

18-15 The European Union's Proposed Digital Services Tax: A De Facto Tariff

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World digital trade in goods and services, conducted via the internet, continues to expand at a rapid rate.¹ Global e-commerce increased from \$19.3 trillion in 2012 to \$27.7 trillion in 2016 (USITC 2017), and about 12 percent of global goods trade are handled on the internet (McKinsey Global Institute 2016). New technology drives this growth, and the relative absence of government barriers has enabled technology to thrive. But barriers are beginning to emerge, and particularly worrisome are localization requirements and digital taxes. Like the United States, the European Union vigorously opposes localization requirements, which are

gaining a foothold elsewhere in the world.² This Policy Brief, however, examines the other threat: digital taxes proposed by the European Union.

Digital taxes are part of a larger European agenda. Over the past three years, the European Union has sought various ways to curb tax avoidance practices and collect more revenue from an array of US multinational corporations (MNCs), triggering disputes with some of the giants in the field. In 2016, for example, Apple was ordered to pay billions of dollars in back taxes to Ireland, which the European Union said was part of its crackdown on the use of low-tax countries to shelter MNC income.³ The European Commission argues that Ireland and other EU members are violating rules against state subsidies by granting favorable tax treatments to US MNCs. This is a popular claim throughout Europe, but not surprisingly, MNCs and some member states are fighting back.

Now the Commission is exploring a new way to raise member state tax revenues from US MNCs: tax MNCs' digital earnings. It proposed two digital taxes in March 2018: a digital services tax (DST), which would tax the part of a digital firm's revenues attributed to European member states, and a digital profits tax, which would tax the slice of corporate profits derived in member states. Firms with global revenue exceeding €750 million and EU revenue exceeding €50 million in a financial year will be subject to the proposed 3 percent DST on revenues arguably derived from European internet users. However, certain types of revenues will not be subject to the DST, including subscription fees paid over the internet and crowdfunding revenues. The revenue thresholds and these exclusions capture important US MNCs, while allowing many EU firms to escape the proposed DST.

These new tax proposals arise in a general European atmosphere of distrust towards highly successful US firms,

1. By contrast, over the 2011-16 period, following the Great Recession, world merchandise trade grew at just 2.7 percent per year on average in constant 2009 dollars. In decades prior to the Great Recession (1986-2006), world merchandise exports expanded at 8.7 percent per year on average in constant dollars, thereby spurring the world economy. Various factors are responsible for the slowdown, among them the absence of new tariff liberalization (exemplified by the failure of the Doha Round) and slow progress on implementing the trade facilitation agenda. Trade data are from United Nations Conference on Trade and Development (UNCTAD), <http://unctadstat.unctad.org/wds/TableViewer/tableView.aspx?ReportId=101> (accessed on April 23, 2018).

2. The European Union is drafting a proposal on "Horizontal provisions for cross-border data flows and for personal data protection." Draft Article A rejects localization requirements. See Politico European Edition, www.politico.eu/wp-content/uploads/2018/02/Data-flow-provisions-POLITICO.pdf (accessed on April 23, 2018).

3. See Hufbauer and Lu (2016). For an update, see Sam Schechner, "Apple Takes a Step on Payment of Back Taxes to Ireland," *Wall Street Journal*, April 24, 2018, www.wsj.com/articles/apple-takes-a-step-on-payment-of-back-taxes-to-ireland-1524592457 (accessed on June 26, 2018).

exemplified by attacks on US digital firms over privacy issues and concerns that tech giants may be defying EU competition policy standards. Many US MNCs in the digital industry, such as Google and Facebook, may be subject to the newly proposed taxes.

The Commission's tax proposals reflect a general but dubious belief that digital firms operating in the European Union are taxed at much lower effective tax rates than traditional nondigital companies, and the contention that the traditional "permanent establishment" concept that a corporation resides in a fixed place of business—an office, a factory, a distribution center, or the like—is outmoded in the digital

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age.⁴ Beyond this flawed contention, from a legal perspective, this Policy Brief argues that the DST has the characteristics of a prohibited tariff under the rules of the World Trade Organization (WTO). More specifically, the high revenue thresholds that subject a firm to the DST, and the exclusion of certain revenues widely earned by European firms, create de facto discrimination against US digital firms, in violation of the European Union's national treatment commitment under the General Agreement on Trade in Services.

The tax on digital corporate profits squarely conflicts with the permanent establishment concept affirmed in EU member state bilateral tax treaties with the United States. In addition, measuring the share of corporate profits earned in Europe would be highly controversial, even if tax treaty obligations are set aside. For these reasons, the digital profits tax may not be enacted for some years, if ever. The DST poses a more immediate challenge.

If the European Union moves forward with implementing the DST, the United States could pursue several countermeasures (described in section 4). Most immediately, the United States could seek termination of the DST as part of the price for dropping the US "national security" tariffs imposed on European steel and aluminum exports under

Section 232 of the Trade Expansion Act of 1962. Also, the United States could open an investigation, under Section 301 of the US Trade Act of 1974, into the "unreasonable, discriminatory, or unjustifiable" aspects of the DST, as a preview to the threat of penalty tariffs on imports from Europe. These responses would be controversial, but the European Union's unilateral claim on a significant amount of foreign revenue as part of its own tax base invites a unilateral countermeasure by the United States.

Over a longer period, the United States could challenge the DST at the WTO as a violation of the national treatment principle, and it could launch a plurilateral agreement to prohibit the DST and similar taxes. Finally, as an extreme measure, the United States could invoke an obscure provision of US tax law, Section 891 of the Internal Revenue Code, to threaten double taxation of US income earned by European firms if the DST enters into force.

1 THE EUROPEAN UNION PIONEERS DIGITAL TAXATION

The common antecedent of the earlier tax challenges and the two recent European Commission tax proposals is an initiative led by advanced industrial countries belonging to the Organization for Economic Cooperation and Development (OECD), known as the Base Erosion and Profit Shifting (BEPS) project. This initiative grew out of a session of the 2012 G-20 Summit in Mexico, where the leaders of the world's leading economies committed to greater transparency in the international tax area and reiterated the need to combat tax avoidance.⁵ In response to the call of the G-20 leaders, the OECD launched BEPS, a multipart project that recommended 15 actions to prevent MNCs from shifting profits to tax havens. As of May 2018, 116 countries signed up as members of the inclusive framework on BEPS.⁶ The members developed a review process for four minimum standards set by the OECD's action plan. They may extend the review mechanism for other actions of the BEPS package in the future.⁷

Motivating BEPS was the perception that MNCs were massively avoiding corporate taxation, both by situating intellectual property in low-tax jurisdictions and by abusing transfer pricing schemes. Not acknowledged in the BEPS

4. See Article 5 of the US-Germany tax treaty, www.irs.gov/pub/irs-trty/germany.pdf (accessed on April 23, 2018).

5. G-20 Leaders' Declaration, Los Cabos, Mexico, June 19, 2012, www.g20.utoronto.ca/2012/2012-0619-loscabos.html (accessed on April 23, 2018).

6. OECD, Members of the Inclusive Framework on BEPS, www.oecd.org/tax/beps/inclusive-framework-on-beps-composition.pdf (accessed on June 6, 2018).

7. The four minimum standards are Existence of Harmful Tax Regimes (BEPS Action 5), Preventing Treaty Abuse (BEPS Action 6), Country-by-Country Reporting (BEPS Action 13), and Effective Dispute Resolution (BEPS Action 14).

project, but increasingly evident as the action recommendations unfolded, was the targeting of US MNCs.⁸

During the last year of the Obama administration, this realization cooled the initial enthusiasm of the US Treasury for the BEPS project since higher foreign taxation of US MNCs would not only reduce US tax revenues but also drain the pockets of US shareholders. Nevertheless, several European countries, as well as the European Commission, drew on the BEPS recommendations to augment European tax revenues by targeting the offshore profits of MNCs, particularly US firms.⁹

Among other recognized tax rules, the BEPS project attacked the concept of “permanent establishment,” the classic threshold, long enshrined in bilateral tax treaties, giving a country the right to tax the profits of a business enterprise. A “permanent establishment” is defined (for example, in the US-Germany tax treaty) as “a fixed place of business through which the business of an enterprise is wholly or partly carried on.”¹⁰

8. Several BEPS recommendations are critiqued in Hufbauer et al. (2015).

9. The United Kingdom introduced a “diverted profits tax” in its Finance Act 2015, www.legislation.gov.uk/ukpga/2015/11, and French Finance Minister Bruno Le Maire often commented that giant technology companies such as Google, Apple, Facebook, and Amazon (GAFA) manipulate intracompany transactions to minimize their tax payments to the European Union (see Silvia Amaro and Karen Tso, “US tech firms like Apple and Amazon are posing a ‘huge’ tax challenge for France,” CNBC, October 6, 2017, www.cnbc.com/2017/10/06/apple-amazon-tech-firms-are-a-tax-challenge-for-france.html, and Ingrid Melander, “France, Germany want progress on taxing tech giants,” Reuters, February 7, 2018, www.reuters.com/article/us-eu-tax-digital-france/france-germany-want-progress-on-taxing-tech-giants-idUSKBN1FR29K). France and the United Kingdom pushed for a tax on the digital revenues of US firms before the European Commission floated its proposals (see Madison Marriage and Aliya Ram, “Big Tech faces UK tax on revenues, not profits,” *Financial Times*, February 22, 2018, www.ft.com/content/9bd2c65a-17fb-11e8-9e9c-25c814761640). The European Commission accused Starbucks, Amazon, and Apple of conniving with member states to violate EU rules on state aid. While the Commission initiated these investigations, any taxes collected would be paid to the respective member states. The investigation of Starbucks (Netherlands) is available at http://europa.eu/rapid/press-release_IP-15-5880_en.htm, and the investigation of Amazon (Luxembourg) is available at http://europa.eu/rapid/press-release_IP-17-3701_en.htm. In the case of Amazon, Luxembourg appealed the European Commission’s decision on December 15, 2017, www.mf.public.lu/actualites/2017/12/amazon_15122017/index.html. Note as well that Ireland vigorously opposed the retroactive imposition of Irish taxes on Apple (Hufbauer and Lu 2016). All links were accessed on April 23, 2018.

10. See Article 5 of the US-Germany tax treaty, www.irs.gov/pub/irs-trty/germany.pdf (accessed on April 23, 2018).

The BEPS project characterized the permanent establishment threshold as an outmoded, 20th century concept, and no longer relevant in the globalized and digitized 21st century. Seizing on this criticism, the European Commission proposed the two digital taxes. The core rationale is that local users of digital platforms provide value to digital firms, either by responding to website advertisements, by disclosing personal information (gender, age, tastes, etc.), or by interfacing with other users. Accordingly, the country where users live should have the power to tax digital firms on their profits or revenue streams, regardless of whether the firms are local or foreign and whether the profits or revenue streams originate in the taxing jurisdiction or abroad.

A similar rationale, when unilaterally applied (as with the Commission’s proposals), has long been rejected in other contexts. As one example, Dutch shipping firms that carry containers from Rotterdam to Baltimore arguably benefit from the sale of merchandise to US buyers. But starting with the Revenue Act of 1921, US law as well as bilateral shipping treaties protect foreign shipping firms from taxation of their revenues or profits by the destination country.¹¹ Shipping treaties were later expanded to cover airlines carrying passengers or cargo destined for a foreign country. Again, in the realm of postal services and telecommunications, a European carrier, such as Deutsche Post, is not taxed by the United States on the revenue derived from conveying messages or carrying personal or business packages to US residents.¹² Finally, in the realm of corporate profits taxation, the permanent establishment concept has been the touchstone to divide the corporate tax base between home and host countries. For example, France can tax a US corporation’s profits attributable to a permanent establishment in France, but it cannot tax profits attributable to the firm’s activities in the United States or other countries.¹³

The European Commission’s rationale for disdaining these precedents rests on a supposedly sharp distinction between “digital users” and “traditional consumers.”¹⁴ Traditional consumers, such as household buyers of food,

11. See US Taxation of International Shipping and Air Transport Activities (Portfolio 6740), Bloomberg Tax, www.bna.com/taxation-international-shipping-p7754/ (accessed on April 23, 2018).

12. For international transmission of voice and data, telecom firms divide the revenues paid by customers between the originating telecom firm and destination telecom firm according to a negotiated contract that sets out rates and conditions of service. In turn, each telecom firm is taxed by its own jurisdiction.

13. Of course, France can also tax the income of a foreign subsidiary corporation or branch created under French law.

14. This distinction originated in the OECD BEPS project and was reflected in the Action 1 Report issued in 2015. Further analysis was provided in OECD (2018).

clothing, or autos, are claimed to provide little value to producers of those wares. Such consumers are passive shoppers, who either like or dislike the goods, and register their preferences by putting money on the counter or guarding their wallets. By contrast, digital users are characterized as the wellspring of value to purveyors of internet services. Simply by logging on a website, they enrich the digital firm. To match the locale of tax collection with the site of value creation, according to the Commission, the country where users reside should tax the digital firm, no matter where the firm's personnel or equipment are located.

It is widely agreed that the jurisdiction where value is created has the right to tax the profits or income thereby generated (OECD 2018). But "value creation" has historically referred to the jurisdiction where employees and assets are located, not the jurisdiction where goods or services are sold. If a country wants to tax the revenue from local sales by a foreign firm that has no local presence, it can apply its sales or value added tax to those revenues. But the Commission wants to do much more: It wants to tax the cross-border flow of electrons, even though local residents pay nothing to the company.

The justification for this expansive grasp is a binary distinction between "digital users" and "traditional consumers," with respect to the locale of value creation. A binary distinction is too simplistic. United Technology and Rolls Royce learn a great deal from airline purchasers about the characteristics of jet engines. To a lesser extent, Amazon and Alibaba learn from customer reviews of goods purchased online. But Cargill probably learns nothing from the remote Chinese buyer of animal feed offloaded in Shanghai. In other words, the corporate world has a spectrum of experience, in terms of learning from customers.

For the European Union to assert a right of taxation based on the "discovery" of a previously unknown source of value creation—namely feedback and information from digital users—is both conceptually bold and fiscally convenient. The personnel who create digital websites are, for the moment, concentrated in the United States. If the European Union's attribution of value creation is adopted globally to establish a distinct tax regime for digital firms, no doubt the European Union would gain tax revenue at the expense of the United States. It is a mystery why the United States would embrace this change in long-established tax rules.¹⁵

To buttress its tax claim on digital firms, the Commission contends that digital firms pay much lower real effective cor-

porate tax rates than traditional international or domestic business firms. Matthias Bauer of the European Center for International Political Economy analyzed this contention and found it seriously misleading (Bauer 2018). The Commission rested its contention on hypothetical tax rates calculated from the most favorable tax laws and regulations of European countries. This exercise suggested effective corporate tax rates (ECTRs) of 9 to 10 percent for digital firms and 21 to 23 percent for traditional firms. In contrast with these hypothetical calculations, Bauer examined actual 5-year average ECTRs based on corporate annual reports. He found rates of 27 to 32 percent for digital firms and comparable rates of 27 to 28 percent for traditional firms.¹⁶

Resting on its flawed assumptions, the Commission advanced its two digital tax proposals. To be clear, the taxes in question are not directed at leveling the playing field between merchandise delivered, for example, by Amazon to a customer in France and the same merchandise sold by a local French retailer. To eliminate tax discrimination between brick-and-mortar retailers who sell clothes in France and clothes ordered from remote online sites, France can apply its own value added tax to deliveries from abroad. Similarly, France can theoretically apply its own value added tax to online video or music purchases by French customers (though the administrative burdens might be formidable). The Commission makes the distinction between digital services and wares sold on the internet in the following way:

In order to exclude a taxable nexus based on the place of consumption only, the mere sale of goods or services facilitated by using the internet or an electronic network is not regarded as a digital service. For example, giving access (for remuneration) to a digital marketplace for buying and selling cars is a digital service, but the sale of a car itself via such a website is not.¹⁷

Thus, the new digital taxes exclude online purchases by EU citizens. Instead, the new taxes are applied much more broadly, in the proposed Council Directives, to a wide range of digital services not requiring payments from users.

16. A broader study on US MNC taxation by the Tax Foundation in 2014 drew similar conclusions. See Tax Foundation, "How Much Do U.S. Multinational Corporations Pay in Foreign Income Taxes," May 19, 2014, <https://taxfoundation.org/press-release/how-much-do-us-multinational-corporations-pay-foreign-income-taxes/> (accessed on June 1, 2018).

17. See European Commission, "Proposal for a Council Directive laying down rules relating to the corporate taxation of a significant digital presence," COM(2018) 147 final, Brussels, March 21, 2018, https://ec.europa.eu/taxation_customs/sites/taxation/files/proposal_significant_digital_presence_21032018_en.pdf (accessed on April 23, 2018).

15. Robert Stack, former US Treasury deputy assistant secretary for international tax affairs, criticized the BEPS approach on permanent establishment. See "BEPS in Trouble—Gloves Off at the OECD Conference," International Tax Blog, Bloomberg, www.bna.com/beeps-troublegloves-off-b17179928708/ (accessed on May 22, 2018).

2 THE EUROPEAN COMMISSION'S RECENT DIGITAL TAX PROPOSALS

On March 21, 2018, the European Commission proposed two Council Directives: Council Directive 2018/0072 outlines a corporate profits tax on digital firms,¹⁸ while Directive 2018/0073 outlines a revenue tax on digital flows, the DST.¹⁹ The DST is characterized as an interim measure, with the implication that it will phase out when the digital profits tax is widely adopted.²⁰ For reasons shortly discussed, the interim DST could have a long life because the profits tax faces severe obstacles. Even if EU member states do not reach a consensus on the DST, a subset of member states (France and the United Kingdom, for example) that are pushing for a digital tax may act unilaterally to impose their own variants of the DST.

As far as European politicians are concerned, US multinationals are the “fellow behind the tree.”

Thresholds for applying the profits tax are moderate and would potentially encompass many EU firms as well as US and other foreign firms. By contrast, thresholds for applying the DST are very high and would largely embrace US firms. De facto, if not de jure, the DST discriminates against the United States. Given normal political forces, the discriminatory DST is likely to be enacted far sooner than the profits tax. As Senator Russell Long famously remarked, the politics of taxation comes down to an aphorism: “Don’t tax you, don’t tax me, tax the fellow behind the tree.” As far as European politicians are concerned, US multinationals are the “fellow behind the tree.” The proposed profits tax may take a long time to find its way into member state statute books, but the proposed DST stands every chance of quick enactment, and once enacted it could remain in place indefinitely. Because it is both more immediate and more controversial, the DST is examined first and then the profits tax.

18. Ibid.

19. See European Commission, “Proposal for a Council Directive on the common system of a digital services tax on revenues from the provision of certain digital services,” COM(2018) 148 final, Brussels, March 21, 2018, https://ec.europa.eu/taxation_customs/sites/taxation/files/proposal_common_system_digital_services_tax_21032018_en.pdf (accessed on April 23, 2018).

20. See European Commission, Communication from the Commission to the European Parliament and the Council, COM(2018) 146 final, Brussels, March 21, 2018, https://ec.europa.eu/taxation_customs/sites/taxation/files/communication_fair_taxation_digital_economy_21032018_en.pdf (accessed on April 23, 2018).

Tax on Digital Revenues²¹

Who Gets Taxed?

Introductory language to the proposed Council Directive devotes several paragraphs to justify a digital revenue tax under the argument that local users create value for remote digital firms. No one contests that users provide value to producers. But trading nations have agreed on rules that limit what taxes can be imposed on revenues earned by foreign firms. Thus, a central feature of the General Agreement on Tariffs and Trade (GATT) is the concept of bound tariffs: detailed schedules of maximum tariff rates that a WTO member can apply to merchandise imports from another member. The proposed EU digital services tax assumes that a vacuum exists with respect to international rules that limit the taxation of digital services. The assumption is wrong. There is no vacuum—as explained later in section 3 of this Policy Brief.

The proposed thresholds for a firm to be subject to the DST are much higher than the thresholds for the digital profits tax (discussed in next subsection). The worldwide revenues for the subject firm’s latest financial year must exceed €750 million, and taxable revenues within the European Union must exceed €50 million.

According to the European Commission:

The first threshold (total annual worldwide revenues) limits the application of the tax to companies of a certain scale, which are those which have established strong market positions that allow them to benefit relatively more from network effects and exploitation of big data and thus build their business models around user participation.

The second threshold (total annual taxable revenues in the Union), in contrast, limits the application of the tax to cases where there is a significant digital footprint at Union level in relation to the revenues covered by DST. This threshold is set at Union level in order to disregard differences in market sizes which may exist within the Union.

The two thresholds concentrate the DST on US digital firms (table 1). The only EU firm that might currently qualify is the Swedish firm Spotify.²² However, the types of

21. See European Commission, “Proposal for a Council Directive on the common system of a digital services tax on revenues from the provision of certain digital services,” COM(2018) 148 final, Brussels, March 21, 2018, https://ec.europa.eu/taxation_customs/sites/taxation/files/proposal_common_system_digital_services_tax_21032018_en.pdf (accessed on April 23, 2018).

22. Spotify’s total global revenue in 2017 was €4,090 million. EU revenues totaled €1,170 million, which included revenues of €444 million in the United Kingdom (table 1). Hence Spotify might pass the €50 million EU revenue threshold, even after Brexit. However, much of its revenue

Table 1 Revenue of digital companies, fiscal year 2017 (millions of US dollars or euros)

Company	Total revenue	EU revenue	Headquarters	Note on EU revenue
Amazon	\$106,110	\$21,719	United States	ROW excluding the US = \$54,297. EU revenue = 40% * \$54,297 = \$21,719
eBay	\$9,567	\$3,609	United States	\$1,359 in the UK, \$1,450 in Germany, and \$2,667 ROW excluding the US, the UK, and Germany. EU revenue = \$1,359 + \$1,450 + 30% * \$2,667 = \$3,609
Expedia	\$10,060	\$1,810	United States	ROW excluding the US = \$4,525. EU revenue = 40% * \$4,525 = \$1,810
Facebook	\$40,653	\$9,168	United States	ROW excluding the US = \$22,919. EU revenue = 40% * \$22,919 = \$9,168
Google	\$110,855	\$36,582	United States	EMEA total, which accounted for 33% of total revenue
Microsoft	\$89,950	\$17,881	United States	ROW excluding the US for FY ending 06/30/2017 = \$44,702. EU revenue = 40% * \$44,702 = \$17,881
Netflix	\$11,693	\$1,284	United States	ROW excluding the US = \$3,211. EU revenue = 40% * \$3,211 = \$1,284
RELX Group ^a	€ 7,355	€ 2,642	United States	€1,083 in the UK, €855 in Netherlands, and €704 in other European countries
Salesforce ^a	\$10,480	\$1,904	United States	Europe, for FY ending 01/31/2018
Spotify ^a	€ 4,090	€ 1,170	Sweden	€444 in the UK, €3 in Luxembourg, and €2,066 ROW excluding the US, the UK and Luxembourg. EU revenue = €444 + €3 + 35% * €2,066 = €1,170
Twitter	\$2,443	\$274	United States	ROW excluding the US and Japan = \$686. EU revenue = 40% * \$686 = \$274
SAP ^a	€ 23,461	€ 10,415	Germany	EMEA total. Germany = €3,352
Oracle ^a	\$37,728	\$8,524	United States	\$1,999 in the UK, \$1,417 in Germany. ROW excluding the US, Japan, Canada, the UK and Germany = \$13,822. EU revenue = \$1,999 + \$1,417 + 35% * \$13,822 = \$8,524. Data for FY ending 05/31/2017
Airbnb	Private company; revenue data not publicly available			
Uber	Private company; revenue data not publicly available			

ROW = rest of the world; EMEA = Europe, the Middle East, and Africa

a. Company revenues may not be subject to the digital services tax due to their business models.

Note: The table covers only large publicly traded firms because information is not readily available for smaller companies. Most companies do not report European revenue data separately. EU digital revenue is estimated by allocating the most disaggregated digital revenue by geography in part to the European Union, assuming that the EU share of digital revenue is 10 percentage points plus the European Union's share of that geography's GDP. For example, Amazon's revenue excluding the United States is \$54,297 million. EU GDP as a percentage of the world excluding the United States is roughly 30 percent. Therefore, adding 10 percentage points to reflect more intense EU internet usage, we assume that 40 percent of the \$54,297 million, or \$21,719 million, was Amazon's EU revenue in 2017. Similar calculations are carried out for each company. When digital revenue data are available for individual EU member countries, those figures are used. For example, for Oracle, 26 EU (less the United Kingdom and Germany, which were reported separately) member states' GDP divided by world GDP excluding the United States, Japan, Canada, the United Kingdom, and Germany = 25 percent. So EU digital revenue is estimated as: \$1,999 (from the United Kingdom) + \$1,417 (from Germany) + 35% * \$13,822 (estimate for other EU members).

Source: Authors' calculations using data from company annual reports.

revenue *not* qualifying as “digital services,” discussed next, might exclude even Spotify. Discrimination against the United States could not be more blatant.

What Gets Taxed?

Article 3 of the proposed Directive defines revenues subject to the DST:

1. The revenues resulting from the provision of each of the following services by an entity shall

qualify as ‘taxable revenues’ for the purposes of this Directive:

- (a) the placing on a digital interface of advertising targeted at users of that interface;
- (b) the making available to users of a multi-sided digital interface, which allows users to find other users and to interact with them, and which may also facilitate the provision of underlying supplies of goods or services directly between users;
- (c) the transmission of data collected about users and generated from users' activities on digital interfaces.

2. The reference in paragraph 1 to revenues shall include total gross revenues, net of value added tax and other similar taxes.

is earned from subscriptions, which are excluded from the Commission's definition of “taxable revenue.” Partial data are available at www.nasdaq.com/markets/ipos/filing.ashx?fileid=12643003#D494294DF1A_HTM_ROM494294_6 (accessed on April 23, 2018).

The definition of “taxable revenues” in Article 3 excludes subscription fees paid over the internet and digital wares sold over the internet. In addition, exceptions are made for platforms that facilitate financial trades, platforms that facilitate payments between households and firms, all forms of telecommunications, and crowdfunding platforms. These exclusions and exceptions are important because, in practice, they enable many EU firms to escape the tax net, while ensuring that important US firms are captured. Section 3 further discusses this important distinction.

Each member state is entitled to collect DST on revenues arguably generated within that state, based on some numerical count of users. Article 8 sets the EU-wide tax rate of 3 percent. Obviously, the rate could be raised in the future. However, with a 3 percent rate, the Commission estimates that member states would collect €5 billion in tax revenue annually.²³

Tax on Digital Profits²⁴

Who Gets Taxed?

The proposed tax on corporate digital profits would apply to firms that have a “significant digital presence” in a member state, regardless of whether they maintain a permanent establishment in that state. Significant digital presence exists if at least one of three thresholds is met: (1) the firm’s revenues from digital services provided in the member state exceed €7 million in a tax period (normally a year); (2) the number of users in the member state exceeds 100,000 in the tax period; or (3) the number of business contracts for digital services exceeds 3,000. The thresholds are intended to exclude small firms and incidental providers of digital services.

Under the proposed Council Directive, the thresholds supersede the traditional definition of permanent establishment, thereby giving each member state the right to tax the profits of remote firms based solely on digital flows. Presumably the tax would be applied at the prevailing rate on corporate profits. The critical questions concern the tax base: How are profits defined and what portion of a firm’s profits are subject to tax in the member state? On these questions, the Directive is vague.

23. “Questions and Answers on a Fair and Efficient Tax System in the EU for the Digital Single Market,” European Commission—Fact Sheet, March 21, 2018, Brussels, http://europa.eu/rapid/press-release_MEMO-18-2141_en.htm (accessed on April 23, 2018).

24. See European Commission, “Proposal for a Council Directive laying down rules relating to the corporate taxation of a significant digital presence,” COM(2018) 147 final, Brussels, March 21, 2018, https://ec.europa.eu/taxation_customs/sites/taxation/files/proposal_significant_digital_presence_21032018_en.pdf (accessed on April 23, 2018).

What Gets Taxed?

Taxpayers and tax authorities are supposed to calculate the profits that a large enterprise would have earned if its digital interface had been a separate and independent firm with its own tangible and intangible assets (including network values). The proposed Directive is silent as to whether the hypothetical digital firm should calculate its profits under the tax law of the remote country where it is located or the tax law of the member state. Once the magnitude of profits has been determined, however, the Directive says:

Each of the economically significant activities contributes to the value creation in the digital business models in a unique manner and is an integral part of these models. The profit split method would therefore often be considered as the most appropriate method to attribute profits to the significant digital presence. In this context, possible splitting factors could include expenses incurred for research, development and marketing (attributable to the significant digital presence *vis-à-vis* the expenses attributable to the head office and/or any other significant digital presences in other Member States) as well as the number of users in a Member State and data collected per Member State.

Those familiar with tax administration will immediately see ambiguities inherent in: (1) the construction of a hypothetical independent enterprise; (2) the calculation of profits of that enterprise; and (3) the factors for splitting those profits between a member state and other countries. Nor is it evident that the claim by member state A of a portion of profits in its tax base will be readily accepted by member state B, much less a foreign country. For example, the new US tax on global intangible low taxed income (the GILTI tax) will likely overlap with the European Union’s proposed tax on corporate digital profits.²⁵

Moreover, as the European Commission recognizes, its proposed tax will run headlong into permanent establishment rules enshrined in multiple tax treaties between member states and foreign countries, including the United States. The ambiguities and conflicts promise years of writing tax laws and regulations, lengthy treaty negotiations between member states and foreign countries, and exhaustive litigation between taxpayers and tax authorities. At the end of the day, double taxation or triple taxation of corporate profits is a plausible outcome.

25. GILTI is roughly defined as the combined earnings of foreign subsidiaries in excess of an assumed normal return on tangible business assets, which is set at 10 percent by the United States. The US Tax Cuts and Jobs Act of 2017 (TCJA) introduced a tax on GILTI to combat “profit shifting” by MNCs.

These practical considerations, in addition to raw politics, will delay the tax on corporate digital profits for years. Meanwhile, the DST looms as an imminent possibility. However, the fact that a digital profits tax is a distant prospect should not lull observers into overlooking its fundamental flaw.

The fundamental flaw is potential emulation: If the European Union can unilaterally reach out and claim a significant chunk of a foreign firm's profits as part of the EU tax base, when that firm has no physical presence in the European Union, why can't other countries do the same? In other words, what would prevent the United States or China from imposing an analogous tax on profits earned from other kinds of cross-border transactions? The United States could claim that profits earned by Volkswagen, BMW, and Mercedes on cars made in Europe but sold in the United States should be included in the US corporate tax base. China could claim that profits earned by Airbus on planes sold in China should be included in the Chinese corporate tax base. Just as Europe today is a net importer of digital services, the United States and China are net importers of European cars and aircraft. Unilateral decisions to tax the profits of select foreign firms will simply resurrect protectionism with another name. Along this path, commercial relations could become truly contentious. If the European Union wants to redefine the scope of foreign corporate profits that are subject to domestic taxation, it should start by opening negotiations with the United States and other countries. Unilateral claims, such as the digital profits tax, simply invite unilateral responses.

3 WTO PERSPECTIVE ON THE DIGITAL SERVICES TAX

Ministerial Declaration against Digital Tariffs

At the WTO Ministerial Conference held in May 1998, the ministers, "*recognizing* that global electronic commerce is growing and creating new opportunities for trade," adopted a Declaration on Global Electronic Commerce. The declaration contained an important commitment:²⁶

Without prejudice to the outcome of the work programme or the rights and obligations of Members under the WTO Agreements, we also declare that Members will continue their current practice of not imposing customs duties on electronic transmissions.

26. World Trade Organization, "A description of WTO activities on electronic commerce," WT/MIN(98)/DEC/2, May 25, 1998, www.wto.org/english/tratop_e/ecom_e/ecom_e.htm (accessed on April 23, 2018).

Subsequent ministerial conferences have renewed the declaration with its commitment against customs duties, i.e., tariffs. Meanwhile, the Joint Statement on Electronic Commerce issued after the ministerial conference in December 2017 noted:

We also recognize the important role of the WTO in promoting open, transparent, non-discriminatory and predictable regulatory environments in facilitating electronic commerce.²⁷

While the European Union claims the DST is a "tax," in de jure terms neutral between domestic and foreign digital firms, to the extent the DST discriminates against foreign firms it acts like a "tariff." The next subsection identifies the de facto discriminatory characteristics of the DST. While the ministerial declaration is not a binding obligation, the European Union cannot, in the same breath, claim to honor the declaration and enact the DST.

On April 12, 2018, the United States proposed several measures that WTO members should adopt with respect to electronic commerce, including a permanent prohibition on customs duties.²⁸ New Zealand and Singapore tabled similar proposals.²⁹ Given the Commission's proposals, a permanent prohibition is unlikely to be adopted by all WTO members. In the meantime, a plurilateral agreement might be reached that prohibits digital taxes among participating countries. Moreover, a plurilateral agreement could serve as a stepping stone to an eventual multilateral agreement.

De Facto Discrimination

The DST discriminates against US digital firms in three ways. First and most obvious, the DST thresholds—at least €750 million in global gross revenue and at least €50 million in EU gross revenue—are designed to capture Google, Facebook, Amazon, eBay, Uber, Airbnb, and other successful US digital firms, but few EU firms (table 1). With respect to

27. Joint Statement on Electronic Commerce, https://docs.wto.org/dol2fe/Pages/FE_Search/FE_S_S009-DP.aspx?language=E&CatalogueIdList=240862,240867,240868,240870,240871,240899,240875,240874,240878,240877&CurrentCatalogueIdIndex=4&FullTextHash=371857150&HasEnglishRecord=True&HasFrenchRecord=T (accessed on May 30, 2018).

28. Joint Statement on Electronic Commerce Initiative, Communication from the United States, https://docs.wto.org/dol2fe/Pages/FE_Search/FE_S_S009-DP.aspx?language=E&CatalogueIdList=244489,244495,244488,244469,244463,244471,244470,244437,244474,244472&CurrentCatalogueIdIndex=6&FullTextHash=371857150&HasEnglishRecord=True&HasFrenchRecord=False&HasSpanishRecord=False (accessed on April 23, 2018).

29. JOB/GC/175 for New Zealand and JOB/GC/179 for Singapore, https://docs.wto.org/dol2fe/Pages/FE_Search/FE_S_S005.aspx (accessed on April 23, 2018).

the €750 million threshold, the EU proposal itself states that this threshold enables the tax to “concentrate more on firms with dominant market positions,” in other words, mainly US firms.³⁰ With respect to the €50 million threshold, the Commission initially considered €10 million but decided to raise it, apparently to reduce the number of EU companies subject to the tax.³¹

While the European Union claims the DST is a “tax,” in de jure terms neutral between domestic and foreign digital firms, to the extent the DST discriminates against foreign firms it acts like a “tariff.”

Second, and more subtle discrimination, the revenues subject to the proposed DST are defined to capture the business models of US digital firms but not so many EU digital firms. Such “taxable revenues” include digital advertising (Google and Facebook), digital platforms and marketplaces to sell goods and services (Amazon, eBay, Uber, and Airbnb), and transmission of users’ data to other users (Facebook and Twitter). In addition to these iconic US firms, the DST might well reach traditional US advertisers, retailers with customer loyalty programs, and drug companies conducting clinical trials. However, “taxable revenues” exclude subscription fees (the main revenue of Spotify, based in Sweden) and in-app purchases of digital wares (the main revenue of Supercell, based in Finland). “Taxable revenues” also exclude revenue from platforms that facilitate financial trades (all the EU banks and stock exchanges) and platforms that facili-

30. See page 67 in the Impact Assessment of the referenced proposal, https://ec.europa.eu/taxation_customs/sites/taxation/files/fair_taxation_digital_economy_ia_21032018.pdf (accessed on April 23, 2018).

31. In an earlier European Commission memorandum, “Taxation of Digital Activities in the Single Market,” on February 26, 2018, Section 3.4(2)(ii) recommended a lower bound of €10 million, suggesting it would capture both EU and non-EU firms; see <https://g8fip1kp1yr33r3krz5b97d1-wpengine.netdna-ssl.com/wp-content/uploads/2018/02/taxation-of-digital-economy-2.pdf>. However, in the final proposal, the Commission settled on the upper bound of €50 million, while acknowledging that “...data on the biggest global companies with sizeable revenues from the relevant digital services suggests that a specific threshold above EUR 50 million could risk a de-facto discrimination...” See page 69 in the Impact Assessment of the referenced proposal, https://ec.europa.eu/taxation_customs/sites/taxation/files/fair_taxation_digital_economy_ia_21032018.pdf (accessed on April 23, 2018). The Commission’s threshold is akin to the practice in certain countries, notably Japan and Korea, of applying a higher tax rate on automobiles with larger engines.

tate payments (PayPal is the US example, Skrill is the UK example).

Third, and symbolically important, the proposal allows value added taxes and similar taxes to be subtracted from “taxable revenue” in calculating the base for the 3 percent impost. Almost alone in the world, the United States does not have value added taxes; thus, the tax base for otherwise identical US and EU digital firms will be higher for the US firm. The European Commission could just as easily have allowed property taxes or corporate income taxes to be subtracted, but seemingly it wanted to take an extra swipe at US firms.

GATS National Treatment Obligation

The General Agreement on Trade in Services (GATS) was an essential part of the Marrakesh Agreement that created the WTO in 1995. GATS established a framework of rules to govern global commerce in services. An overarching commitment within this framework was the venerable principle of national treatment, set forth in the first paragraph of GATS Article XVII:

1. In the sectors inscribed in its Schedule, and subject to any conditions and qualifications set out therein, each Member shall accord to services and service suppliers of any other Member, in respect of all measures affecting the supply of services, treatment no less favourable than that it accords to its own like services and service suppliers.³²

A footnote to this paragraph, dealing with its application to electronic commerce, refers to the Progress Report adopted by the Council for Trade in Services in the context of the Work Programme on Electronic Commerce on July 19, 1999.³³ That Progress Report has not been superseded and, along with classification issues and other matters, it affirms the standstill on customs duties.

The third paragraph of GATS Article XVII further explains the meaning of national treatment:

3. Formally identical or formally different treatment shall be considered to be less favourable if it modifies the conditions of competition in favour of services or service suppliers of the Member compared to like services or service suppliers of any other Member.

32. World Trade Organization, General Agreement on Trade in Services, Uruguay Round Agreement, www.wto.org/english/docs_e/legal_e/26-gats_01_e.htm (accessed on April 23, 2018).

33. The Progress Report can be found at [https://docs.wto.org/dol2fe/Pages/FE_Search/FE_S_S006.aspx?Query=\(@Symbol=%20s/l/74*\)&Language=ENGLISH&Context=FomeRScriptedSearch&languageUIChanged=true#](https://docs.wto.org/dol2fe/Pages/FE_Search/FE_S_S006.aspx?Query=(@Symbol=%20s/l/74*)&Language=ENGLISH&Context=FomeRScriptedSearch&languageUIChanged=true#) (accessed on April 23, 2018).

In its schedule of commitments to the GATS, the European Union promised broad market access and national treatment for “Computer-Related Services” and advertising, whether provided by mode 1 (cross-border sales), mode 2 (consumption abroad), or mode 3 (commercial presence, generally by direct investment).³⁴ Because of its de facto discriminatory character, the DST violates the European Union’s national treatment commitment. The third paragraph of GATS Article XVII, cited above, precludes the European Union from relying on the “formally identical” treatment of EU and non-EU firms as a defense against de facto discrimination.

4 POSSIBLE US RESPONSES TO THE DIGITAL SERVICES TAX

Passage of the Tax Cuts and Jobs Act of 2017 (TCJA) made the United States a much more desirable location for firms to do business, relative to other advanced countries, and sharply reduced the incentive for US MNCs to shift profits to low-tax jurisdictions abroad. The central attraction of the TCJA is the new 21 percent corporate tax rate, somewhat offset by the limitation on interest deductions and the GILTI provision. The Commission proposals for digital taxation, however, threaten to undercut the TCJA for a rapidly growing segment of the US economy.

This concluding section indicates possible US responses to the most immediate threat, the digital services tax. Similar responses could be fashioned for the digital profits tax if it moves closer to adoption.

The most measured US response to the DST would be a WTO case against the European Union, emphasizing the violation of its national treatment commitment in the GATS. Even if other measures are also taken, the case should be brought, both to combat tariffs on digital trade and to reinforce the rules-based system to resolve trade disputes. The main drawback is that WTO litigation can be lengthy, and a decision by the Appellate Body might take two years or longer.³⁵

Simultaneously, the United States could forge a plurilateral agreement among like-minded countries to permanently prohibit customs duties and similar taxes (like the DST) on digital traffic among participating countries. Although the European Union would not immediately join, the agreement would help arrest the spread of copy-cat digital taxes elsewhere in the world, and it could potentially serve as the

foundation for a future multilateral WTO agreement if the European Union reconsiders its tax policy.

Meanwhile, the European Union is seeking permanent exclusion from the Trump administration’s Section 232 tariffs on EU steel and aluminum exports to the United States.³⁶ If these tariffs are permanently dropped in the context of a broader transatlantic trade deal, the United States should insist that the European Union drop its DST initiative as part of the bargain.

Most forcefully, the United States might open a Section 301 investigation into the DST, to determine whether, in the language of the statute, the tax is “unreasonable, discriminatory, or unjustifiable.” If the finding is affirmative—a very likely outcome—the US Trade Representative could fashion a proportional response, targeting EU exports, such as autos. Such a unilateral response will be controversial. However, the European Union’s unilateral claim on a substantial amount of foreign company revenues and/or profits, as part of its own tax base, invites a unilateral response.

Apart from trade actions, the United States could invoke little-known Section 891 of the Internal Revenue Code. The law has never been used, but in 2016, when the dispute on Apple’s tax practices in Ireland attracted attention from the US Treasury, the provision was closely studied by US officials.³⁷ Section 891 grants the president the power to double income tax rates on citizens or corporations of a foreign country when, “under the laws of any foreign country, citizens or corporations of the United States are being subjected to discriminatory or extraterritorial taxes.”³⁸ As the law has never been applied, it raises several open questions, such as its

34. See the EU schedule of GATS commitments at http://trade.ec.europa.eu/doclib/docs/2012/november/tradoc_150087.pdf (accessed on April 23, 2018).

35. A WTO case assumes that US objections to the functioning of the Dispute Settlement Body are resolved soon. See Payosova, Hufbauer, and Schott (2018) for more details.

36. On May 31, 2018, the White House announced that US imports of steel and aluminum from the European Union would face 25 percent tariff on steel and 10 percent tariff on aluminum starting June 1, 2018; see White House, “President Donald J. Trump Approves Section 232 Tariff Modifications,” May 31, 2018, www.whitehouse.gov/briefings-statements/president-donald-j-trump-approves-section-232-tariff-modifications-2/. In response to the US tariffs, the European Union started to implement “rebalancing measures” (i.e., tariffs) on €2.8 billion of US exports on June 22, 2018. See European Commission, “EU adopts rebalancing measures in reaction to US steel and aluminum tariffs,” Brussels, June 20, 2018, http://europa.eu/rapid/press-release_IP-18-4220_en.htm (accessed on June 26, 2018). The May 31 White House statement said, “The administration will continue discussions with them [the European Union, Canada, and Mexico] and remains open to discussions with other countries.” In other words, negotiations between the United States and the European Union are still under way.

37. “Treasury Department Reviewing Retaliatory Tax Law Against EU,” *Wall Street Journal*, March 4, 2016, www.wsj.com/articles/treasury-department-reviewing-retaliatory-tax-law-against-eu-1457120228 (accessed on May 9, 2018).

38. See 26 U.S. Code § 891 - Doubling of rates of tax on citizens and corporations of certain foreign countries, www.law.cornell.edu/uscode/text/26/891.

relationship with US bilateral tax treaties and the definition of “discriminatory taxes” (Grinberg 2016). However, a US Treasury investigation of the DST, holding out the threat of Section 891, might persuade the European Commission to rethink this ill-considered initiative.

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