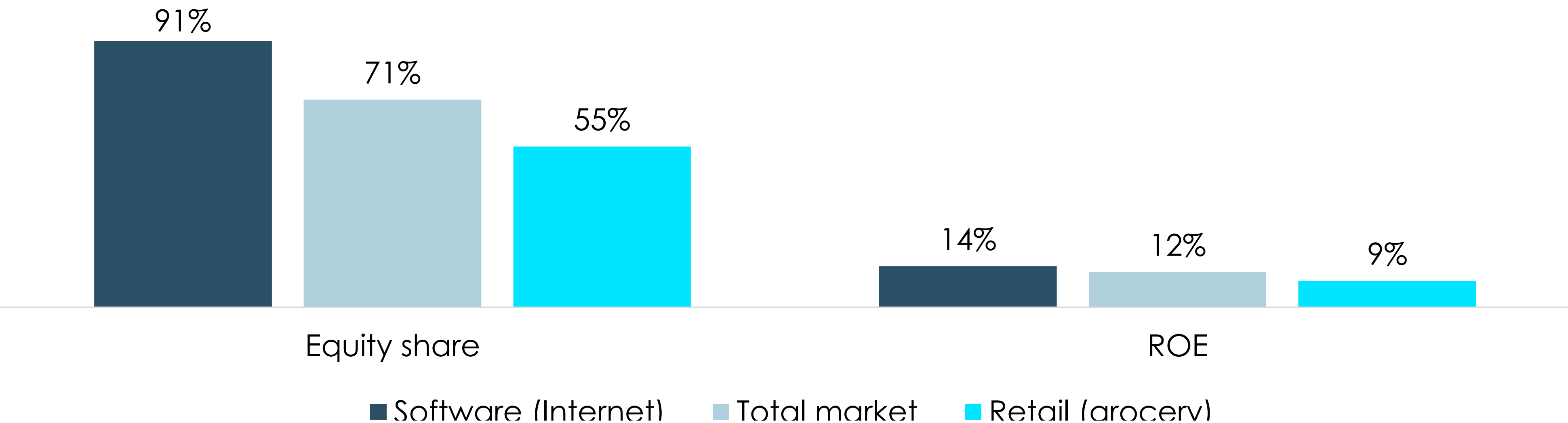
Note: Empirical effective tax rate calculated as total tax payments divided by earnings before interest and taxes (EBIT).

Source: ECIPE (2018) Digital Companies and Their Fair Share of Taxes: Myths and Misconceptions and Impact Assessment page 18

IA only partially accounts for differences between digital companies and ”traditional” companies

IA **does** factor in that digital companies are very R&D intensive and get larger benefits from R&D tax incentives

But **does not** factor in that shares of equity finance and rates of return are also different

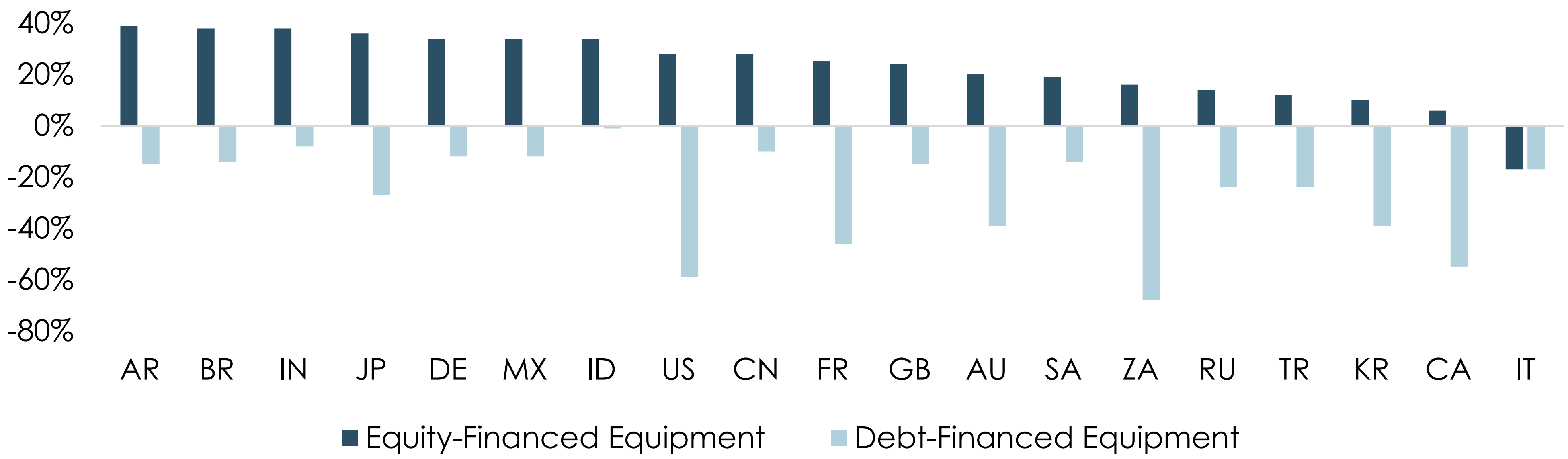


Note: Data from western Europe. ROE: Return on equity. Total market is without financials.

Source: Damodaran Online Database

But why do differences in financing matter?...

…because equity is orders of magnitude more expensive globally as shown by marginal cost of capital rates in G20 countries
(US CBO before tax reform!)



Thus the IA omits important factor

Source: CBO (2017) International Comparisons of Corporate Income Tax Rates, page 24.

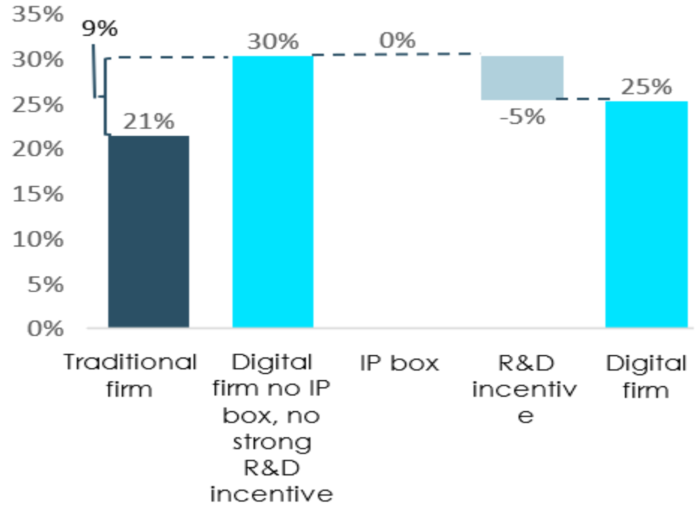
The real issue: Under-taxation in a welfare perspective

R&D tax incentives have been put in place for a reason…
…to align private and social objectives…
… in a context of large perceived positive spill-overs from private R&D

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

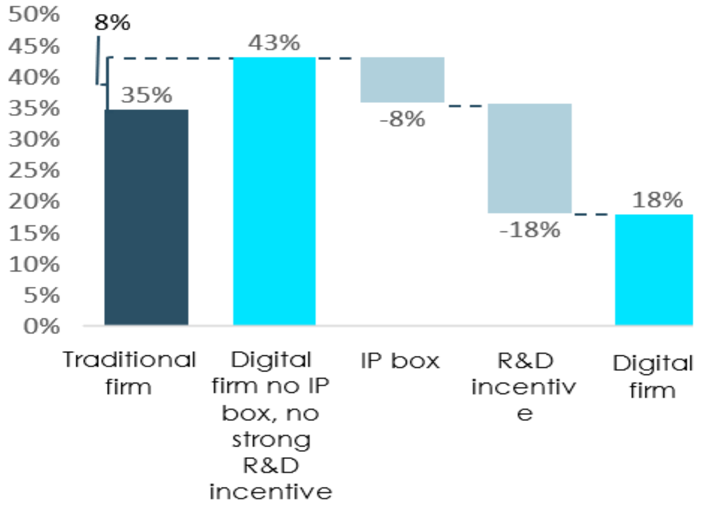
Effective average tax rate, Germany

Statutory CIT rate 30%



Effective average tax rate, France

Statutory CIT rate 34%



Four lessons:

I: In the absence of specific incentives, debt bias punishes digital (and pharma)
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 to use a DST to correct for patent box in some (EU) countries

What erosion of corporate tax base?

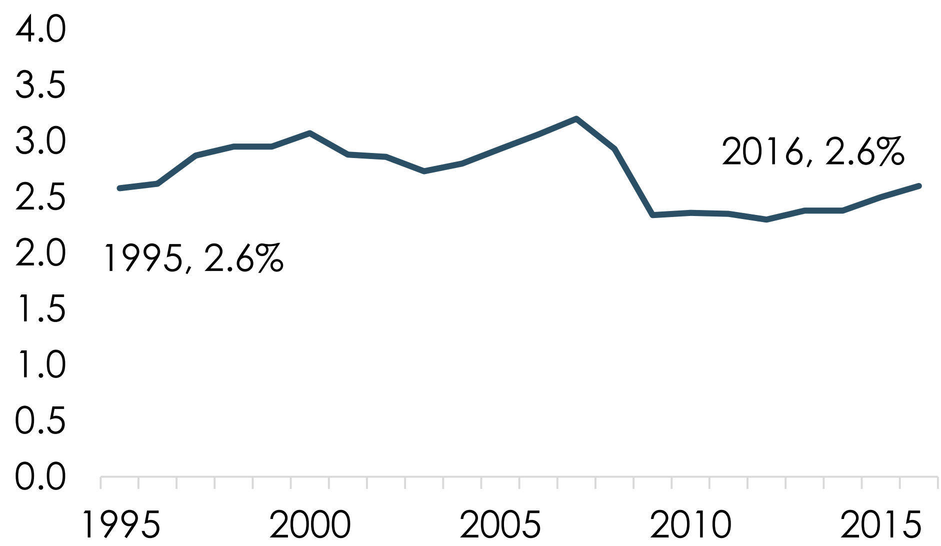
Claim: Digitisation of the EU economy is eroding the corporate tax base

No, tax on corporate profits stable over the past two decades

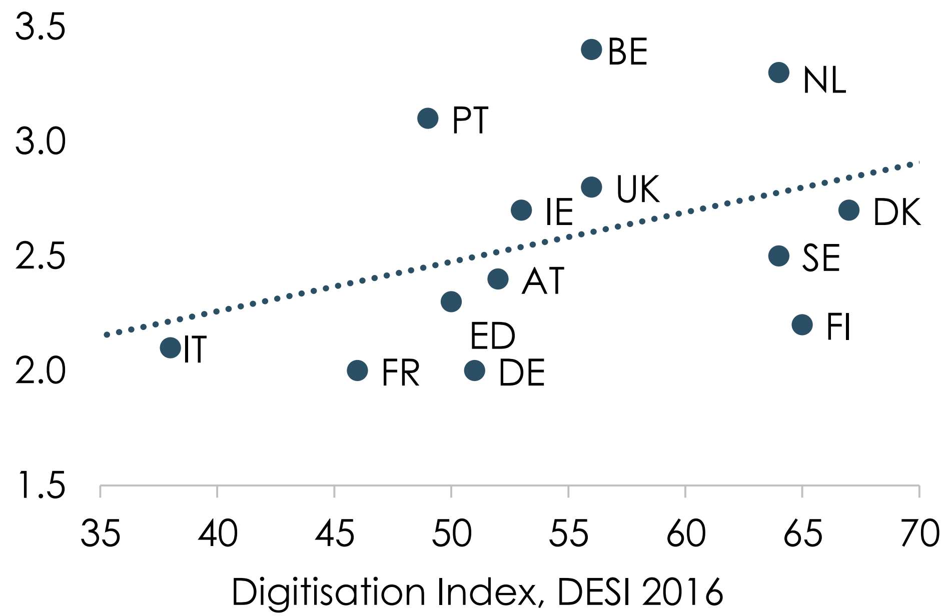
Claim: Corporate tax revenue is lower where digitisation is most intense

No, no negative correlation inside EU. On the contrary, mild positive link

Tax on corporate profits
% of GDP



Corporate tax and digitisation 2016
% of GDP



Source: European Commission and OECD

THE NEW DISTORTIONS

Under-taxation not really the issue… So what about the idea of creating a new tax base namely the user contribution?

IA Argument

- Users interacting with search algorithms, social media and ordering goods and service on online intermediaries are creating value for the platforms
- Value creation belongs also to the countries in which they reside
- This provides case for new tax base

Conceptual problems

How to measure value:

- A click, input time?

How to ringfence digital activity:

- All actors increasingly using digital tools to interact in the value-chain

Reverse causation:

- Customers make the choice because producers use time and resources to develop, produce and market them, nothing new

Teasers

- **User contribution**: A football, a car, a book, a newspaper, playing cars, games only have economic value when customers, often jointly, make use of it
- **IP:** So should the US Treasury add a levy on BMWs produced in Germany or insulin produced in Denmark with value largely linked to IP?

Five distortions in the DST

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

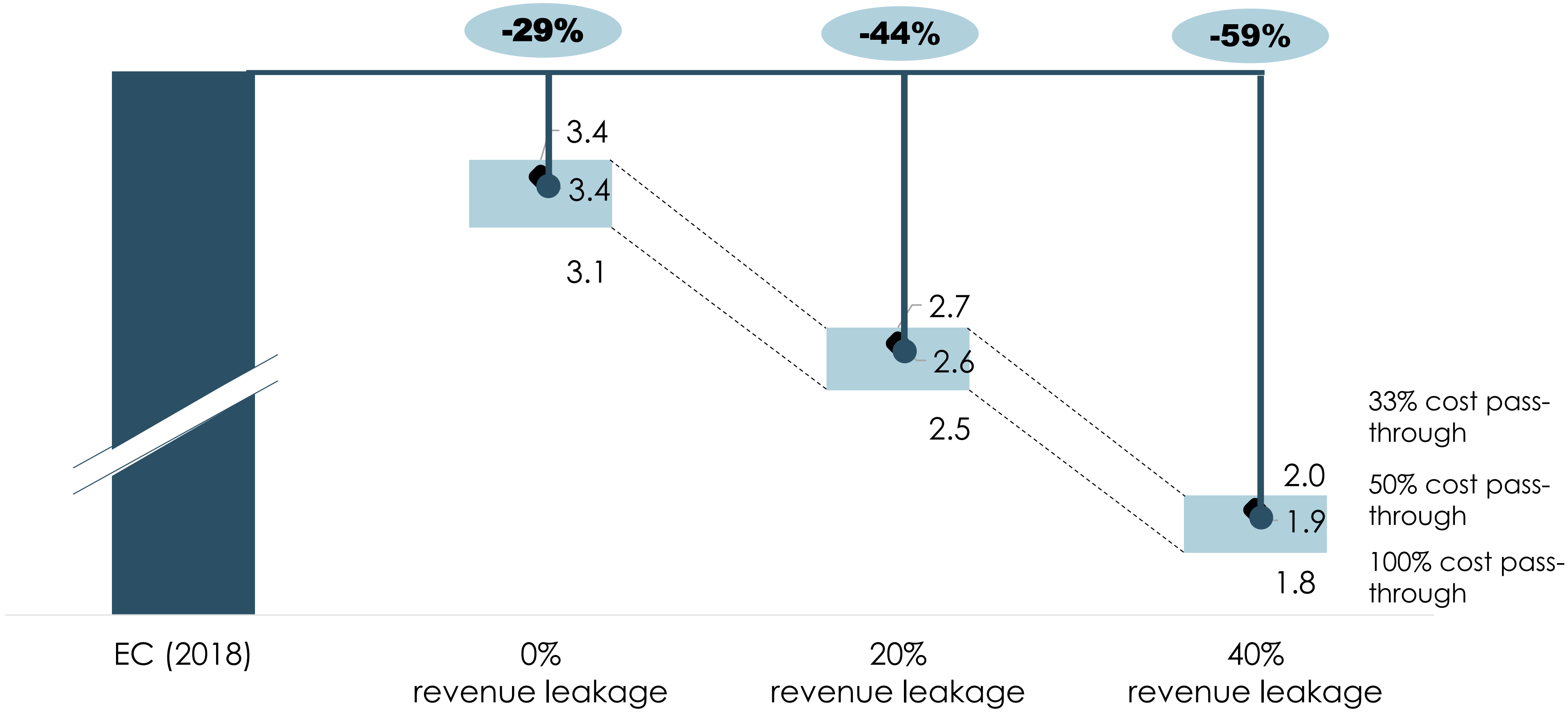
5 Distortion to compliant vs non-compliant businesses

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

EU tax revenue significantly lower than estimated

DST revenue
EUR billion



Source: Copenhagen Economics based on the Commission's IA and own calculations

Link

In conclusion

Under-taxation:

- Tax systems penalise "R&D" intensive in absence of R&D incentives
- EU/member states have powers reform and define balance
- BEPS/US tax reform address cross-border tax abuse, ensure minimum tax, let it work
- Corporate tax revenues stable, no case for panic!

Digital tax: source of new distortions

- User contribution as a tax base: an unclear animal. What problem does it solve?
- Five clear distorstions from the DST. While some repair work may be possible, it may merely shift issues and not solve fundamental problems

Going forward: what focus?

- Define the problem: transfer pricing (linked to IP) or invention of a new kind of tax base?
- For pure platform based internet serviced delivered from distance: *transfer pricing is not really an issue!*
- The nexus/PE discussion: does not really solve profit allocation issue
- User contribution principle: hard to believe in it from a practical or economics perspective