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Phone: +1 646 783 7100 | Fax: +1 646 783 7161 | customerservice@law360.com

EU Nations Won't Wait For Agreement On Digital Tax Rules

By **Natalie Olivo**

Law360 (February 1, 2018, 5:13 PM EST) -- Some European Union countries may forge ahead with their own policies for taxing the digital economy in the absence of bloc-wide consensus, specialists say, citing the new U.S. tax law and another potential punt from the Organization for Economic Cooperation and Development.

In 2015, the OECD had found that digital transactions shouldn't be taxed under a system separate from the economy as a whole, a conclusion that practitioners say the organization could maintain to some degree when it publishes an updated report in April. However, the EU has appeared to widely disregard this approach, including when the bloc's finance ministers in September **released a report** that stressed a need to create new rules for the virtual economy.

Tax specialists say there is likely to be pushback from EU countries including Ireland, the Netherlands and Switzerland, which have attracted the centralized and high-value business activities of multinationals such as digital processing. However, specialists expect that the 28-country bloc as whole, or at least larger countries such as France and Germany, ultimately will move forward with digital taxation policies.

The EU introduced measures to tackle the digital economy before the Republican-led tax overhaul process began, but practitioners say Europe has noticed Congress' willingness to rethink how the U.S. treats income generated outside its borders.

"The whole U.S. tax reform process has emboldened the EU and even other countries outside of the EU to continue their aggressive tax proposals," said Brett Weaver, an international tax partner at KPMG LLP.

What the New U.S. Way of Thinking Means for Europe

Weaver cited a 20 percent excise tax in the U.S. House of Representatives version of the bill that would have applied to payments other than interest made by a U.S. corporation to a related foreign business. The tax, which ultimately did not end up the final law, generally would have applied unless the related company elected to treat the payments as income effectively connected with a U.S. trade or business.

He said a lot of countries have pointed to this and other proposals as "evidence that the U.S. government is apparently willing to look to new standards of nexus, new standards moving the pendulum toward market-based taxation."

While the move toward taxation in the U.S. market is a concern to European countries, the EU is trying to tax more in its own market, said Will Morris of PricewaterhouseCoopers LLP, who chairs the tax committee of the Business and Industry Advisory Committee to the OECD.

He pointed to the EU's proposed measure to tax the digital turnover, or revenue, in each country where a company has a significant presence. Morris noted that even before the U.S. was moving off in a destination-based direction, "the Europeans were suggesting exactly the same thing."

According to Ryan Dudley, a partner in Friedman LLP's international tax services, the U.S. law is focused on ensuring that income from U.S. tech companies is brought back to the U.S. and taxed in the U.S. as much as possible, while the EU proposals are more focused on ensuring that tech companies are paying some amount of tax in Europe, even if they don't have a permanent establishment or other form of taxable presence.

He added that while the new U.S. measures will curb some of the activities that the EU views as giving rise to inequitable results, the bloc won't stop looking for revenue and pursuing taxation of the digital economy.

"Some of these companies attracted a lot of attention because they were paying no taxes, but now the fact that they may be paying more U.S. taxes will probably not stop the EU from pursuing policies that will increase the tax burden on companies that are operating in the digital economy," Dudley said.

Waiting for the OECD

While Morris noted that the U.S. has shown a capability for new thinking, the momentum of digital policies in the EU ultimately turns on what the OECD will say in April when it delivers its interim report on taxing the digital economy.

The OECD's October 2015 recommendation against separating digital transactions was part of its larger base erosion and profit shifting project, or BEPS, which was the culmination of the organization's effort to tamp down international tax avoidance.

As Morris put it, there is a hope that the OECD will accept the need for a more structured and detailed project for the digital economy, which would last about 18 months to two years. Such an approach will allow the organization to really dig into issues about value creation and business models while trying to reach an international consensus about that, he said.

"And if that's the place that the OECD can get to, then my guess is that the European proposals will be less radical than they would have been if the OECD had just thrown its hands up in the air," Morris said.

At the same time, however, he said rumors surrounding the organization's paper suggest that the OECD will maintain the stance it had from the beginning: that it's clear the digital economy shouldn't be "ring-fenced" and that there shouldn't be digital-only rules. Morris added that the paper may offer a few pointers on how to make digital policies "less damaging than they could be" without endorsing them.

For Weaver, unless the OECD's report says the organization can obtain consensus and move very quickly, it will be a signal to European countries that are considering interim measures to go ahead with them.

"They're working on them as we speak," he said.

Countries that Want Interim Measures and Countries that Don't

On the EU level, the bloc's finance ministers in their September report said immediate action was needed while the bloc considers longer-term changes. It proposed three "alternative options for shorter-term solutions": an equalization tax on the revenue of "digitalized" companies, withholding of tax on digital transactions, and a levy on revenue generated from providing digital services or advertising activity.

When it comes to individual countries, tax specialists pointed to France and Germany. Both nations have been aggressive toward corporate taxpayers in the past. Germany in 2008 introduced rules, widely criticized by other OECD members, that effectively reversed the result when companies restructured into tax-efficient commissionaire arrangements in which they conducted their foreign sales through agents. France, long known for its aggressive audits, has in recent years focused its efforts on companies including Amazon.com Inc., Apple Inc. and Google LLC.

"I think the larger countries like France and Germany are pushing most for this EU-wide approach to dealing with the digital economy," Dudley said.

As Weaver put it, a number of market-oriented countries in the EU have not been successful in attracting the centralized, high-value activity that countries like Ireland and the Netherlands have. These countries view the outcome of the BEPS project as not giving them a place at the table to tax these companies because the report defined "value creation" in terms of the human and physical capital deployed by multinationals.

"They're unsatisfied with the outcome, so they're looking to change the rules and say 'OK, if we don't have employees and assets, let's tax based on marketplace or destination principles,'" Weaver said. "The Irelands of the world rightfully should have some caution about the impact that this would have on their economies."

However, Weaver said that while countries like Ireland and the Netherlands would be the ones to stop an EU-wide policy, they likely won't. Rather, he said they'll find discussions with bloc leaders safe ground to fight for a fair outcome, to approach measures in a more deliberate manner and to push for global consensus involving the OECD.

"It's not saying 'no' to the EU, but rather it's saying let's do this right, otherwise we could — and I think this is a valid argument — hurt economic development generally and the advancement of the digitalization of Europe specifically," Weaver said.

At the moment, Morris said he doesn't think there is a consensus for dramatic changes among all of the 28 EU countries to change the tax system. For example, he did not expect to see a bloc-wide agreement on the common consolidated corporate tax base, which was introduced to standardize the way taxable profits are calculated throughout Europe.

In the meantime, certain countries may go it alone. The U.K., for example, already is.

In November, the government **published a budget** that included a plan to tax intercompany royalty payments for intellectual property related to sales to British customers even if the subsidiary using the IP is in another country. The government said the measure is aimed at digital multinational businesses shifting profits into low-tax jurisdictions.

However, Dudley noted that countries introducing rules independently also risk harming their own technology sectors.

"So on the one hand, every country wants to have a strong technology sector that creates good, high-paying jobs," Dudley said. "On the other hand, they also want to generate tax revenue from it, and there may be a trade-off in relation to that in some circumstances."

--Additional reporting by Vidya Kauri and Molly Moses. Editing by Brian Baresch and Tim Ruel.
