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EXPLANATORY MEMORANDUM ON EUROPEAN UNION PROPOSAL FOR A COUNCIL DIRECTIVE LAYING DOWN RULES RELATING TO THE CORPORATE TAXATION OF A SIGNIFICANT DIGITAL PRESENCE & COMMISSION RECOMMENDATION OF 21.3.2018 RELATING TO THE CORPORATE TAXATION OF A SIGNIFICANT DIGITAL PRESENCE

7419/18; ADD 3; FISC 150; ECOFIN 276; DIGIT 47; IA 77; **COMMISSION STAFF WORKING DOCUMENT EXECUTIVE SUMMARY OF THE IMPACT ASSESSMENT** Accompanying the document Proposal or a Council Directive laying down rules relating to the corporate taxation of a significant digital presence and Proposal for a Council Directive on the common system of digital services tax on revenues resulting from the provision of certain digital services

7419/18; ADD 2; FISC 150; ECOFIN 276; DIGIT 47; IA 77; **COMMISSION STAFF WORKING DOCUMENT IMPACT ASSESSMENT** Accompanying the document Proposal or a Council Directive laying down rules relating to the corporate taxation of a significant digital presence and Proposal for a Council Directive on the common system of digital services tax on revenues resulting from the provision of certain digital services

7419/18; ADD1; FISC 150; ECOFIN 276; DIGIT 47; IA 77; **ANNEXES to the Proposal for a Council Directive laying down rules relating to the corporate taxation of a significant digital presence**

COM(2018) 146 final; 7418/18; FISC 149; ECOFIN 275; DIGIT 46; **COMMUNICATION FROM THE COMMISSION TO THE EUROPEAN PARLIAMENT AND COUNCIL: Time to establish a modern, fair and efficient taxation standard for the digital economy**

COM(2018) 146 Final; 7418/18; FSIC 149; ECOFIN 275; DIGIT 46 **ANNEX to the COMMUNICATION FROM THE COMMISSION TO EUROPEAN PARLIAMENT AND THE COUNCIL Time to establish a modern, fair and efficient taxation standard for the digital economy**

Submitted by HM Treasury on

4 May 2018

SUBJECT MATTER

1. On the 21st of March 2018, the European Commission published proposals for two Council Directives and a Commission Recommendation on the taxation of

businesses in the digital economy. This follows on from a Commission communication on the 21st of September 2017 (see Explanatory Memorandum 1249/17) and Council conclusions at the December 2017 ECOFIN.

2. The basis for the proposals is the thinking that the current international corporate tax system does not appropriately capture how digital businesses create value in a country.
3. This explanatory memorandum relates to the Commission's proposal for a Directive on the taxation of a "significant digital presence", the annexes to this proposed Directive and the Commission Recommendation to Member States to modify their double tax conventions in line with this Directive.
4. It also covers a Communication, including an annex, an impact assessment and an executive summary of the impact assessment. These latter documents all relate to both this proposed Directive and Recommendation and to another proposed Directive introducing a "digital services tax" (the Committee will receive a separate explanatory memorandum on the latter proposed Directive [EM – 7420/18]).
5. The documents draw attention to the growing importance of the digital economy, and express support for the Commission's Digital Single Market Strategy. They then argue that the existing international corporate tax rules do not properly recognise where value is created by users within certain digital business models. This is considered important because the international corporate tax framework is based on the principle that profits should be taxed where value is created.
6. The failure of the tax system to account for user-created value is exacerbated by digital businesses' ability to supply digital services in a country without being physically present there, and the importance for the businesses of intangible assets, such as patents and algorithms. The Commission say that these factors contribute to digital businesses paying lower rates of corporate tax in Europe than other businesses.
7. The Commission say that the best solution to this will be international reform of the corporate tax rules.
8. It is worth separately noting that on 16 March the OECD published the interim report of the Task Force on the Digital Economy. This report reflected the difference in views between different countries on this issue. The G20 subsequently called for the OECD to seek a consensus based solution by 2020.
9. The Commission argue that achieving agreement will be difficult, so in this context and to reduce the likelihood of Member States taking unilateral action, it is appropriate for the EU to act.
10. With this proposed Directive and the associated Recommendation, the Commission put forward what they call a "comprehensive solution". It would have three main features:
 1. The modification of permanent establishment rules to introduce a form of permanent establishment based on "significant digital presence". When a company has a permanent establishment in a jurisdiction, that means that the jurisdiction has the right to tax profits generated there which are

attributable to that permanent establishment. A significant digital presence will be deemed to exist if a company's business consists wholly or partly in the supply of digital services through a digital interface (such as a website or an app) and one of the following conditions is met:

- i. It derives revenue of €7mn (£6,189,050) or more from the supply of digital services to users in the country in a tax year
- ii. It has more than 100,000 users in the country in a tax year
- iii. It concludes more than 3,000 contracts for the supply of digital services in the country in a tax year

2. The development of methods for allocating profits from the provision of digital services between companies based on the performance of certain functions (e.g. collecting data). The Commission suggest that a profits split method would be the default, but that companies could suggest alternatives if they are well supported.

3. Because the changes to the permanent establishment rules and profit allocation methods would be overruled by a country's tax treaties, they would only apply between EU Member States or between Member States and third countries where there is no tax treaty, and not in cases where a company is in a third country with which Member States do have a tax treaty. As such, the third element is a Recommendation from the Commission that countries update their tax treaties with third countries to reflect the new rules.

11. The Commission repeats its position that the Common Consolidated Corporate Tax Base (CCCTB) would lead to fairer and more efficient corporate taxation in Europe. The proposed Directive is separate from the CCCTB. However, the Commission say that if in future the CCCTB is introduced, it should incorporate the provisions of this Directive.

12. An advisory "DigiTax Committee" is proposed, to examine questions of the application of the Directive. The Commission would evaluate the implementation of the Directive five years after its entry into force and report to the Council.

13. The annexes to the proposed Directive are as follows:

1. A list of national corporate taxes
2. A list of activities that would be deemed to be digital services
3. A list of activities that would not be deemed to be digital services

14. The other documents are: a Communication setting out the Commission's case for both this proposed Directive and Commission Recommendation; an annex to that Communication, giving the state of play of various European taxation initiatives; an impact assessment of the proposed measures; and an executive summary of the impact assessment.

SCRUTINY HISTORY

15. On 21 September, the Commission published a Communication setting out its position at the time on the issue of taxation and the digital economy. This Communication is referred to in these documents. This Communication [EM 1249/17] has been cleared from scrutiny by the House of Lords European Union Committee,

having considered by the EU Financial Affairs Sub-Committee on 14 March 2018, but remains under scrutiny at the House of Commons European Union Committee.

16. The documents refer to the Common (Consolidated) Corporate Tax Base (C(C)CTB) proposal [EM 38210 and EM 38211] which remains held under scrutiny in both the House of Commons and House of Lords European Union Committees. The Commons Committee considered the proposal on 8 December 2016.

MINISTERIAL RESPONSIBILITY

17. The Chancellor of the Exchequer has responsibility for United Kingdom policy on European Union monetary and economic issues. The Foreign and Commonwealth Secretary is responsible for overall United Kingdom policy towards the European Union

INTEREST OF DEVOLVED ADMINISTRATIONS

18. Tax policy is a reserved matter under the UK's devolution settlements and the devolved administrations have therefore not been consulted in the preparation of this EM. In March 2015, Parliament passed the Corporation Tax (Northern Ireland) Act, which devolves corporation tax rate setting powers to the Northern Ireland Assembly, subject to commencement regulations. If implemented, the Commission proposal could affect the corporation tax base, including for Northern Ireland, and the government will monitor this possibility as discussions develop.

LEGAL AND PROCEDURAL ISSUES

i. Legal basis

19. As a direct tax matter, the proposal for a Council Directive has its legal base in Article 115 of the Treaty on the Functioning of the European Union.
20. The Justice and Home Affairs opt-in is not a consideration.

ii. European Parliament Procedure

21. Special legislative procedure – the Council acting unanimously after consulting with the European Parliament and Economic and Social Committee.

iii. Voting procedure

22. Council is required to act by unanimity.

iv. Impact on United Kingdom Law

23. If the Directive were to be issued while the UK is subject to EU law, the UK would be required to adopt laws, regulations and administrative procedures to comply with it.

v. Application to Gibraltar

24. If adopted, the Directive would apply to Gibraltar.

vi. Fundamental Rights analysis

25. This proposal does not appear to engage any of the rights laid down in the European Convention for the Protection of Human Rights and Fundamental Freedoms.

APPLICATION TO THE EUROPEAN ECONOMIC AREA

26. None.

SUBSIDIARITY

27. The government considers that the most effective way to reform the international corporate tax rules is likely to be a global solution. This reflects that digital businesses will operate in many countries, both within and outside the EU, so a successful solution would need to account for that fact. The question is whether in the absence of that global agreement there is scope under the subsidiarity principle for the European Commission to suggest its own solutions.
28. The government's view is that these proposals are justifiable under the principle of subsidiarity. The issue to be addressed is the way that taxing rights are attributed between different states. Changes by individual states to their definition of permanent establishment will be of limited effectiveness if they cannot also update their agreements with other states on how to attribute profits between them. Actions undertaken by individual states would also likely differ from each other, which would increase complexity, creating compliance burdens for businesses and introducing risks of double taxation.
29. Given the difficulty of acting unilaterally, and in the absence of global agreement, there is consequently value in the Commission setting out constructive proposals for how a 'comprehensive solution' could work at an EU level. The main potential benefits of this are that it provides a basis upon which to explore options for global reform and may act to encourage non-EU countries to consider changes. There is therefore a benefit to coordinated discussions at the EU level. The government would note that it does not agree with the suggestion, noted in the Recommendation, that the Commission could have a role to play in helping Member States renegotiate double tax treaties with third countries and believes this would be more effectively conducted at Member State level.
30. The government considers the proposed Directive and Recommendation to be proportionate. The most effective solution to the policy challenge will be for different countries to introduce matching or similar measures in a coordinated way and to agree the same rules for profit allocation. However, the government continues to view the C(C)CTB as disproportionate, and this would also apply to the merger of these proposals with the C(C)CTB.

POLICY IMPLICATIONS

31. On 23 June 2016, the EU referendum took place and the people of the United Kingdom voted to leave the European Union. The government respected the result and triggered Article 50 of the Treaty on European Union on 29th March 2017 to begin the process of exit. Until exit negotiations are concluded, the UK remains a full member of the European Union and all the rights and obligations of EU membership

remain in force. During this period the government will also continue to negotiate, implement and apply EU legislation.

32. The government recognises that the taxation of the digital economy is an important issue. In November 2017 it published the position paper *Corporate tax and the digital economy* and at Spring Statement in March 2018 it published an update to that paper. It is therefore the case that in many places the government will judge the EU's proposals on the basis of their alignment with those position papers.
33. The government welcomes the Commission proposals as a constructive step forward on the taxation of the digital economy. They may form a helpful basis for multilateral discussion on this issue, both at the EU level and between other groups of concerned countries. They may also be valuable in maintaining progress towards global reform of the corporate tax system. The government also welcomes the statement, including in the Communication, that the Commission supports work through the OECD to achieve a global solution.
34. The government agrees with the Commission documents that any comprehensive solution to this question will mean updating both the definition of permanent establishment and methods for allocating profits between different entities. However, the government views the question of profit allocation to be the more substantial issue, whereas the Commission proposals concentrate on the issue of permanent establishment.
35. On the details of the proposal, the government believes there are a number of questions and issues that need to be investigated further.
36. As the government has set out in its position papers, it thinks the key question regarding the digital economy is the extent to which users are considered to generate value for a business. The list of services included in Annex II (those which are to be treated as digital service, and therefore within scope) is quite broad. It may include services for which it is not clear that users are a key contributor of value. The government therefore thinks it will be important to consider whether further refinement is needed to focus it more closely on services where value is created by users.
37. The concept of a significant digital presence has been the source of discussion at both an EU and OECD level in the past. The Commission state that the three alternative criteria for a permanent establishment based on significant digital presence: revenues, number of users, and business contracts. The government thinks there will need to be a detailed discussion – alongside the point on scope above – to ascertain the precise activities this may bring within a Member States' right to tax. It will also be important to consider whether the thresholds for these activities are proportionate.
38. The Commission acknowledge that unless Member States can update their tax treaties with third countries, the updated rules stemming from the Directive would apply only to companies based in other Member States. The government sees value in using the Commission's proposals to help influence, and push for progress, at a global level. Nonetheless, there is also a need to consider, in the absence of global agreement, how these provisions would interact with existing tax treaties and the extent to which they would resolve the challenge of taxing digital businesses on the basis of where they create value.

39. The Commission suggest that that the location of users and of business contracts can be determined by reference to the internet protocol (IP) addresses of users. The government agrees that this is a promising line of thinking. There are issues such as the use of virtual private networks (VPNs) or cross-border travellers which may need further consideration. It will also be important to establish how readily available this information is to businesses.
40. An important question in the design of a measure such as that proposed is which entity within a group of companies should be liable for tax in a country in which it has a digital presence. The Commission propose that the permanent establishment created through the significant digital presence should be remunerated by other group companies according to agreed profit allocation mechanisms, and that the country would then tax the permanent establishment.
41. The government has set out in its most recent position paper that an alternative approach could be to give the user jurisdiction the right to tax the companies in a digital business that are considered to be realising the value from the participation of users – that is, those companies that realise the residual profit after routine returns have been assigned to the companies in the group providing different services (called “principal companies” in the paper). User jurisdictions would then be entitled to tax the proportion of those principal companies’ profits that are deemed to be attributable to the participation of their local users based on the methodologies outlined above.
42. The government has also set out a different method to the Commission for determining the amount of profit subject to tax. The Commission’s approach focuses on deeming certain activities to tax place in the jurisdiction of users (e.g. data collection), whereas the government has suggested focusing on more directly determining a value of the contribution made by users. It will therefore be important to explore the merits of the alternative approaches.
43. The government does not support the proposal for a C(C)CTB, considering it to be neither proportionate, in terms of the constraints it puts on Member States’ ability to dictate their own tax policy, nor effective in achieving its policy goals. As such it does not agree with the Commission’s assessment that it will be the most effective solution to the question of tax and the digital economy. However, this proposed Directive is separate from the C(C)CTB.

CONSULTATION

44. The OECD carried out a consultation on digital taxation, which closed on 13 October 2017. The European Union carried out a consultation on this issue, which closed on 3 January 2018. The government published its position paper *Corporate tax and the digital economy* on 22 November 2017, and invited responses to that paper until 31 January 2018. Responses to the paper have been helpful in the development of the government’s position. The government published an update to the position paper on 13 March 2018 and welcomes responses to this update.

IMPACT ASSESSMENT

45. The Commission has carried out an impact assessment on the proposals which includes a useful assessment of the different potential options for a comprehensive

solution. The government will be doing further work to assess these proposals in more detail, alongside its work evaluating the responses to its updated position paper.

FINANCIAL IMPLICATIONS

46. The Commission's Directives state they have no effect on the EU Budget. The comprehensive solution does not include an estimate of the potential yield. The proposed changes would likely lead to a different allocation of profit across different Member States, but the precise amount would depend on transfer pricing adjustments that it is not possible to provide a conclusive estimate of at this stage.

TIMETABLE

47. These proposals were issued in March and Council negotiations will commence from April onwards. Taxation and the digital economy was discussed at the April informal ECOFIN.

A handwritten signature in black ink, appearing to read 'Mel Stride', is centered on the page.

**RT HON MEL STRIDE MP
FINANCIAL SECRETARY TO THE TREASURY AND PAYMASTER GENERAL**