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REQUEST FOR INPUT ON WORK REGARDING THE TAX CHALLENGES OF THE DIGITALISED ECONOMY

Input Statement by the International Observatory on the Taxation of the Digital Economy

(University of Lausanne, International Bureau of Fiscal Documentation, KU Leuven)

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I Introductory remarks and scope of the input statement

The present input statement is prepared by the International Observatory on the Taxation of the Digital Economy. The Observatory is a joint initiative put in place by the Tax Policy Center of the University of Lausanne (www.unil.ch/taxpolicy) and the International Bureau of Fiscal Documentation (www.ibfd.org) as part of a research project "Taxation and Digital Innovation" (https://goo.gl/5MWCKZ). The Observatory is a neutral academic platform aiming at contributing to fiscal policy challenges raised by the digital economy. In addition to its founding members, the Observatory also includes other research partners, in particular the Institute for Tax Law of KU Leuven (https://www.law.kuleuven.be/fisc/). The contributors who prepared this input are listed in the cover page of this document in alphabetical order.

The input statement concentrates on the following issues raised by the OECD request for input on work regarding the tax challenges of the digitalized economy ("the request for input"):

- The implementation of the current BEPS package (section II hereafter).
- Options to address the broader direct tax policy challenges (section III hereafter). Our comments thus focus on (i) the concept of *"significant presence test"* (SEP), (ii) a withholding tax on certain types of digital transactions and (iii) a digital equalization levy. We in particular look at the compatibility of these measures with international obligations, namely tax treaties, EU law and WTO law (section III hereafter).

Needless to say, however, that our comments ought to be considered as a **preliminary and high level analysis** and would of course need to be refined/revisited once the details of a particular policy option are known.

II Implementation of the current BEPS package

1. Although the final report on Action 1 report[1] has not led to a conclusive output shared by all States on a possible adaptation of the international tax law framework to the new business models, it is, on the other hand, quite clear that some of the items of the BEPS package were

[1] OECD (2015), Addressing the Tax Challenges of the Digital Economy, Action 1 – 2015 Final Report, OECD/G20 Base Erosion and Profit Shifting Project, OECD Publishing, Paris (cited Action 1 Final Report hereafter).

designed to also tackle the tax policy challenges raised by the digital economy. Conceptually, the most promising item in this respect is **BEPS Action 7**[2] which aims at reducing the Permanent Establishment ("PE") threshold by amending paragraphs 4, 5 and 6 of art. 5 of the OECD Model Tax Convention. Pursuant to these amendments, the maintenance of a very large local warehouse in which a significant number of employees work for purposes of storing and delivering goods sold online to customers by an online seller of physical products (whose business model relies on the proximity to customers and the need for quick delivery to clients) would constitute a permanent establishment for that seller under the new standard[3]. Further, BEPS Action 7 also modifies the agency PE definition to address circumstances in which artificial arrangements relating to the sales of goods or services of one company in a multinational group effectively result in the conclusion of contracts, such that the sales should be treated as if they had been made by that company. The Action 7 Final Report notes for example that an online provider of advertising services habitually plays the principal role in the conclusion of contracts with prospective large clients for those products or services, and these contracts are routinely concluded without material modifications by the parent company, this activity would result in a permanent establishment for the parent company[4]. From this perspective, BEPS Action 7 introduces a change of policy as compared to the existing agency PE concept under tax treaties, especially in jurisdictions favoring a formal interpretation of this concept.

2. This being said, BEPS Action 7 has at least two main shortcomings. First of all, BEPS Action 7 does not represent a minimum standard and several signing jurisdictions to the Multilateral Instrument (MLI) have reserved the right not to include the revised PE definition in their treaty practice. Moreover, under the MLI the modifications to the PE definition would come into effect only when both parties to the Covered Tax Agreement (CTA) agree to adopt the provision. Secondly, it is well known that a number of jurisdictions have not adopted the changes recommended by BEPS Action 7 because of concerns regarding how profit attribution should take place under this revised PE definition. This latter debate is of course still ongoing.

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2 OECD (2015), Preventing the Artificial Avoidance of Permanent Establishment Status, Action 7 – 2015 Final Report, OECD/G20 Base Erosion and Profit Shifting Project, OECD Publishing, Paris (cited Action 7 Final Report hereafter).

3 See Action 1 Final Report, p. 12 and Action 7 Final Report, Para. 13 (commentary to new Art. 5(4) in Para. 22).

4 See OECD, Action 7 Final Report, Para. 32.6.

In its input to the 22 June 2017 Discussion Draft on Additional Guidance on the Attribution of Profits to Permanent Establishments, the Tax Policy Center of the University Lausanne has discussed the challenges raised in this area[5]. For instance, with respect to the warehouse PE, the taxable profit in market jurisdiction will be restricted to the limited functions performed by the PE i.e. warehousing activities[6]. Similarly, in the case of the agency PE, once the intermediary is compensated on an arm's length basis, the input statement argues that no further profit should be attributed to the PE[7]. For these reasons, it is therefore fair to say that **the implementation of BEPS Action 7 by jurisdictions is rather heterogeneous[8]**. Accordingly, some of us advocate in favor a stronger coordination between the tax treaty aspects (lowering or rethinking the permanent establishment definition) and transfer pricing issues (attribution of profits to permanent establishments), on the other hand[9].

3. We feel that the tax policy challenges raised by the digital economy underscore the need for an **increased coordination between tax treaty and transfer pricing aspects**. Therefore, some of us feel that if future work is to be carried in this area with a view to revisit, once again, the permanent establishment threshold it would be desirable to (i) first resolve the controversy surrounding the attribution of profits under BEPS Action 7 and (ii) simultaneously address

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5 University of Lausanne, Tax Policy Center, DANON R./CHAND V., Comments on the 22 June 2017 Discussion Draft on Additional Guidance on the Attribution of Profits to Permanent Establishments (cited Comments on the Discussion Draft hereafter), Example 4, Paras. 45-49.

6 *Ibidem*

7 University of Lausanne, Tax Policy Center, DANON R./CHAND V., Comments on the Discussion Draft, Example 2, Paras. 28-35. The analysis under the foregoing situations is premised on the assumption that the tax treaty at stake follows the Authorized OECD Approach (AOA), see OECD (2010), 2010 Report on the Attribution of profits to permanent establishments, Paris (cited Attribution Report hereafter), Part I: General Considerations, Para. 10.) However, if the tax treaty at stake provides for a non-AOA methodology (a formulary approach), then the profits attributable to the PE could be significantly higher (for instance, the market jurisdiction may allocate a percentage of the sales to the PE). Therefore, attribution of profits to the PE in a market jurisdiction would depend on the exact wording of the treaty. Consequently, uniform attribution rules do not exist and each State may adopt its own approach.

8 See thereupon DANON R. / SALOMÉ H., The BEPS Multilateral Instrument – General overview and focus on treaty abuse, in IFF Forum für Steuerrecht, 3, 2017, p. 197

9 See DANON R., The Permanent Establishment Concept in the Post BEPS world – Selected thoughts on future challenges, forthcoming; CHAND, V./SPINOSA, L., Shortcomings of BEPS Action 7 with Respect to Taxing Digital Business Models, Section 6, forthcoming.

whether a consensus and a feasible solution could be found under transfer pricing rules for the digital economy[10]. Otherwise, the entire exercise would in our view yield little practical results.

4. Finally, the lack of agreed coordinated framework under BEPS Action 1 has, meanwhile, led several jurisdictions to adopt **unilateral measures**. Experience shows that these measures may have **distortive effects and lead to new international double taxations situations.**

III Options to address the broader direct tax policy challenges

III.1 Significant Economic Presence test (SEP)

III.1.1 In general

5. Turning to options aiming at addressing the broader direct tax policy challenges of the digital economy, we begin with the tax nexus concept of ***"significant economic presence"*** **(SEP)**. Specifically, an input is requested on the following questions: what transactions should be included within its scope? (ii) how should the digital presence be measured and determined? (iii) how could meaningful income be attributed to the significant economic presence and how would such an approach interact with existing transfer pricing rules and profit attribution rules applicable to the traditional permanent establishment? and (iv) how could such a measure be efficiently and effectively implemented in practice?

6. The objective of any business is to sell goods or provide services or do both. Goods can either be physical products or digital products. Physical products could either be sold through brick/mortar models or through online mediums. On the other hand, digital products are mostly sold online. Likewise, services can either be provided physically through brick and mortar models or through online mediums. The question arises as to whether the SEP concept should apply to "all enterprises" that commercialize their activities through brick and mortar models and/or online mediums or should the concept capture only *"digital enterprises"* that commercialize their activities mainly through online mediums? In order to avoid the issue of *"ring-fencing"* the digital economy (i.e. applicability of the rules only to "digital enterprises"), the SEP concept should, from a subjective standpoint, be applicable to "all enterprises" [11]; at the

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[10] Ibidem.

[11] On this issue, see also COMMITTEE OF EXPERTS ON INTERNATIONAL COOPERATION IN TAX MATTERS, Report E/C.18/2017/CRP.22 on Tax challenges in the digitalized economy: Selected issues for possible consideration,

same time, as far as the objective scope is concerned, the test should not be overly broad. Of course, the SEP test would apply to non-resident enterprises that have a purposeful and sustained interaction with the economy of the market jurisdiction.

III.1.2 Compatibility issues

III.1.2.a Relation with tax treaties and transfer pricing

7. The Action 1 report proposes several factors[12] (such as revenue based, digital based and user based factors) to determine whether or not a SEP exists in the market jurisdiction. The adoption of the SEP threshold would of course require **an amendment to the tax treaty definition of permanent establishment**[13], so to allow this concept to operate as nexus for taxing rights on profits also for the new business models connected with the digital economy. Yet, as discussed above, this option would yield little practical result if the possibility of making changes to the **attribution guidelines**[14] and **the transfer pricing guidelines**[15] is not explored simultaneously. Indeed, if the existing AOA is applied, profit attribution will depend on the significant people functions performed at the level of the PE. If significant people functions are not performed in the market jurisdiction then the income attributable to the PE will be negligible[16]. Therefore, significant changes will need to be made to the current profit allocation framework, which will require thorough studies of the possible reform options.
8. Some of the contributors of this input argue that it would be desirable to ascertain whether the application of a specific method for allocation of taxing rights (such as for instance the profit-

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Fifteenth session (17-20 October 2017) (cited Report on Tax Challenges in the digitalized economy hereafter), Para. 8 – 12.

12 With reference to the potential factors that could further be considered to that effect, see HONGLER, P./PISTONE, P., Blueprints for a New PE Nexus to Tax Business Income in the Era of the Digital Economy (January 1, 2015). Available at SSRN: https://ssrn.com/abstract=2586196.

13 Art. 5 of the OECD Model (see OECD (2014), Model Convention with Respect to Taxes on Income and on Capital (cited OECD Model hereafter)).

14 Art. 7 of the OECD Model; OECD (2010), 2010 Report on the Attribution of Profits to Permanent Establishments, Paris.

15 OECD (2017), OECD Transfer Pricing Guidelines for Multinationals Enterprises and Tax Administrations 2017, OECD Publishing, Paris.

16 CHAND, V./SPINOSA, L., Shortcomings of BEPS Action 7, Section 6.

split method) could reach satisfactory results for the new business models connected with the digital economy and the current framework be reformed accordingly. In this regard, it should be determined whether the concept of assets for the purpose of attribution of income to the permanent establishment could also include intangibles that are connected with the involvement of users in the market jurisdiction[17].

9. Some of the other contributors feel by contrast that another possible alternative may be to implement the SEP test through a shared taxing rights mechanism (for instance, see Art. 10 and 11 of the OECD Model or Article 12 of the UN Model). The Tax Policy Center of the University of Lausanne is currently exploring whether and how this option or other similar options that move in the same direction could concretely be implemented and how the policy and legal issues such an option may raise could be addressed.

III.1.2.b Relation with EU Law

10. The EU Law implications of a SEP-based approach would refer to the two planes of EU primary and secondary law. In particular, EU primary law issues would refer to the interaction with the EU fundamental freedoms and with the prohibition of State Aid enshrined in the Treaty on the Functioning of the European Union (TFEU). Secondary law would mainly refer in this context to the interaction of the proposed measures with the existing framework of Directives in the area of direct taxation[18].

11. From an EU primary law perspective, it is settled case law that under the case law of the Court of Justice of the European Union (CJEU) Member States' retain the power to define, by treaty or unilaterally, the criteria for allocating their powers on taxation[19]. Therefore, the introduction of the SEP threshold for purposes of allocating taxing powers should in principle not be incompatible with the **EU non-discrimination concept**. It may also be envisaged that the SEP be coupled with a non-final withholding tax acting as a supplementary collection mechanism and enforcement tool, as outlined in section III.2.1 of this note. Under such a scenario, it should

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17 See in this regard HONGLER, P./PISTONE, P., Blueprints for a New PE Nexus and BRAUNER, Y./PISTONE, P., Adapting Current International Taxation to New Business Models: Two Proposals for the European Union, Bulletin for International Taxation, 12, 2017, in particular Section 3.

18 With reference to the compatibility of the SEP with EU Law further considerations are carried out in BRAUNER, Y./PISTONE, P., Adapting Current International Taxation, in particular Section 3.

19 See CJEU, 21 September 1999, C-307/97, Saint-Gobain, Para. 56-58.

be explored whether any concern could be raised from a primary EU Law viewpoint with regard to the different treatment (essentially in terms of cash-flow disadvantage and supplementary administrative burden) of different "categories" of non-residents, assuming that non-resident taxpayers with a "traditional" PE would not be subject in the PE State to a withholding tax while non-resident taxpayers with a "digital" SEP would be subject to a withholding tax, albeit non-final[20].

12. **State aid law** (art. 107 et seq. TFUE) should however also be borne in mind. State aid rules could indeed become potentially applicable if a Member State unilaterally introduces rules on profit allocation that result in a different (higher) tax burden for certain undertakings, as compared to other undertakings that are legally and factually comparable, adopting as a reference framework the tax regime ordinarily applicable to undertakings[21]. From the perspective of State Aid rules, therefore, it would be important to ensure that the new rules do not ring-fence a specific sector of activity, such as for instance the digital economy. Accordingly, any tax bias between the regime applicable to traditional and new business models can potentially generate a ring-fencing effect and become a selective tax advantage that distorts or threatens to distort competition within the internal market.

13. On the other hand, the SEP concept does not seem problematic from the perspective of **secondary EU law**[22].

[20] This circumstance also raises a new form of market equality problem between two different ways of exercising the secondary right of establishment that trigger the liability to tax in the host state at different standards, i.e. between the "traditional" PE and the SEP. See in this regard, CJEU, 21 September 1999, C-307/97, Saint-Gobain, Para. 47 – 53, where the Court concludes that two forms of exercise of the secondary right of establishment are equivalent whenever the host State exercises its taxing jurisdiction on them.

[21] See in this regard, CJEU, 21 December 2016, Case C-20/15 P, World Duty Free and CJEU, 15 November 2011, Joined Cases C-106/09 P and C-107/09 P, Gibraltar with regard to the assessment of the presence of legal and factual selective advantages.

[22] For the sake of coherence, however, it may be worthwhile to consider whether PE definitions in secondary EU law (e.g. in article 2(b) of the Parent-Subsidiary-Directive) would benefit from an interpretation and application that is consistent with those proposed solutions.

III.2 Withholding Tax on Certain Digital Transactions and Equalization levy

III.2.1 Scope of the analysis

14. The BEPS Action 1 Report mentions that a **withholding tax**[23] could, in theory, be imposed alternatively[24]: (i) as **a standalone gross-basis final withholding tax** on certain payments made to non-resident providers of goods and services ordered online; or (ii) as a **primary collection mechanism and enforcement tool** to support the application of the nexus option based on SEP.

15. The first configuration of the concerned withholding tax could be applied to transactions for goods or services ordered online (i.e. digital sales transactions) or to all sales operations concluded remotely with non-residents. Under the second configuration, the withholding tax would be non-final and would be used as a tool to support net-basis taxation. In this scenario, a broad scope of application covering all remote supplies could be foreseen, the tax so withheld could be claimed against any outstanding tax liability resulting from the detection of SEP or, shall no SEP be detected, be claimed back by the affected taxpayer.

16. Based on the wording of the "Request for inputs", it would be our understanding, based on reference to potential instances of "international double taxation", that, for the purposes of the consultation, the focus would be placed on the first configuration of a withholding tax approach. At the same time, it would seem to us that it would be hard to distinguish between such a "standalone gross-basis final withholding tax on certain payments made to non-resident providers of goods and services ordered online" and an "equalization levy" as currently understood in the current international tax policy debate. For this reason, we have brought these two options under a single heading, provided that they would raise analogous issues in terms of compatibility with EU and international trade law obligations[25]. It should also be noted that this

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[23] A further implementation model of withholding-based approach that would not be limited only to specified "digital transactions" may be found in BRAUNER, Y./BÁEZ MORENO, A., Withholding Taxes in the Service of BEPS Action 1: Address the Tax Challenges of the Digital Economy (February 2, 2015). WU International Taxation Research Paper Series No. 2015 - 14. Available at SSRN: https://ssrn.com/abstract=2591830.

[24] See Action 1, Para. 7.6.3.

[25] On the other hand, the second configuration of the withholding tax would have to be placed with the broader framework of the SEP and would only function as a collection mechanism and enforcement tool. For this reason, for the broader implications of such an option, a reference could be made to the considerations carried out in relation to the SEP in Section III.1.

approach seems justified by the circumstance that questions raised with regard to the "withholding tax" approach and the *"equalization levy"* approach are the same in the "Request for inputs", namely:

(i) What transactions should be included within [the] scope [of the tax]?

(ii) How could the negative impacts of gross basis taxation be mitigated?

(iii) How could the threat of double taxation be mitigated?

(iv) How could such a measure be efficiently and effectively implemented in practice?

17. As acknowledged also by the BEPS Action 1 Report, an equalization levy could be structured in a variety of ways depending on its ultimate policy objective[26]. The policy rationale of an equalization levy as purported by the Action 1 Report would be intended to serve as a way to tax non-resident enterprises where it is perceived that the latter would have a SEP in a jurisdiction.

18. In this regard, even though no detailed draft has been circulated, the **Communication** recently released by the **European Commission** briefly refers to an equalization levy as a "[a] tax on all untaxed or insufficiently taxed income generated from all internet-based business activities, including business-to-business and business-to-consumer, creditable against the corporate income tax or as a separate tax."[27] At the same time, no public draft has been circulated to date.

19. In the light of the above, we shall consider an equalization levy on the digital economy as a tax charged on the turnover of enterprises operating in this sector, i.e. the turnover derived from their global business. Moreover, we shall assume that this levy pursues the goal of allowing the country of value creation to exercise its taxing sovereignty over business connected with the digital economy and to equalize the tax burden applicable to business in the traditional scenario of the physical economy. For such reason, we shall also assume that the equalization levy applies neither to traditional business activities, nor to the ones that operate under the sole sovereignty of that state (so-called purely domestic business activities). Finally, we shall assume in such scenario that the state of residence of all business will continue levying taxes on all

[26] See Action 1, Para. 7.6.4.

[27] COMMUNICATION FROM THE COMMISSION TO THE EUROPEAN PARLIAMENT AND THE COUNCIL. A Fair and Efficient Tax System in the European Union for the Digital Single Market, COM(2017) 547 final, Brussels 21.9.2017, at 10.

business income, thus both the ones connected with the digital and physical economy, giving relief for foreign taxes levied on income under the applicable domestic and treaty rules.

III.2.2 Compatibility issues

III.2.2.a Relation with tax treaties

20. Although the characterization of an equalization levy is debatable, it seems however outside the scope of tax treaties (art. 2 OECD Model Tax Convention)[28]. Therefore, the introduction of an equalization levy by market jurisdictions on a unilateral basis may **entail a risk of international double taxation** as the State of residence would not be obliged to provide relief under the applicable tax treaty and/or, as the case may be, under its domestic double taxation relief rules[29].

III.2.2.b Relation with EU Law

21. The EU Law implications of an equalization levy would refer to the two planes of EU primary and secondary law. In particular, EU primary law issues would refer to the interaction with the **EU fundamental freedoms and with the prohibition of State Aid enshrined in the TFEU**. Secondary law would mainly refer in this context to the interaction of the proposed measures with the existing framework of Directives in the area of taxation and, in particular, due to the circumstance that the equalization levy may be characterized as tax on turnover, with secondary EU law in the area of VAT.

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[28] In the Indian experience, the equalisation levy has been expressly carved out of the income tax. It may however always be argued that the Indian Equalisation Levy may more correctly be characterised as a withholding tax rather than a "pure" equalisation levy in the sense purported by the BEPS Action 1 Report.

[29] It may be noted that the US allows the interpretation of its tax treaties in a way that foreign tax relief is given for taxes levied "in lieu of income tax", including in such context especially withholding taxes. Yet, it is doubtful whether such an interpretation could allow to reach satisfactory results in respect of relief for taxes levied on turnover, as it would be the case for an equalisation levy, provided that the latter ones are substantially different from the ones levied on income. Therefore, this situation could lead to polarise taxation of income in the country of residence of the enterprise and taxation of turnover in that of the market, generating a potential negative tax bias that could severely undermine cross-border economic relations connected with the new business models and the digital economy.

22. Under the case law of the CJEU,[30] any tax advantage resulting for providers of services from the low taxation to which they are subject in the Member State in which they are established cannot be used by another Member State to justify less favorable treatment in tax matters given to recipients of services established in the latter State. Since the object and purpose of equalization levies would be to allow for an exercise of taxing powers in the State of the recipient of digital services, thus systematically compensating taxes charged by the State of the supplier in conformity with a different nexus, such levies would clearly constitute a tax obstacle on the free circulation of services within the European Union. Accordingly, insofar as digital services are effectively supplied from an EU Member State to another EU Member State, any compensatory effect produced by the equalization levy charged by the latter State in respect of a more favorable tax treatment applicable in the former State, may be incompatible with Article 56 of the Treaty on the Functioning of the European Union. The likely non-creditability of such a tax under tax treaties may further exacerbate the different treatment across the borders as compared to the one applicable to traditional business models, which can further dissuade persons from supply digital services in another Member State.

23. In summary, the very concept of equalization levies, as described in the previous section, would be at odds with the principles and foundational legal values of the EU internal market, to the extent that the levying of tax on business activities connected with the digital economy may potentially harm level-playing field in the European Union. This may occur insofar as such levies apply to the revenue derived from cross-border digital situations only, and a give rise to different tax treatment from the one that applies to income generated from traditional business activities. In fact, this situation may therefore generate a different treatment across the borders as compared to the one applicable to traditional business models, which can further dissuade persons from supplying their services digitally.

24. In concrete terms, the equalization levy would be implemented in the form of a final withholding tax on certain transactions. Such an approach would be compatible with the EU fundamental freedoms only insofar as it would apply identically to comparable residents and non-residents or, more generally, to comparable cross-border situations and purely domestic situations. This yardstick would preclude different rates, but also – given the case law of the CJEU – taxation on a gross basis in cross-border situations and on a net basis in comparable domestic situations.

[30] See in particular, CJEU, 26 October 1999, case C-294/97, Eurowings Luftverkehr, especially Para. 44 – 45.

25. **From an EU primary law viewpoint**, a domestic measure that distinguishes between residents and non-residents (assuming that the withholding tax be applied only to non-residents) appears to be problematic from the perspective of the fundamental freedoms.

26. Any domestic measure that imposes a higher tax on either of these categories would only be compatible with EU law if justified by an overriding reason relating to the public interest. A likely justification on which Member State may tend to rely would be the need to prevent tax avoidance and evasion. In this regard, the CJEU's traditional response to this type of justification has been that domestic measures in that area ought to specifically target wholly artificial arrangements[31]. Measures that go beyond this standard, and also cover arrangements that are not 'wholly artificial', such as the one hereby under scrutiny, would be difficult to maintain in the light of the CJEU's consistent case law.

27. It may also be observed in more specific terms that, provided that, the BEPS Action 1 Report traces the idea of an "equalization levy" to the taxation of the insurance industry[32], it may be useful to refer to the CJEU decision in the Safir case[33]. That case concerned a Swedish rule requiring residents that took a life insurance policy with a non-resident insurer to pay an insurance premium tax in Sweden (leading to burdensome procedural requirements for policy-takers choosing a non-resident insurer). The Swedish measure was intended "to ensure competitive neutrality" between domestic and foreign policies. The CJEU held that, due to its dissuasive effect on cross-border insurance services, the measure was contrary to the freedom to provide services. Given the express reference in the Final Report of BEPS Action 1 to such levies on insurance premiums as an inspiration for the suggested equalization levy (as well as its objective of "ensuring equal treatment of foreign and domestic suppliers"), the Safir case serves as a useful illustration of the possible restraints imposed by European law in this context.

28. Moreover, **EU State Aid law** could apply if an EU Member State unilaterally introduces a withholding on (certain) digital transactions in such a way that the conditions of application

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31 CJEU, 12 September 2006, Case C-196/04, Cadbury Schweppes, Para. 55.

32 Namely, in the area of insurance, some countries have adopted equalisation levies in the form of excise taxes based on the amount of gross premiums paid to offshore suppliers. Such taxes are intended to address a disparity in tax treatment between domestic corporations engaged in insurance activities and wholly taxable on the related profits, and foreign corporations that are able to sell insurance without being subject to income tax on those profits, neither in the state from where the premiums are collected nor in state of residence. See Action 1, Para. 7.6.4.

33 See CJEU, 28 April 1998, case C-118/98, Safir.

thereof (*de iure* or *de facto*) result in a different (higher) burden for certain undertakings, as compared to other undertakings that are legally and factually comparable, adopting as a reference framework the tax regime ordinarily applicable to undertakings[34]. Asymmetric tax burdens may arise, for instance, where a specific sector of activities is treated more favorably than other sectors. The design of a withholding tax should thus carefully consider the limits imposed by EU State Aid law and avoid creating asymmetric burdens.

29. Finally, EU law precludes EU Member States from introducing 'turnover taxes' in addition to **VAT**[35]. The CJEU has held this to be the case for turnover taxes that display the essential characteristics of VAT even if they are not identical to it in every way[36]; at the same time such a test would foresee that all the four characteristics of VAT would have to be met to that effect[37]. The qualifying characteristics would in particular be the following: (i) the tax applies generally to transactions relating to goods or services; (ii) it is proportional to the price charged by the taxable person in return for the goods and services which he has supplied, (iii) it is charged at each stage of the production and distribution process, irrespective of the number of transactions which have previously taken place, (iv) the amounts paid during the preceding stages of the process are deducted from the tax payable by a taxable person, with the result that the tax applies, at any given stage, only to the value added at that stage and the final burden of the tax rests ultimately on the consumer. Since the taxable basis of an "equalisation levy" would most likely be the sales price charged to the customer, these characteristics should be borne in mind in order to ensure that the withholding tax cannot be considered as a turnover tax in the sense of EU law.

[34] See in this regard, CJEU, 21 December 2016, Case C-20/15 P, World Duty Free and CJEU, 15 November 2011, Joined Cases C-106/09 P and C-107/09 P, Gibraltar with regard to the assessment of the presence of legal and factual selective advantages.

[35] See Art. 401 of Council Directive 2006/112/EC of 28 November 2006.

[36] CJEU, 31 March 1992, Case C-200/90, Dansk Denkavit and Poulsen Trading, in particular Para. 11 – 14 and CJEU, 29 April 2004, Case C-308/01, GIL Insurance and Others, Para. 32.

[37] See in this regard CJEU, 8 June 199, Case C-338/97, Pelzl and Others and CJEU, 3 October 2006, Case C-475/03, Banca Popolare di Cremona, Para. 28 – 38 where the "test" and the underlying reasoning is applied to a tax such as IRAP. At the same time, a more literal interpretation of the prohibition to introduce turnover taxes has recently been set forth by Advocate General Kokott in her Opinion of 5 September 2013 delivered in relation to the case C-385/12 on the special Hungarian retail tax. For the time being, however, the Court of Justice would appear to have upheld its narrower test.

30. An additional issue of compatibility with EU law could arise insofar as the equalization levies were introduced **by means of enhanced cooperation**, i.e. by a number of EU Member States representing at least one third of the total EU Member States[38]. In particular, Article 326 TFEU indicates that such cooperation shall neither undermine the internal market, nor constitute a barrier to trade between Member States or distort competition between them. Article 327 adds that it should respect the sovereignty of States not participating to enhanced cooperation. Because of its compensatory effects, the equalisation levies may in our view undermine the sovereignty of EU Member States that have opted not to participate to it.

III.2.2.c Relation with International Trade Law

31. The most obvious part of the WTO umbrella of agreements that is at odds with the equalization levy is the GATS, since it is likely that the majority of the equalization levy's base is likely to be viewed as receipts from the provision of services. The classification of the tax base is important for the WTO analysis since the different agreements protect different sorts of trades differently, the GATS applying to the provision of services only.

32. A precise and detailed analysis of compatibility of an equalization levy with the GATS would require a detailed legal rule as well as a particular national context, since different countries submit in the GATS specific and differing obligations, and such obligations were based on a classification method that had been devised prior to the ascent of the digital economy, so the analysis of the specific countries obligations under the GATS is not straightforward when it comes to the digital economy[39]. Yet, basic treaty interpretation rules and common practice must lead one to conclude that arguing that the later evolution of the digital economy cannot be used to fully exempt it from GATS scrutiny.

33. In fact, at a broader level, it may be argued that there is a general agreement that the digital economy should not be ring-fenced and hence it should be treated as "the economy" for the purposes of its taxation. In more specific terms, it should be observed that many countries have

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38 For further considerations on the potential implications of an introduction of this measure by means of enhanced co-operation, see BRAUNER Y./ PISTONE, P., Adapting Current International Taxation, in particular Section 2.

39 The case of India is a peculiar one, in fact, the scope of application of the equalization levy would cover digital advertisement. This circumstance would provide India with some significant leeway given that, in its Schedule of Commitment to National Treatment under GATS, India has not included advertisement services. The Schedule of Commitments for each economy may be retrieved at the following link: https://www.wto.org/english/tratop_e/serv_e/serv_commitments_e.htm

made GATS commitments in sectors that clearly include digitalization, such as advertising, telecommunication and software. For the purposes of our compatibility analysis we assume therefore that the equalization levy will impact trade in services subject to GATS obligations in many if not most cases[40].

34. The GATS include two primary rules: national treatment ("NT") and most-favored-nation ("MFN"). The application of the former concerns discrimination among foreigners, and therefore it applies in cases of different treatment of residents of different countries. We are unable to predict whether such practice is likely to occur in this context and hence we shall focus on the NT norm. GATS Art. XVII prohibits a less favorable treatment of foreign service providers compared to domestic service providers (in the covered industries).

35. There is little doubt that the equalization levy provides an additional burden on foreign service providers, especially if we assume that the levy is unlikely to be creditable by the state of residence of the service provider.

36. GATS includes an exception in Art. XIV(d) for "difference in treatment … aimed at ensuring the equitable or effective imposition or collection of direct taxes," direct taxes defined as "all taxes on total income, on total capital or on elements of income or of capital, including taxes on gains from the alienation of property, taxes on estates, inheritances and gifts, and taxes on the total amounts of wages or salaries paid by enterprises, as well as taxes on capital appreciation."[41] Even if the equalization levy were argued to operate as an "equalizer" it would not pass this exception on point since it is levied on the turnover of corporations.[42]

37. In any event, GATS Art. XIV's chapeau[43] provides that carve-outs are not absolute, and may still be challenged under GATS if they constitute arbitrary or unjustifiable discrimination or disguised restrictions on trade in services. There is little law on the interpretation of this

40 The Indian equalisation levy is a notable exception because it would apply to (online) advertisement and India has not committed to National Treatment under GATS with regard to advertisement services. Shall the scope of application of the levy be broadened – as it was originally proposed – significant international trade law issues may arise also for India.

41 See Art. XXVIII (o) GATS.

42 This provision includes a footnote with illustration of measures that may be acceptable, yet since the levy cannot qualify for the exception, one cannot analyse it in light of this footnote.

43 That reads: "Subject to the requirement that such measures are not applied in a manner which would constitute a means of arbitrary or unjustifiable discrimination between countries where like conditions prevail, or a disguised restriction on trade in services ..."

chapeau, yet it obviously may be used as a basis for litigation against the equalization levy in front of the WTO.

38. It should be noted that the application of the GATS may be just part of the WTO law compatibility of the equalization levy. The GATT also includes NT and MFN provisions. Assuming irrelevance of the MFN norm (see above assumption), the NT rule in the GATT, Art. III:2 prohibits discrimination against imported goods by the means of internal (nontariff) taxes. Discrimination is measured by comparison between the treatment of the imported goods and "like" domestic products. The likeness test may be complex in this case, yet if the equalization levy is imposed on the turnover it may very well be viewed as applying separately to each and every product imported, especially if it is a simple flat tax as its seems to be under the currently floated proposal. Moreover, there is no reason to argue that products in this case do not include digitized products. Many digitized products compete against very similar digitized domestic products, and therefore one must anticipate exposure of the equalization levy to the GATT NT with respect to these products.[44]

39. **In conclusion, an equalisation levy substantially displaying the features of a turnover tax is likely to be incompatible with WTO obligations of many countries, primarily pursuant to the GATS, but also pursuant to the GATT.** The exact exposure depends on the exact articulation of the levy and the countries applying it, yet, in any event the incompatibility is likely to very meaningful. A non-universal levy, applying differently to different countries, may require even further caution due to the potential application of the MFN clauses in addition to the NT provisions discussed above.

III.2.3 Synthesis

40. An "equalization levy" implemented in the way it is generally purported in the current international tax policy debate on the basis of the Indian experience would appear to be hard to distinguish from a turnover tax. This characterization would evidently not raise issues of compatibility with income tax treaties as such tax would fall outside of their scope. At the same

[44] As earlier mentioned, Art. III.2 is traditionally understood as applying only to indirect taxes, and not to income (or other direct) taxes because these cannot be qualified as taxes on products. Nevertheless, there is no clear language necessitating this interpretation. In our opinion even direct taxes may qualified under Art. III, para. 2 as "other internal charges of any kind". The equalization levy is even more vulnerable than income taxes when applied to the turnover as explained above.

time, this would imply that said levy would typically not be creditable in the State of residence of the affected taxpayer thus giving rise to instances of international double taxation.

41. On the other hand, such a levy would be susceptible to raise varied and not easy to resolve compatibility issues with European law and international trade law obligation. The latter potential issues have most likely not been raised with regard to the Indian equalization levy simply because such levy would fundamentally apply to online advertising and, for the time being, India has not committed to National Treatment for this type of services under the GATS.

42. In a way, the equalization levy may actually be considered as "a solution in search of a problem", provided that the trigger behind the whole digital taxation policy debate was offered by the perception that MNEs were not paying their "fair share" of (income) taxes. By introducing a solution outside of the scope of the income tax we would be moving in unchartered territory and potentially encourage a proliferation of "alternative levies" that are likely to undermine not only the international tax regime but the very reliance on the income tax as a pillar of the international tax regime.

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