G | M | F The German Marshall Fund of the United States
STRENGTHENING TRANSATLANTIC COOPERATION

Transatlantic Take

Digital Tax: The Critical Importance of a Multilateral Approach

By Josh Kallmer

WASHINGTON, DC — Of the many sources of global economic uncertainty, international tax policy is getting much less attention than it deserves. Yet the European Union may soon take action that could fundamentally reorder approaches to cross-border taxation, by imposing new types of taxes on "digital economy companies." While the challenge that the EU identifies is a real one, its envisioned response would create significant economic, legal, and diplomatic costs.

Under traditional corporate tax principles, tax obligations arise only in jurisdictions where a company has a physical presence or a "permanent establishment." In recent years, technology has eroded the utility of the permanent establishment concept. The ability of firms to provide services digitally across borders means that they no longer need to be physically located in a market to serve customers there. Companies in virtually every line of business — whether life insurance companies writing policies, health care firms providing radiological results, or accountants performing audits — increasingly use flows of data rather than bricks and mortar to sell their services.

To date, the world's leading economies have appreciated the importance of taking a coordinated, multilateral approach to the tax implications of digitization. The ongoing Organization for Economic Cooperation and Development (OECD) Base Erosion and Profit Shifting (BEPS) project directly addresses these issues, while recognizing that because "the digital economy is increasingly becoming the economy itself, it would be difficult, if not impossible, to ring-fence the digital economy from the rest of the economy for tax purposes."

Unfortunately, much of Europe has begun to lose patience with the BEPS project. In September, Germany, France, Italy, and Spain called on the European Commission to consider imposing an "equalization levy" on the revenues of — as French Minister of Economics and Finance Bruno Le Maire later put it — "digital giants." The European Commission then issued a Communication that encouraged "multilateral, international solutions" but argued, curiously, that in "the absence of adequate global progress, the EU should implement its own solutions." The Commission's October consultation questionnaire then essentially preordained its own result, noting that "[t]here is a risk that member states' tax bases will gradually erode if there is no EU action to address this. This and the unfairness of the situation increase pressure on policymakers to act." The Commission put forward four possible

Photo credit: pogonici / Shutterstock

"targeted, temporary solutions," which include the equalization levy recommended by member states and other types of taxes on digital services.

It is understandable that European leaders would want to address the public policy challenges raised by digital technologies, including in the area of tax. But the way in which the EU appears inclined to act — by rejecting a productive, ongoing multilateral process in favor of quick unilateral measures — is deeply misguided, for several reasons.

First, the EU misdiagnoses the nature of the challenge. The Commission speaks of "new digitalized business models" and focuses on an exceedingly narrow category of "new ways of doing business," namely Internet platforms such as e-commerce and social media companies. Yet the issues that the EU seeks to address are not unique to Internet platforms, or to any specific type of company for that matter. Digital technologies enable companies in all sectors to do business in ways that rely less on physical presence. Digitization is not a "business model." Nor is it a choice. It is an imperative for virtually any company that hopes to compete internationally. Addressing the tax policy implications of digitization, therefore, should focus on concrete considerations raised by digitization itself.

Second, the Commission's approach would disproportionately harm Europeans. Like all entrepreneurs, startups, and other small businesses, those in Europe frequently have expenses that exceed revenues. Taxing the little revenue that early-stage companies generate or the money they spend on digital services would make it more difficult for them to even exist, let alone to grow and scale. For larger, more well-established companies, such measures would mean reducing resources available for investment, which would impede job creation and overall competitiveness.

Finally, unilateral EU action would generate transatlantic conflict. That is because, while there are questions about the tax liabilities of leading U.S. tech firms in Europe, there are no questions about those same companies' tax liabilities in the United States. New tax action by the EU would trigger a strong and immediate response from the United States and could violate Europe's existing tax treaties, many of which provide that earnings are taxable only in the territory where a service provider is located. Indeed, the current effort to reform the U.S. tax system may aggravate these tensions, as it likely will involve lowering the corporate tax rate and incentivizing the repatriation of overseas earnings. In effect, European authorities would be seeking to tax an ever-diminishing amount of income earned in Europe by U.S.-based multinationals.

Like economies around the world, the EU and its member states have a sincere and legitimate interest in addressing the tax challenges raised by the digitization of business. European leaders plainly appreciate the global nature of the challenge. The Commission notes that "a meaningful solution to capture and allocate the value created in the digital economy can take time," and November 30 Council conclusions also encouragingly express greater openness to a multilateral solution to these issues. At the same time, it is not clear that the EU and the member states fully understand either the breadth of the issues at play or how a mad dash toward EU action would harm Europe. Here's hoping that, for as plodding and unsatisfying as it may be, Europe's leaders reverse course and unambiguously recommit to the multilateral conversation on which genuine progress on these issues depends.

About the Author

Jonathan (Josh) S. Kallmer a non-resident fellow with The German Marshall Fund of the United States (GMF) in Washington, DC and Information Technology Industry Council's (ITI) senior vice president for global policy.

About GMF

The German Marshall Fund of the United States (GMF) strengthens transatlantic cooperation on regional, national, and global challenges and opportunities in the spirit of the Marshall Plan. GMF does this by supporting individuals and institutions working in the transatlantic sphere, by convening leaders and members of the policy and business communities, by contributing research and analysis on transatlantic topics, and by providing exchange opportunities to foster renewed commitment to the transatlantic relationship. In addition, GMF supports a number of initiatives to strengthen democracies. Founded in 1972 as a non-partisan, non-profit organization through a gift from Germany as a permanent memorial to Marshall Plan assistance, GMF maintains a strong presence on both sides of the Atlantic. In addition to its headquarters in Washington, DC, GMF has offices in Berlin, Paris, Brussels, Belgrade, Ankara, Bucharest, and Warsaw. GMF also has smaller representations in Bratislava, Turin, and Stockholm.

1744 R Street NW
Washington, DC 20009
T 1 202 683 2650 | F 1 202 265 1662 | E info@gmfus.org
http://www.gmfus.org/