

# Taxation of the Digital Economy: A Pragmatic Approach to Short-Term Measures

**The taxation of profits within the digitalized economy has been at the forefront of the agendas of both the European Union and OECD, with the debates focusing on both long-term solutions and “quick fixes”, such as equalization taxes. In light of the political momentum that is building, this article briefly analyses and distinguishes between the various business models applicable to the digitalized economy with the aim of identifying a reasonable starting point for temporary, short-term measures.**

## 1. Introduction

The challenges that arise in dealing with the digital economy are keeping both tax administrations and tax policymakers around the globe busy.<sup>1</sup> In addition to the interim report by the OECD Task Force on Digital Economy, which is expected in April 2018, the ECOFIN has recently adopted conclusions,<sup>2</sup> inviting the European Commission to prepare proposals by early 2018. The proposals are expected to respond not only to the challenges of the taxation of profits of the digital economy in a broader sense, but also to take “note of the interest of many Member States for temporary measures such as for example an equalisation levy based on revenues from digital activities in the EU that would remain outside the scope of double tax conventions concluded by Member States”.<sup>3</sup> In doing so, the proposals are supposed to take “into account relevant developments in ongoing OECD work” and be introduced “following an assessment of the legal and technical feasibility as well as economic impact”.<sup>4</sup>

These statements clearly take into account the political pressure and momentum that is mounting, as well as the broad public and technical debate on the issue.<sup>5</sup> These

statements are also indicative of the various options for long and short-term measures discussed in the Commission’s Communication on “A Fair and Efficient Tax System in the European Union for the Digital Single Market”.<sup>6</sup> As international consensus on a long-term framework does not seem to be within close reach, which would likely involve a broad overhaul of the international tax system, the Council is focused on the apparent misalignment between value creation and the taxation of profits in the digitalized economy and envisages pragmatic and concrete proposals for short-term measures that temporarily address that misalignment until an internationally agreed upon long-term approach is found.

While the authors, in *European Taxation* 12 (2017), already discussed the various issues surrounding “quick fixes”, such as equalization taxes, and also highlighted their disadvantages (including negative impact on growth, innovation and productivity; non-neutrality; double taxation; and administration problems),<sup>7</sup> it seems necessary to provide further thoughts on short-term measures. Indeed, such measures may only provide “patches” that correspond to the current political agenda. As such, they should be temporary (for example, sunset clauses should be included), in line with international obligations (for example, EU and tax treaty law), simple to administer and not overreaching in their scope. This article, therefore, follows up on current developments by analysing and distinguishing characteristic business models of the digitalized economy with the aim of identifying a reasonable starting point for temporary, short-term measures.

## 2. New Business Models: Same Same but Different

### 2.1. “Prototypes” of the new business models

Since the Ottawa Ministerial Conference on Electronic Commerce,<sup>8</sup> it has become standard to argue that the digital economy cannot be separated from the traditional

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1. For a brief overview of the current state of discussions, see G.W. Kofler, G. Mayr & C. Schlager, *Taxation of the Digital Economy: “Quick Fixes” or Long-Term Solution?*, 57 Eur. Taxn. 12 (2017), Journals IBFD.  
2. Council of the European Union, Council conclusions on ‘Responding to the challenges of taxation of profits of the digital economy’, Doc. 15175/17 FISC 320 ECOFIN 1064 (30 Nov. 2017).  
3. Id., at para. 24.  
4. Id., at para. 25.  
5. For a recent and detailed analysis, see, for example, W. Schön, *Ten Questions about Why and How to Tax the Digitalized Economy*, Max Planck

Institute for Tax Law and Public Finance Working Paper 2017 – 11 (Dec. 2017), arguing, inter alia, against a “quick fix”, as it “might not only be distortive and inefficient, it might also stand in the way of a new international consensus built around a new set of overall tax principles”.

6. European Commission, Communication on A Fair and Efficient Tax System in the European Union for the Digital Single Market, COM(2017) 547 final (21 Sept. 2017), EU Law IBFD.

7. See Kofler, Mayr & Schlager, *supra* n. 1, at 530-532.

8. See Report by the Committee on Fiscal Affairs, *Electronic Commerce: Taxation Framework Conditions*, presented to the Ministers at the OECD Ministerial Conference, “A Borderless World: Realising the Potential of Electronic Commerce” on 8 Oct. 1998, available at <https://www.oecd.org/ctp/consumption/1923256.pdf>, noting, inter alia, that “taxation should seek to be neutral and equitable between forms of electronic commerce and between conventional and electronic forms of commerce”.

economy. While this might be true when it comes to classical value chains (for example, production and/or distribution of tangible and intangible products), new business models that are prevalent in the digital economy put a new focus on value creation through mediating technology in multi-sided markets (for example, social networks, online marketplaces, sharing economy platforms) and highly-specialized services in single-sided markets (for example, cloud computing, diagnostics, etc.).<sup>9</sup> Indeed, as a starting point, the OECD's Final Report on Action 1 on the tax challenges of the digital economy provides an overview of the various business models of the digital economy and analyses four typical structures: online retailing, internet advertising, cloud computing and internet app stores.<sup>10</sup>

There is, however, broad consensus that, within the current international taxation framework,<sup>11</sup> neither the mere consumption of goods or services in a country<sup>12</sup> nor the deductibility in a country of payments for goods or services received from non-residents<sup>13</sup> should, in itself, entitle that country to tax the profits of the business providing the goods or services. Nevertheless, the recent focus is on the utilization of passively provided user-related data (for example, search and surfing history for targeted advertising) and on more active contributions to value creation by users (for example, through active user participation in social media platforms, online marketplaces that match suppliers and purchasers or user-generated content on streaming platforms),<sup>14</sup> whether or not those users are identical to the business's customers. The value generated by user data, participation and creation of content "is not captured under the existing international tax framework, which focuses exclusively on the physical activities of a business itself in determining where profits should be allocated for corporate tax purposes", meaning that significant value can be generated from a market without the profits derived from that value being subject to tax therein.<sup>15</sup>

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9. See, for example, the discussion in HM Treasury, *Corporate tax and the digital economy: Position Paper* (22 Nov. 2017), available at <https://www.gov.uk/government/consultations/corporate-tax-and-the-digital-economy-position-paper>.
  10. See OECD, *Addressing the Tax Challenges of the Digital Economy – Action 1: 2015 Final Report* (OECD/G20 2015), International Organizations' Documentation IBFD, at 51 et seq. with a summary in box 4.1 at 64 (Report on Action 1).
  11. For broad policy discussions, for example, with regard to a destination-based corporate tax (focusing on the customer's residence), see, for example, A. Auerbach, M. Devereux, M. Keen & J. Vella, *Destination-Based Cash Flow Taxation*, Oxford University Centre for Business Taxation WP 17/01 (2017).
  12. See, more generally, for the lack of source taxation rights with regard to services provided by non-residents, *OECD Model Tax Convention on Income and on Capital: Commentary on Article 5* para. 139 (21 Nov. 2017), Models IBFD.
  13. There are, however, some notable exceptions, such as the introduction of a new distributive rule for fees for technical services in the 2017 update to the UN Model. For discussion, see, for example, F. Sixdorf & S. Leitsch, *Taxation of Technical Services under the New Article 12A of the UN Model – Improved Taxation or A Step in the Wrong Direction?*, 57 Eur. Taxn. 6, 234 et seq. (2017), Journals IBFD.
  14. See, for example, para. 3.14 et seq. in HM Treasury position paper, *supra* n. 9.
  15. *Id.*, at para. 3.21.

While, in its Final Report on BEPS Action 1, the OECD attempted to describe digital business models (electronic commerce, payment services, app stores, online advertising and cloud computing) in an abstract way and analyse them with regard to tax avoidance strategies, there are obvious limitations on the suitability of this analysis in terms of answering the question of which segments of the digital economy should be subject to either a (corporate) income tax or a short-term taxation measure. A pragmatic starting point for further deliberations could be: Which business models differ so markedly from those in the traditional economy that traditional principles of taxation (currently in effect) lead to improper results? This approach of differentiating between the various forms of value creation, which fall on a continuum that ranges from a classical value chain to value networks and value shops,<sup>16</sup> may be simplified and exemplified through certain business model prototypes, for example, those of Amazon and Google.<sup>17</sup>

## 2.2. Online retailing: Amazon as a "prototype" for classical "value creation"

Amazon is the best known online retailer in North America and Europe.<sup>18</sup> Its business model is not a new model that first arose in the context of digitalization but is a refined form of the traditional mail order business model, pursuant to which goods are presented, contracts are concluded, and payments are made over the Internet. The physical goods continue to be delivered in the traditional way (for example, by parcel post) – as was the case with the precursor to this online mail order business, the "catalogue mail order business". However, online retailers may be in a better position to use their consumers' data automatically for their own marketing purposes. Nevertheless, its operation can still be described as a classical value chain model with inputs, transformation processes and outputs.

Focusing on taxation in the source country, the details of Amazon's tax-optimized US structure are less relevant in this regard than implementation of the business model in Europe, where consumers generally conclude a mail order contract with the Amazon distribution company in Luxembourg. This is important from a tax perspective, since, with regard to direct sales, only the company's residence state is entitled to tax the enterprise's profits, unless a PE exists in the other state. The actual delivery is then made by one of Amazon's logistics centres; Amazon currently operates 31 such logistics centres in Europe in seven different countries. Therefore, for some countries, the question of how to tax the logistics centres arises, i.e. if there

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16. See, for example, C.B. Stabell & Ø. Fjeldstad, *Configuring value for competitive advantage: on chains, shops, and networks*, 19 Strategic Mgt. J., 413-437 (1998).
  17. Those business models have already been subject to intense discussion in the literature. See, for example, R. Pinkernell, *Internationale Steuergestaltung in Electronic Commerce*, ifst-Schrift 494, 131 et seq. (2014).
  18. Amazon also offers a wide range of other services, such as e-books, audiobooks, digital videos and music subscriptions (Amazon Prime) and services for third parties (Amazon Marketplace), as well as Amazon Web Services. However, for the purposes of this article, the authors focus on Amazon's well-known core activity.

is a (warehouse) PE or a subsidiary and how much profit can be attributed to it.<sup>19</sup>

In Austria, for example, consumers order goods via “amazon.de”, which is operated by Amazon Luxembourg. The goods are usually delivered by one of the logistics centres operated by Amazon in Germany to Austria. While Germany has to deal with the taxation of the logistics centres, there is no physical presence in Austria. In such instances, where online mail order sellers supply customers without logistics centres or warehouses in the market jurisdiction (for example, Austria) from (neighbouring) foreign countries, the traditional set-up of the international corporate tax system does not allow for the market jurisdiction to tax the retailer’s profits (but it may, of course, levy VAT). It is in this area that the question of a new approach to the taxation of the digital economy arises. This scenario also exemplifies that “digital” B2C transactions must be viewed in the context of similar transactions in the “traditional” economy, for example, conventional mail order sales, and hence with regard to the competitive environment, including taxation. It also raises the question as to whether or not selling goods (for example, physical books, clothing, computer hardware, etc.) via a website makes the company a “digital company”.

Indeed, not only Amazon retail (and, for example, Alibaba, Walmart, etc.) but also a number of other businesses in the digitalized economy can be seen as a mere extension of the “traditional” economy in that they are basically producers or resellers. Netflix, for example, has the best-known subscription-based B2C streaming service and develops its own TV series and films; but aside from offering its service via the Internet, Netflix’ business model seems comparable to traditional pay TV/video-on-demand providers (or even subscription services where physical DVDs are sent by mail) and, more generally, to a producer (for original content) or a reseller (for third-party content). The same analysis holds true for Apple with regard to its hardware business and the offering of digital content, for example, in the iTunes store. Moreover, Spotify, which offers music streaming services, is comparable to a traditional retailer with regard to “Spotify premium”, where paying customers receive ad-free music streaming services at a fixed monthly rate.<sup>20</sup>

### 2.3. Internet advertising: Google as a “prototype” for new “value creation”

Google uses its free search engine and other well-known useful programs and apps to create an appropriately large target audience, whose (search) behaviour is analysed so it can be used in targeted advertising. Its income, however, is not directly generated from the search engine’s target audience, but through the use of the search engine and other websites, including third-party websites, as adver-

tising space for advertisers. Google’s two main products are “AdWords” and “AdSense”.<sup>21</sup>

In the European market, Google is structured such that the local Google companies merely provide support services for the local market (promotion, marketing, etc.), while customers generally conclude advertising contracts directly with an Irish subsidiary of the US parent. This tax-optimized structure only works if the local company does not establish an agency PE for the Irish subsidiary and if the actual functions of the local company are not so involved that the chosen transfer pricing structure (usually compensation on a cost-plus basis) can be questioned. If these conditions are met, under tax treaties patterned after the OECD Model, the market jurisdiction, i.e. the state where the targets of the advertisement and oftentimes also the advertisers are resident, is generally barred from taxing the foreign enterprise’s profits. Again, a new framework for taxation of the digital economy would have to establish the respective nexus to and identify the value created in the market jurisdiction, taking into account that it is the user data of the targets of the advertisement that enables Google to offer highly targeted advertising services in this market.

Google’s B2B advertising services are clearly based on Google’s precise knowledge about users, based on (passively provided) various user-related data (for example, searches, surfing history, device used, location, etc.), i.e. the monetization of user preferences and behaviours in a process that is quite different from value creation in a classical value chain. Facebook,<sup>22</sup> which is clearly a value network and is the most successful social media platform, not only receives user-generated content, but also monetizes personal user data for targeted advertising services.<sup>23</sup>

In the authors’ view, other models of value creation in multifaceted businesses that connect demand and supply fall somewhere between “traditional” and “new” forms of value creation and largely cover and facilitate various forms of B2B, B2C and C2C relations. Replacing or improving on traditional forms of “matchmaking” (for example, catalogues, newspaper advertisements, etc.), these businesses may permeate a local economy without any physical presence, i.e. they have “scale without mass”. This is especially true for multifaceted intermediaries (for example, Amazon’s marketplace, Apple’s or Google’s app stores) and platforms within the collaborative economy (for example, Airbnb and Uber).

19. See, for a brief discussion in light of the OECD/G20 BEPS Project, Kofler, Mayr & Schlager, *supra* n. 1, at 526-527.

20. Spotify also has a free subscription service that is financed through advertisements.

21. See R. Pinkernell, *Ein Musterfall zur internationalen Steuerminimierung durch US-Konzerne*, 89 *StuW*, 370 (2012).

22. Facebook has recently announced a change to its tax structure, which would involve moving to a “local selling structure” in countries where it has an office to support sales to local advertisers; see D. Wehner, *Moving to A Local Selling Model*, Facebook Newsroom (12 Dec. 2017), available at <https://newsroom.fb.com/news/2017/12/moving-to-a-local-selling-model/>.

23. Google and Facebook dominate the global advertisement market, with an estimated share of 44% (Google) and 18% (Facebook) of all earnings from online advertisement worldwide and a share of 25% of all advertisement; see C. Cakebread, *Google and Facebook dominate digital advertising — and they now account for 25% of all ad sales, online or off*, Business Insider Deutschland (9 Dec. 2017), available at <http://www.businessinsider.de/google-and-facebook-dominate-the-world-of-online-advertising-charts-2017-12?r=US&IR=T>.

### 3. Building Blocks for a Pragmatic Short-Term Measure

#### 3.1. Narrowing the scope

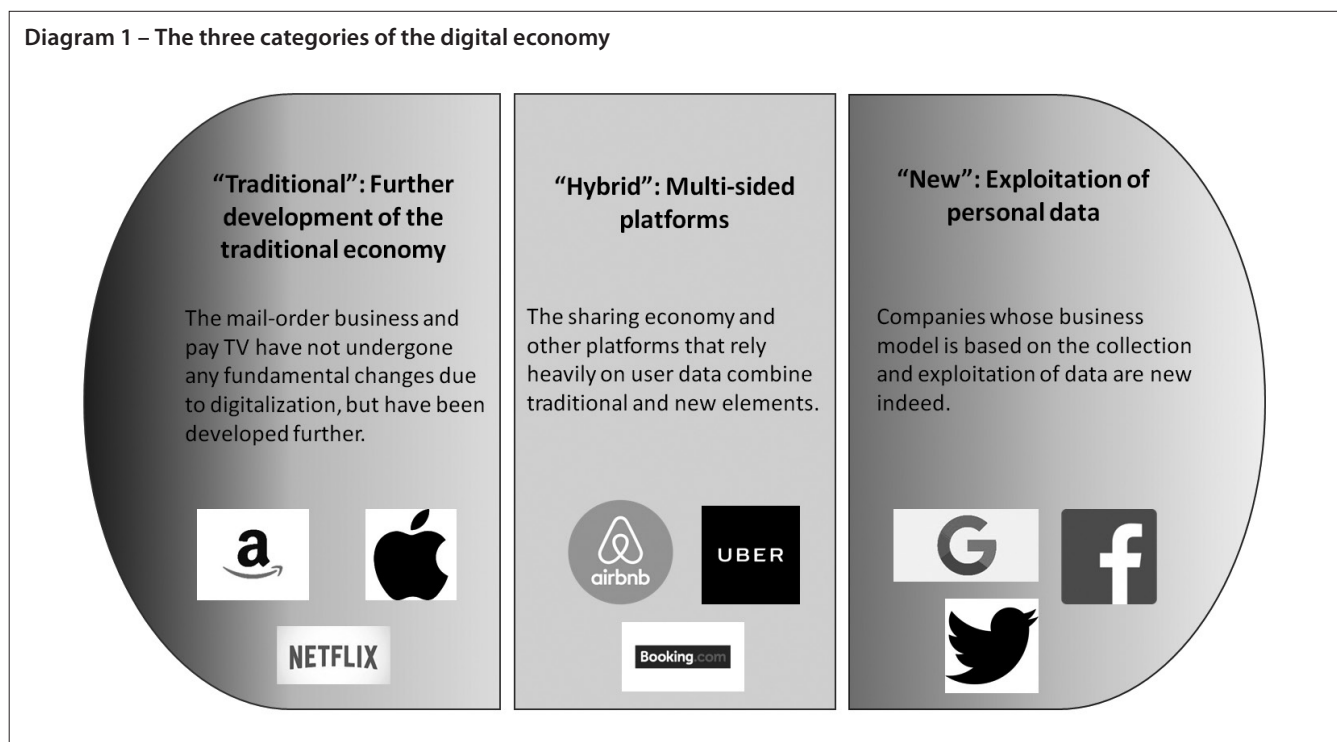
The authors' analysis of the various business models has demonstrated that there is a huge range of models in the digital economy, some based on a more traditional value chain and others on new forms of value creation. As "quick fixes" certainly have a number of serious disadvantages, a short-term measure should be as neutral as possible and not overreaching. Categorizing the different models of value creation from a tax perspective, the focus has to shift from similarities (i.e. the fact that the Internet and IP is heavily used) to differences between the models (i.e. the question of how the internet is used and how value is generated).

Taking a rather narrow approach, the focus should be on the main and unique features of "digitalization". Hence, the mere use of the Internet to facilitate the sale of goods or services (for example, retailing) and multifaceted intermediaries and marketplaces (for example, app stores or platforms in the collaborative economy) seem to be mere extensions of the "traditional economy". These might achieve "scale without mass", but their inclusion in any short-term measure would also raise a myriad of delimitation issues. In the authors' opinion, therefore, the scale of the collection, use and exploitation of personal data, as a core aspect of a business model and value creation, can serve as a good indicator. Monetizing user data is the backbone of Internet advertising, but such data plays quite a different role and is prevalent on a different level for multifaceted platforms operating as intermediaries (for example, in the sharing economy) and generally for businesses that are based on traditional value creation. Consequently, the digital economy might be divided into the following categories:

Without losing sight of the "traditional" and "hybrid" categories (which will need to be addressed in respect of a long-term solution), the emphasis with regard to a short-term measure should, in the authors' opinion, be placed on the "new" category of business models based on the exploitation of personal user data in targeted advertising or promotion for third parties (i.e. advertising customers). While the mere collection of personal data does not constitute something new or unique, or seem "worth" taxing in itself, the value created through the exploitation of personal data for third-party advertisers might well be viewed as giving rise to a claim to tax by the state from whose residents the user data is collected (for example, Google's fee-based exploitation of personal data for advertising purposes).

Certainly, such a tax claim by the market jurisdiction would not sit well with traditional concepts regarding justifications for the right to tax, such as the ability to pay or the benefit principle. If a political decision is made to introduce a short-term measure, there are several advantages to a narrow approach, i.e. to only applying a short-term measure to situations in which user data is exploited to generate revenue from third parties. First, it largely avoids delimitation problems. Many companies collect personal data (for example, food chains, fitness centres, etc.). The main business purpose of these companies, however, is not the collection of personal data. Rather, this personal data merely supports the company's main business purpose and is analysed for this reason (for example, food chains use the data to tailor their offerings to their customers' wishes, which – if successful – results in higher sales). Moreover, the mere collection and analysis of personal data for a company's own business purposes could scarcely be delimited. Therefore, finding that there is no tax nexus unless the personal data is exploited to generate fees from third parties, avoids difficult delimitation ques-

Diagram 1 – The three categories of the digital economy



tions. Second, it would link taxation to the exploitation of data that generates revenues from third parties (i.e. advertisers) and hence to the value created by such exploitation (i.e. advertising income under the specific business models in question). Thinking in terms of an “equalization levy”, therefore, a pragmatic approach could focus on advertising and similar activities provided through the Internet that are based on the exploitation of personal data.

### 3.2. Is there a need for a threshold?

In the course of general discussions on when a digital or economic presence should be deemed to be “significant” (to give rise to source state taxing rights), several factors or indicators have been discussed, for example, country-specific turnover from digital transactions; “digital” factors, such as a local domain name, a local digital platform, local payment options; or user-based factors, such as active domestic monthly users of a platform.<sup>24</sup> Although a short-term measure may not focus on “significant” economic presence, the practical reasons for defining an “entry criterion” are similar, i.e. lowering tax compliance costs, especially for innovative small and medium-sized enterprises.

It is sometimes argued that a clear-cut threshold could be found by piggybacking on country-by-country (CbC) reporting requirements, i.e. by applying the short-term measure only to multinational enterprises with annual consolidated group revenue of EUR 750 million or more. While a turnover criterion indeed seems to be the simplest “entry criterion” from an administrative and compliance perspective, a EUR 750 million threshold (on an MNE basis) as a stand-alone criterion could carve out significant advertising business; alternatively, therefore, one might either put the threshold for application of the short-term measure to either exempt SMEs (as defined in the recommendation of the European Commission)<sup>25</sup> or provide for a de minimis exception for revenues generated in a specific country (for example, the revised Hungarian advertisement tax provides for a de minimis threshold of HUF 100 million, i.e. approximately EUR 325,000, for sales from marketing activities). In any event, in order to comply with EU and constitutional non-discrimination requirements, as well as EU State aid rules, the threshold likely needs to be equal for cross-border and domestic situations and for various forms of advertising. This is a specific consideration for countries (such as Austria) that cur-

rently levy an advertisement tax on “offline” commercials but are considering expanding it to online advertising.<sup>26</sup>

### 3.3. Tax base and tax rate

Based on the idea of a short-term measure as an “equalization levy” that applies in lieu of profit taxation, it makes sense to begin the discussion regarding the tax base and the tax rate against this background. If such a measure were to focus on the “new” category of business models, based on the exploitation of personal user data in targeted advertising, the real challenge under the traditional corporate income tax framework would be to analyse and find a common position on the contribution of such exploitation to value creation and profits. Even if general consensus on an abstract methodology can be achieved, an individual analysis would be necessary to determine the concrete value added and profit generated through exploitation of user data under each “new” business model (for example, with regard to the passive use of data by a search engine versus the active use of user-generated content by social media platforms).

Moreover, one would have to determine the share of the profit attributable to the domestic market based on domestic value creation. Indeed, one might start with the overall profit margin of a particular enterprise and the turnover in a specific country and then try to allocate an amount of the respective profits within the framework of a “profit split” with the market jurisdiction. Such a “profit split” would take into consideration “classical” criteria,<sup>27</sup> as well as the extent of exploitation of the personal data of users (from passive sharing to user-generated content). This would, of course, require a determination of the extent to which domestic exploitation profits are attributable to personal data, taking into account that, in value networks, user data is certainly more than just the “raw material” it might be in a classical value chain. It is unclear, however, if comparables can be derived from a value creation analysis of marketing and sales units of traditional MNEs, and proposals made in the literature therefore aim to make rough approximations, for example, a modified “profit split” “with an upfront allocation of a partial profit to the market jurisdictions”.<sup>28</sup>

While a pragmatic short-term measure should have a narrow scope and focus on the exploitation of user data, its aim is (and should be) to provide a temporary “patch” to address pressing calls for more immediate action.<sup>29</sup> That being said, and without taking a position on the soundness of this idea from a policy perspective, a short-term measure can (temporarily) sidestep an in-depth discussion about value creation and the nuanced technical problems that arise in identifying a significant digital presence and

24. See, for example, Report on Action 1, *supra* n. 10 and the more concrete proposal by P. Hongler & P. Pistone, *Blueprints for a New PE Nexus to Tax Business Income in the Era of the Digital Economy*, IBFD White Paper, 15 et seq. (20 Jan. 2015); see also the EU Parliament’s considerations regarding the definition of “digital permanent establishment” in the context of a common (consolidated) corporate tax base in the *Opinion of the Committee on Legal Affairs for the Committee on Economic and Monetary Affairs on the proposal for a Council directive on a Common Corporate Tax Base*, PE 602.948v03-00 (19 Sept. 2017), available at <http://www.europarl.europa.eu/committees/en/JURI/opinions.html>, Amendments 6, 12, 15, 16, 19 and 26.

25. Commission Recommendation of 6 May 2003 concerning the definition of micro, small and medium-sized enterprises, OJ L 124/36 (20 May 2003).

26. It should be noted, however, that the Austrian Constitutional Court recently held that taxation of “offline” advertisement, while not taxing online advertising under the Austrian advertisement tax (*Werbeabgab*) does not violate the principle of equal treatment. See AT: VfGH, 12 Oct. 2017, Case E2025/2016, ECLI:AT:VFGH:2017:E2025.2016.

27. Such as the business concept, technology/intellectual property (based on the DEMPE functions), use of brands, personnel, etc.

28. Hongler & Pistone, *supra* n. 24, at 32 et seq.

29. See, for example, Doc. 15175/17, *supra* n. 2.

attributing profit to it. Therefore, a short-term measure should be disconnected from the fundamental debate regarding profit (or loss) allocation. Hence the measure would represent an “equalization levy” more in a political sense than a legal one. Indeed, as the EU Council has clearly noted, such a short-term measure “would remain outside the scope of double tax conventions concluded by Member States”.<sup>30</sup> Given the broad scope of “taxes covered” in article 2 of the OECD Model (2017),<sup>31</sup> which also encompasses gross-basis taxes on elements of income, this would require that any short-term measure be independent from the recipient’s profit situation; hence, an equalization tax structured as “creditable against corporate income tax”<sup>32</sup> would likely risk such tax being considered as falling under article 2 of the OECD Model. As such, the “equalization tax” would not be creditable, but only tax deductible for corporate tax purposes.<sup>33</sup>

In order to ensure that the economic distortions resulting from such a short-term measure remain as small as possible, and in the absence of a thorough economic analysis, a pragmatic approach would be to find a targeted solution, building on existing tax regimes. In this context, the Indian 6% “equalization levy” on payments to foreign companies for online advertising services,<sup>34</sup> the revised 5%-7.5% Hungarian advertising tax,<sup>35</sup> or the Austrian 5% turnover-based tax on “traditional” advertising<sup>36</sup> could serve as examples. Hence, also from an administrative perspective, a pragmatic short-term measure likely has to be turnover-based<sup>37</sup> and be levied at a low rate, the tax being payable either by the recipient of the service payment (i.e. the digital service provider) or withheld by the domestic recipient of the service (for example, the enterprise purchasing online advertising services). A short-term measure must also be delimited geographically, likely through a proxy for the jurisdiction in respect of which residents provide user data. While certainly not

perfect, such a proxy could, for example, be the residence of the recipients of the service (i.e. the advertisers).<sup>38</sup>

One should not, however, forget that even a notionally low tax rate on a turnover-basis can have huge distortive effects depending on the specific situation of a taxpayer and its profit margins.<sup>39</sup> It is, therefore, interesting to compare the fiscal effects of, for example, a 5% turnover-based advertising tax with the potential outcome of a long-term solution within the corporate income tax framework, as per the following example.

Example: An international IT group generates EUR 250 million of revenues in State A. These sales are based on the exploitation of personal user data in the market of State A, i.e. State A companies pay for targeted digital advertising to A’s residents provided by the IT group. Otherwise, only routine activities with little added value are performed in State A. Two conclusions can be drawn:

- (i) if a 5% advertising tax were to be levied on domestic sales, this would result in tax due of EUR 12.5 million (5% of EUR 250 million); and
- (ii) if a significant digital presence were to be assumed in State A, the attribution of profits could begin with an overall profit derived from sales in State A (based on the respective overall profit margin, which is assumed for the sake of this example to be 40%, and domestic turnover of EUR 250 million) of EUR 100 million. If domestic value creation is weighted at 30%, a profit share of EUR 30 million would be attributable to the domestic market. Assuming a 25% corporate tax rate, that would result in corporate income tax of EUR 7.5 million in State A.

As this example shows, even assuming relatively high profit margins and significant local value creation, the fiscal impact of a 5% advertisement tax will still be higher than a potential solution within the corporate income tax system, even disregarding questions of double taxation. Hence the tax rate applicable to a turnover-based short-term measure should be moderate.

30. Id., at para. 24.  
 31. *OECD Model Tax Convention on Income and on Capital* (21 Nov. 2017), Models IBFD.  
 32. See, for example, A Fair and Efficient Tax System in the European Union for the Digital Single Market, *supra* n. 6, at 10.  
 33. See Kofler, Mayr & Schlager, *supra* n. 1, at 531-532.  
 34. See the detailed discussion by S. Wagh, *The Taxation of Digital Transactions in India: The New Equalization Levy*, 70 Bull. Intl. Taxn. 9, 543 et seq. (2016), Journals IBFD.  
 35. The Hungarian advertising tax was revised for State aid reasons. The revised version now differentiates between primary taxpayers (company providing the advertising service; 5.3%-7.5% tax rate) and secondary taxpayers (person/company that orders and pays for the advertisement; 5% tax rate) and provides different thresholds. See <http://taxsummaries.pwc.com/ID/Hungary-Corporate-Taxes-on-corporate-income> (accessed 23 Feb. 2018).  
 36. The Austrian advertising tax was implemented in 2000 and does not currently cover Internet advertising. There is, however, an ongoing political and academic discussion about the future and possible expansion of this advertising tax. See also *supra* n. 26.  
 37. For a brief discussion in light of European VAT rules, see Kofler, Mayr & Schlager, *supra* n. 1, at 531, concluding that there are good arguments that such a tax is not covered by art. 401 of Council Directive 2006/112/EC of 28 November 2006 on the Common System of Value Added Tax, OJ L 347/1 (2006), EU Law IBFD, i.e. the prohibition against “turnover taxes”, because it would not be an all-phase, input deduction tax that generally applies to transactions relating to goods or services. However, a turnover tax that is not all-phase might lead to cascading effects and, hence, double taxation.

#### 4. Conclusion

“Quick fixes”, such as equalization taxes, have a number of disadvantages, but they may nevertheless act as a temporary “patch” to address pressing political calls for more immediate action. The analysis of the various “digital” business models in this article has shown that a differentiated approach is certainly needed to keep distortions at a minimum and avoid extreme overreaching. For tax purposes, “digital” business models can be divided into three categories (traditional, hybrid and new), with the focus of a short-term measure

38. Such a proxy, of course, could be further refined, taking into account that the state of residence of the recipients of the service may be different from the state of the persons whose data is used to target advertising and which may also be the consumers of the advertised products or services.  
 39. See Kofler, Mayr & Schlager, *supra* n. 1, at 531.

being on the “new” category of business models, i.e. those based on the exploitation of personal user data in targeted advertising or promotion on behalf of third parties. A short-term measure, which would avoid delimitation problems, reflect tax systematics

and not stand in the way of a new international consensus built around a new set of overall tax principles,<sup>40</sup> could be a turnover-based advertising tax levied at a moderate tax rate.

40. See, for that specific concern, Schön, *supra* n. 5.



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