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The Taxation of Digital Giants

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After nearly two years of negotiations, in July 2023, the 138 member countries of the Inclusive Framework on Base Erosion and Profit Shifting (BEPS) approved a final declaration summarising the policy package to be developed to meet the tax challenges posed by the digitisation of the economy.

In fact, the new and unique business models emerging in the digital sphere challenge the traditional criteria on which states' right to levy taxes is based, such as tax residence or the presence of a permanent establishment, given the potential to dissociate the 'physical' business structure from the reference market, especially with regards to digital services.

Against this backdrop, the debate continues at the European and international levels on the tax reforms needed to ensure the fair distribution of profits and taxation rights among countries in relation to multinational digital companies. Under consideration is a long-term EU proposal, which aims to reformulate the traditional canons and principles of taxation; in the meantime, before an agreement at the supranational level can be reached, some states have implemented temporary and transitional measures, i.e., the so-called digital services taxes (DST) or web taxes, which, however, are not free of critical issues.

The digital economy: new business models and challenges to traditional taxation criteria

The digitisation of the economy, and the consequent development of new business models, have radically altered international markets: if, in the last century, the main companies operating on a global scale belonged to the industrial sector, today, the global market is also significantly influenced by digital companies, operating through the web, using algorithms, and running social networks and platforms where users, businesses, customers, and consumers can exchange information, products, and services. Moreover, the business models employed by such 'web' multinationals are manifold, spanning those that that are based in a foreign country and offer digital goods and services within a country and those that are hybrid, headquartered elsewhere, with local production facilities and workforce. Such a changed socio-economic framework has set the stage for a profound rethinking of the criteria by which a person becomes a taxable person for income tax purposes.

Traditionally, an enterprise or entity is subject to taxation in the place where it is considered to be fiscally resident, that is, where, for the greater part of the tax period, the registered office or the corporate headquarters is located: these are elements that make it possible to establish and affirm the relationship between the enterprise and a certain territory and, consequently, the right of the state to tax the wealth (wherever) produced by that taxable entity. The tax base is the business income earned, which is determined using the company's balance sheet, to which are applied variations, based on the tax legislation of each country (principle of derivation). The criterion of tax residency is accepted by most tax systems globally and is 'consecrated' at the international level in double taxation conventions, which aim to resolve any conflicts of double taxation that arise from entities operating in more than one tax jurisdiction.

In addition, a state may also tax the income of non-residents if they have, in that territory, a fixed place of business, i.e. a production plant, an office, or any premises devoted to business activities (or, in other words, a 'permanent establishment'). Even in this case, a link can be traced between an entity's business activities and the territory in which it operates, albeit to a lesser extent than in cases where the requirements of tax residence are met, so a state will be entitled to tax the share of the income of the non-resident that is attributable to the permanent establishment located on its territory.

These criteria lose their meaning, however, when we consider digital businesses operating exclusively on the web, whose profits are derived mainly from the provision of online services (e.g. advertising) or from the exercise of intangible rights (i.e., trademarks, patents, intellectual works, etc.). In fact, it is relatively easy for such businesses to locate their tax residence – for example, their registered office or seat of administration – in low-tax territories, while operating in a global market. And, at the same time, the digital business model allows them to avoid having facilities in territories other than their tax residence, avoiding taxes in jurisdictions where their users are located (and which typically have a higher tax rate). Ultimately, big tech represents an element of risk to state finances.

Thus, though some big tech companies have a strong physical presence in countries around the world, for example, through branches and subsidiaries employing several employees, they face lower taxation than those operating under traditional business models. In fact, according to data from the European Commission, the average tax rate of web-based multinationals is 8.5 per cent, compared to 23.2 per cent for other companies ([1]). The fact that these multinational digital companies earn substantial profits from their online activities around the world, while being based in low-tax jurisdictions under traditional taxation

[1] COM(2017) 547 final, 21.09.2017.

criteria (i.e., tax residence and/or permanent establishment), has set the stage for a heated debate on how to ensure that these entities pay 'their fair share of taxes' in their markets of operation.

In fact, the absence of a traditional territorial link (registered office, seat of administration, or permanent establishment) legally limits states' rights to tax a share of the profits that these companies produce. Nevertheless, states expect to partake in the profits of these digital giants in an attempt to combat the erosion of their tax bases, which have progressively 'migrated' to territories with advantageous tax rates.

So the criterion of location of income becomes a matter of debate – in particular, whether it is relevant to tax income where the goods/services are produced in the traditional sense, i.e., at production centres or the company's headquarters, or should the tax paradigm be transformed to focus on where the 'value' is created, i.e., where the user market is located, regardless of where the production facilities are (which, in the case of digital enterprises – with some exceptions – are usually not in the same jurisdiction as the user market). From this perspective, the prerequisite for taxation would no longer be the tax residence of the enterprise but, rather, the place where it has the greatest verified economic presence. However, defining the parameters for measuring a digital company's revenues within a particular territory is also riddled with uncertainties.

On a practical level, the challenges posed by new digital business realities can be addressed in various ways, either by retaining existing conceptual categories (i.e., tax residence, permanent establishment, etc.), adapting them to the changed context, or by radically changing the scenario and rewriting them from scratch. However, due to the difficulties in reshaping the rules on international taxation, and due to the way income taxes are conceived today, completely changing the paradigm poses a highly complex issue that is subject to political influences given the presence of multiple conflicting interests, first and foremost those involving the countries that export technology.

Multilateral proposals and attempts to identify new criteria for relocating 'digital' profits

At the European and international levels, the need to redefine taxation criteria for digital companies is much debated, and there have been multiple attempts to define appropriate taxation measures for large digital players.

In fact, the essentially intangible nature of digital businesses requires going beyond traditional concepts such as tax residence and permanent establishment, which are both defined in terms of physical presence, to identify the criteria under which the revenues of digital corporations can be subject to taxation. To enable countries to 'localise' digital enterprises and their profits within their territory (outside the digital business's state of residence), and thus affirm their right to tax them, the concept of permanent establishment needs to be updated and adapted to new business realities. It is ultimately necessary to review the nexus between profits, businesses, and the right to tax, as the non-material nature of digital activities can lead to double non-taxation.

On this front, one possible approach jurisdictions could take is to embrace the idea of a digital permanent establishment: an approach mentioned by the Organisation for Economic Co-operation and Development (OECD), whose Base Erosion and Profit Shifting (BEPS) project proposes to include within the concept of permanent establishment, as established in treaties against double taxation, the additional clause of digital permanent membership, which has been devised to recognise the economic impact of a digital company in a certain territory, even though it does not have a physical presence there. Such impact could be measured on the basis of three parameters: revenues earned in a given geographical market, the number of contracts concluded, and the number of users. Upon exceeding the set threshold for even one of the parameters in a tax period, the so-called digital permanent establishment would be configurable. In this way, it would be possible to identify new forms of territorial rootedness, where both physical presence and (especially) digital presence within a territory become significant. Where a digital permanent establishment can be configured, the state would then be able to tax the revenue generated within its territory regardless of physical presence.

At the European level, there have been attempts to adapt traditional taxation criteria to digital realities. Indeed, discussions on digital permanent establishment and significant digital presence converged in a 2018 European Union (EU) proposal ([2]) that undoubtedly represents the most advanced and structured attempt to incorporate the concept of digital/virtual permanent establishment into the corporate income tax framework as a long-term solution to the challenges posed by the digital economy. Under the aforementioned proposal, the digital presence of a non-resident digital enterprise would be deemed to be significant if, in a tax year, at least one of the following criteria is met: the entity's revenues exceed €7 million; it has more than 100,000 users in the state; and it has delivered more than 3,000 contracts for digital services. If so, a proportionate share of the digital enterprise's profits would then become taxable in the country where it has a taxable digital presence, at rates equivalent to those that apply to traditional companies.

However, the European negotiations have since stalled due to the lack of unanimous consensus among EU member countries. Meanwhile, the OECD's work has led to the identification of both innovative and temporary measures to deal with the problematic taxation of multinational digital companies.

[2] COM(2018) 147 final, 21.03.2018. At present, the procedure is still under negotiation.

The OECD's discussions on formulating a harmonised approach to taxing the digital economy, i.e., the proposed two-pillar approach to addressing the tax challenges arising from the digital economy, aim on the one hand, to grant countries the right to tax (a part of) the profits of digital companies based on their sales in each jurisdiction, so as to ensure a more equitable distribution of profits, and will apply to the largest multinationals ('Pillar 1'), and on the other, to introduce an overall minimum corporate tax rate to avert a race to the bottom in such rates, thus limiting tax competition and protecting state tax bases ('Pillar 2').

In detail, **Pillar 1** aspires to identify and formulate a completely new taxation model based on where the profits of multinational companies are generated independent of their physical presence. This innovative model aims to distinguish, for digital companies, the part of (normal) profit taxed according to traditional rules and a surplus part that is taxed based on destination location, i.e., where the sales took place and the customers, users, and consumers are located (so-called 'market jurisdiction'). If adopted, there would be a reallocation of taxation power such that a part of the taxable amount, which would not accrue under the ordinary rules to the country where the sales take place, because there is no physical company or permanent establishment, would be liable for taxation in those territories: OECD estimates indicate that reallocation could affect more than $100 billion in profits.

Pillar 2, on the other hand, responds to the need to stem the erosion of tax bases by establishing a global minimum tax rate, which will discourage the shifting of multinationals' profits to countries with privileged taxation. According to this approach, multinational groups subject to an effective tax rate of less than 15 per cent could be subject to a top-up tax mechanism, such that the effective tax rate would be brought back (at least) to the aforementioned threshold. OECD estimates indicate that the global minimum tax could generate additional tax revenues of about $150 billion annually.

The 'two-pillar' solution proposed by the OECD aims to provide stability to the international tax system, making it more equitable and functional in an increasingly digital and global economy. However, there remain understandable difficulties in reaching a consensus on solutions, so the project can be said to be far from finished. While there has been significant progress in implementing the second pillar in the EU, with the adoption of Directive 2022/2523 of 14 December 2022 – which introduced measures for the minimum effective taxation of multinational groups and which will have to be transposed by member states by the end of 2023 – negotiations with regard to the first pillar are still ongoing. However, it is clear that joint operationalisation is required to achieve the set goals: in the absence of a shared synergy, individual measures or actions may render the framework incomplete or cause other critical issues, as can be observed in the case of web taxes.

Web taxes: unilateral, urgent, and temporary measures

In parallel with the OECD's work, the EU has also been actively working towards redefining the criteria for taxing the profits of digital companies, including by brainstorming ideas and promoting avowedly temporary actions pending the identification of a global solution.

These include the European Commission's proposed digital services tax (DST or web taxes).[3] According to the original intentions, it should affect gross revenues, net of value-added tax, derived from the provision of certain digital services within the territory of the EU, such as the placement of advertising targeted at users on a digital interface, the provision of digital platforms where users can interact, potentially facilitating the supply of goods or services, and the transmission of data about users. That is, the DST should enable the taxation of those revenues generated from services rendered through digital interfaces, which represent a monetisation of users' contribution to value creation.

By proposing a directive, which has remained unimplemented, the European Commission intended to outline a common tax system for revenues generated from the provision of digital services, which would apply, specifically, to large multinational digital companies that are non-resident and have no permanent establishment (in the traditional sense) within the EU territory, even though they can count on a wide audience of users and consumers within it. The proposal indicated that for the revenue to be subject to tax, it should exceed two size thresholds: one related to the total revenues earned worldwide (so-called 'generic revenues') and the second pertaining to the revenues generated within EU territory for the provision of the digital services (so-called 'digital revenues').

In this sense, the proposal for a harmonised tax on digital services aligns with the principle of equalisation of taxes, as it is aimed at compensating for taxes on the 'lost', or relocated, profits of web multinationals. However, it has always been intended as a temporary solution pending the redefinition of the criteria for the localisation of multinationals' profits under Pillar 1 proposed by the OECD. Despite its intended objectives, the approval of the proposed directive has met with strong opposition, both internally within the EU and externally, mainly by the United States, and at present, there has been no significant progress.

In view of the slow progress in international negotiations with regard to the adoption of new paradigms for the localisation of digital business revenues at the OECD level, and with regard to the approval of the Digital Services Tax Directive as a temporary solution at the European level, several countries have gone their own separate ways, unilaterally adopting their own web taxes, concerned about the impact of the digital economy on tax revenues.

[3] COM(2018) 148 final, 21.03.2018.

India was the first country to implement a web tax, configured as a withholding tax of 6 per cent on payments made by companies that are tax resident in India, or by Indian permanent establishments of non-resident companies, to non-resident companies against online advertising services provided. In Europe, several 'unilateral' web taxes have been introduced: France, Italy, Spain, the United Kingdom, and Belgium have introduced taxes on digital services that resemble, in their structure and stated objectives, the measure proposed by the European Commission, although they differ from it in many critical aspects.

The unilateral action by several EU states was met with strong opposition, mainly from the United States, to which belong most of the 'digital' multinationals affected by the application of European national DSTs. The US has demanded immediate abolition of the taxes, preferring the adoption of other measures arrived at through mutual agreement (i.e., the implementation of Pillar 1). The political compromise reached provided for the mere suspension of the introduction of new unilateral DSTs as well as any increase in the rates of DSTs already in force; instead, the withdrawal of the already enforced DSTs was linked to the implementation of Pillar 1, initially scheduled for 31 December 2023, a deadline that was recently extended to 31 December 2024, to no small discontent.

New digital business models have challenged several aspects of traditional taxation models, which require rethinking and adaptation to the new global economic realities. The conflicting interests at stake require the achievement of a political compromise. However, no consensus has yet emerged, neither on the European nor on the global level, despite negotiations having been underway for several years.

Critical aspects in the design of web taxes and potential undesirable effects

The challenges posed by digital business models to taxation methods and criteria has led to the unilateral adoption of the measures known as web taxes, pending broader coordination. Though these measures were designed on a transitional basis, one has to note several critical aspects that require careful consideration. Indeed, the adoption of a tax on digital services undoubtedly poses multiple structural and design challenges for the state eager to introduce it.

A taxation on gross revenues

A first conceptual aspect that requires attention relates to the fact that this type of taxation targets the gross revenues of digital enterprises and not their income (the traditional index of taxable capacity, assumed as the tax base for ordinary corporate tax). The underlying idea is that revenues are a proxy for the business income that is assumed to be relocated to countries with privileged taxation and are therefore not subject to any form of taxation. Fixing gross revenues as the tax base, however, can lead to some issues.

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In the first place, the assumption that revenues can constitute a suitable and approximate measure of business income may be incorrect, since it is not possible to infer with certainty that a certain amount of revenues (albeit high) has resulted in an equal and corresponding business profit (the latter is used generally to calculate taxable income). Profits are influenced by fixed and variable costs, based on the way the business is run, its sector of operation, and the organisational model. For example, the retail sector is known to have low profit margins, and therefore, a tax on the gross revenues of a company in this sector would probably not be proportionate to the profit actually earned, in the sense that it would probably exceed the company's ability to pay. This applies to big tech as well; analysis of balance sheet data shows that although the gross revenues of these companies are substantial, the overall profit is significantly lower and may even be negative. In these cases, the arbitrariness of a tax on the former as a proxy for the latter is evident. In fact, large revenues may not be synonymous with high profitability, and a tax on gross revenues may well conflict with the principle of ability to pay.

There are other aspects of a tax on gross revenues that are problematic. Indeed, a tax structured in this way means that even loss-making enterprises would in principle be subject to the tax, which would have side effects that are clearly undesirable – for example, they may hinder investments, cause disadvantages for start-ups, and so on. Moreover, it is apparent how such a form of taxation disregards the ability to pay of the enterprise.

Additionally, taxing gross revenues and not income makes it unclear whether the DST is a direct or indirect tax; in the latter case, it is likely to be passed on to consumers. This raises the question of who ultimately bears the burden of the tax: following the introduction of the DST in France, several multinational groups have announced that they will be transferring the tax burden to consumers.

Taxable persons

Generally speaking, the current national DSTs identify as taxable persons those multinational corporations that render digital services and meet certain criteria. Only a narrow set of entities, predominantly US based, meet the criteria, due to which the US has been a strenuous opponent to making these measures permanent. This gives rise to another concern: globally, there are

several multinationals that are not strictly ‘digital’ and that are excluded from the DST, despite the fact that the same risks of non-taxation or slight taxation of profits may arise in their case as well.

The localisation and distribution of profits based on users

A further critical aspect concerns the criteria to be adopted to locate a share of the digital enterprise’s profits within a certain territory. In this regard, national regulations, resembling the European Commission’s proposal, ‘create’ the link between a non-resident digital enterprise without a permanent establishment and the national territory stemming from the presence of a user market, i.e., the presence of users, customers, and consumers who benefit from the digital platform, website, marketplace, etc.

This is based on the premise that such digital business models are highly dependent on the participation of users, whose contribution ‘in fact constitutes the creation of value for the enterprise[4], almost as if users were employees who ‘work’ for the enterprise; therefore, for taxation purposes, the place of value creation is where users are located.

In this regard, regulations tend to locate users based on the Internet Protocol (IP) address of the device used to connect; however, this does not consider the fact that IP addresses often do not precisely indicate the location of the user, given that users of digital services often use virtual private networks (so-called VPNs), which allow the IP address to be hidden or modified. In addition, the use of IP addresses poses quite a few privacy problems, given that it is a personal data, and its capture and storage needs some thought.

In any case, apart from these technical aspects, the very premise on which the proposed directive and national regulations are based is likely to be questioned – namely, that the presence of registered users on a certain website, social network, or platform is in itself indicative of the significant economic presence of the digital enterprise or the creation of value. With regard to the first aspect, it is indeed necessary to also consider the phenomena of multi-accounts, fictitious accounts, and those that are silent or have not been operational for a long period of time, which are unlikely to translate into ‘value’ for the company; with regard to the second aspect mentioned, it would also be appropriate to assess the negative business impact caused by those users, customers, or consumers who engage in conduct likely to damage the company’s reputation, business, or services, as when inappropriate content is shared. In other words, the existence of users in a certain territory does not always translate to greater value for the company.

Level of rates, possible national tax competition, and tax yield

In relation to the web taxes hitherto unilaterally introduced by individual countries, there is a real risk of downward competition in tax rates, in a manner quite similar to what has already occurred with reference to corporate income tax. This could cause further erosion of tax bases (which web taxes seek to curb) and could reduce even more substantially the tax revenues generated through domestic DSTs, which are already meagre when compared with corporate income tax revenues.

Risks of possible double taxation

A further risk concerns possible international double taxation. As mentioned, the tax on digital services is conceived as a tax on gross revenues, not on income, and it is therefore likely to result in quite a few problems with regard to double taxation treaties: since it is not a tax on income, it is not covered in the treaty text nor in the provisions dealing with the elimination of possible double taxation, and therefore, it would not be recognised as a tax credit for taxes paid abroad.

Further, multinational digital companies that meet the criteria for DST inclusion in more than one country risk double taxation. In fact, we can well imagine cases of possible double taxation, for example, where two or more national DSTs apply to the same transaction, when there are multilateral digital intermediaries between entities located in two different territories, giving rise to DST-relevant transactions in both states. In such cases, it would be better to reduce the taxable base or rate on a flat-rate basis or to redefine as a platform user only the purchaser (this hypothesis, however, has obvious repercussions and is probably undesirable to one of the states involved and presents complications for the sharing of upstream profits).

We can also imagine a further risk of double taxation: DSTs apply regardless of the physical presence of the digital enterprise considered (i.e., the possible existence of a subsidiary company or a permanent establishment in the territory of the taxing state), and therefore, there could be cases in which multinational groups are already subject to ordinary income taxation and yet must also pay the tax on digital services. This already happens for multinational companies that operate through the web and at the same time through production establishments in various territories: here, corporate tax (whose taxable base is income) and DST (whose taxable base is gross revenues) are both applied. This leads to obvious duplications and distortions, leaving one puzzled as to the need to apply additional taxation on gross revenues when the company already pays ordinary corporate taxes, on par with other ‘traditional’ companies. This gives rise to the suspicion that the DSTs, in their current configuration, are actually discriminatory.

[4] COM(2018) 148 final, par. 1.

Administrative criticality of the one-sided approach

Finally, one needs to note that national web taxes, in the absence of harmonisation, give rise to critical administrative issues for enterprises brought newly under their ambit. The fact is that almost every national regulation requires the adoption of precise formalities, which are sometimes applied even retrospectively, such as the acquisition of a tax code, the adoption of separate accounting, etc. How can companies truly be compliant with dozens of different regulations?

Toward a multilateral model

New digital business models have certainly challenged several aspects of traditional taxation models, which need to be reworked and adapted to new global economic realities. The conflicting interests at stake require the achievement of a political compromise with respect to which, however, no certainty has yet emerged, though the negotiations at the European and international levels have been underway for several years. While waiting for supranational agreements to be reached, several countries have acted autonomously, introducing ad hoc regulations, which, however, expose taxpayers to further risks and uncertainties. Even the European Commission has argued for slowing down the state approach by favouring agreed solutions, partly in light of the fact that 'divergent national approaches within the EU can fragment the single market, increase tax uncertainty, destabilize the level playing field and open new loopholes for tax abuse'.[5] All these considerations thus drive the urgent need for long-term multilateral international collaboration in response to the challenges of the digital economy.

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