International developments happening around Italy's web tax

Tommaso Di Tanno, professor and founder of Di Tanno e Associati, explains how the EU and OECD efforts to tax the digital economy are progressing.

Two issues have recently gained the attention of internet businesses: the OECD's May 2019 document on the digitalisation of the economy and the Fukuoka report from the G20 meeting held in June 2019 in Japan.

Both issues underline the necessity to overcome the traditional international tax principles according to which:

- All source of revenues, including entrepreneurial income, have to be attributed (and taxed) on the basis of fiscal residency; and
- Any cross-border activity has to be placed – for taxing purposes – in the country, if any, where a permanent establishment exists.

Overcoming these needs is not new, but rather the result of the work undertaken by the BEPS group over the past three-four years. What is new, however, is the full awareness – on technical and political matters – of the need to adopt an international standard to prevent the damage that may be caused by unilateral action.

The European Commission (EC) also follows this objective. In March 2018, it started to acknowledge that if the EU failed to tackle the problem of taxing digital companies through a common framework, each EU country would have adopted its own solution, resulting in an uncoordinated EU tax framework and an unbalanced EU digital market. Moreover, as the digital market grows, the EC could see the situation worsening and damaging the bloc's entrepreneurial competition.

For this reason, the EU Commission presented two different proposals. The first was a long-term solution that updates the concept of a permanent establishment (PE) based on a tougher link between market and activity (nexus), which somewhat repeals the need for a physical relation between sources of revenues and business-guided decisions.

Considering, however, that such a proposal has to be accepted by the EU member states and other members of the business community (namely the US, Canada, Japan and China) and be included within each pertinent income tax treaty, the EU Commission filed a second "interim" proposal based only on the taxation of revenues derived on specific digital services (the DST).

The DST was explicitly presented as a temporary solution and characterised by a tough restriction on what can be defined as "taxable services". The focus is placed on those services in which the collaboration of the "end users" on the value creation chain appears fundamental and on the magnitude of the enterprise (or group of enterprises) to be involved (in excess of €750 million as worldwide turnover, more than €50 million of which derived from digital services realised within the EU).

The taxable services mostly include advertising, intermediation and the sale of data. There are numerous exemptions to avoid capturing financial activity that are already under control by other community rules and/or regulators.

Notwithstanding the exemptions, the definition of what a "taxable service" may include remains indefinite. Any definition of a "taxable service" appears, in fact, somewhat avoidable and rather easy to overcome. As a matter of fact, on one side, any law requires a coordinated sequence of words; on the other side, events often create the necessity to establish words that are adequate to capture the new scenarios. One might argue that this is an ordinary matter in modelling laws. What is extraordinary, however, is the pace at which the digital world let this phenomenon happen.

In addition, considering the prominent role attributed by the EU proposal to the end user, one has to deal precisely with the localisation of such users. This matter is, on the contrary, too simply attributed to the IP (internet protocol), which is just a commercial tool for identification without any sort of official accountability. The matter is also wider than just tax, but it is important to identify the tax liability when each country that is in the value chain is entitled to a portion of the tax.

The magnitude requisite (€750 million ($845 million) worldwide revenue, €50 million of which is realised in the EU) is intended to tackle two different worries. The first is the consideration of the administrative weight of the computation to be carried to face the DST's application. The information system required appears too complicated for start-ups or small businesses. The second is to focus on those activities where turnover is large enough to benefit from the data it obtains or sells.

Italy, France and Spain are progressing in the implementation of their DST proposals. While Spain has approved its law in the lower house of Parliament only, lawmakers in Italy and France have fully adopted the proposed rules. The French version is in place, while the Italian one requires some further details to be adopted (to be issued through a government act) to enter into force.

The long-term EU proposal that would update the PE concept to include the "nexus" perspective is based on activities performed in a certain territory, regardless of where the business has their fiscal residency. The digital services involved are, generally speaking, those rendered through a "digital interface". If a business entered into any taxable digital activities in any EU country within a fiscal year, at least one of the following thresholds is deemed to have created a "digital permanent establishment" in the EU member state:

- Revenues in excess of €7 million deriving from digital services;
- End users (or clients) in excess than 100,000. The end user tax residency would be identified through the IP address; or
- Number of commercial contracts (presumably resulting in sales) in excess of 3,000.

Once the PE's existence is confirmed through of one the above thresholds, the EU proposal indicates the methodology to ascertain the taxable profit. The "profit split method" is indicated as the preferable one, but the proposal is open to other methodologies if the taxpayer can effectively determine the company's taxable profit.

However, notwithstanding the restrictions, the proposal was rejected at the beginning of 2019 by a consistent minority of EU member states. Nevertheless, the EU Commission believes the matter has not been abandoned and intends to revise its proposal to include further restrictions that will almost result in focusing on advertising services only. The matter, however, will be inevitably transferred to the new EU Commission.

The OECD's and the G20's positions are almost similar and include some interesting news. The OECD position (the OECD document) is, of course, much more detailed that what the G20 has released, which goes no further.

The OECD – heavily influenced by US representatives – has long followed positions that focus on the PE definition (or redefinition) and new transfer pricing guidelines. Such positions are clearly defensive and, although referring to tools and matters very well known in the international tax context, appear somewhat unable to lead to a convergence of interest between dramatically different parties (for example, the US as providers and the EU member states as purchasers).

As such, what has emerged is an expansion of the discussion to include solutions that recognise the role of the end users and the localisation of them. This route seems to be the one which may let the duelling parties converge and find a practical – although if, theoretically speaking, discussible – solution.

Paragraph 22 of the OECD public consultation document from February 13 refers to three proposals that have been articulated to develop a consensus-based solution on how taxing rights on income generated from cross-border

activities in the digital age should be allocated among countries. These proposals are:
- The "user participation" proposal;
- The "marketing intangibles" proposal; and
- The "significant economic presence" proposal.

Such proposals carry important differences, including the objective and scope of the reallocation of taxing rights. At the same time, they all allocate more taxing rights to the jurisdiction of the customer and/or user in situations where value is created by a business activity through (possibly remote) participation in that jurisdiction that is not recognised in the current framework for allocating profits.

In addition, they have important common policy features because they all:

a) Contemplate the existence of a "nexus" in the absence of physical presence;
b) Contemplate using the total profit of a business;
c) Contemplate the use of simplifying conventions (including those that diverge from the arm's-length principle) to reduce compliance costs and disputes; and
d) Would operate alongside the existing profit allocation rules.

For all these reasons, a specific programme of work was created and grouped into three blocks that can be summarised as follows:
- Different approaches to determine the amount of profits subject to the "new taxing right" and the allocation of those profits among the jurisdictions;
- The design of a new "nexus rule" that would capture a novel concept of business presence in a market jurisdiction, reflecting the transformation of the economy, and not constrained by physical presence requirement; and
- Different instruments to ensure full implementation and efficient administration of the new taxing rights, including the effective elimination of double taxation and resolution of tax disputes.

The programme is apparently complete and adequate to fulfil the needs of OECD countries and taxpayers. However, while the final point above shows a full understanding of the practical difficulties that may result in further restrictions, the other two issues also give rise to a perilous subjective approach. The indication that the OECD will deliver the final version of the proposals by late 2020 appears, in this context, as a way to postpone any undesirable decision.

Nevertheless, there is a clear motive to use the so-called 'nexus rule' as a fundamental step to move away from the traditional PE definition. The OECD document explicitly refers to the development of the nexus rule to "capture a novel concept of a business presence in a market jurisdiction reflecting the transformation of the economy and not constrained by physical presence requirement, and which would allow market jurisdiction to exercise taxing rights over the measure of profits allocated to them under new allocation rules".

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Tommaso Di Tanno founded Di Tanno e Associati in 1986. The firm now employs 16 lawyers and 18 certified public accountants.

Tommaso chaired the board of directors of large betting company Sisal, from 2005-2010, of insurance company Assicurazioni di Roma from 2005-2011, and of real estate company Central Sicaf from 2017-2019. He chaired the board of statutory auditors of Banca Monte dei Paschi di Siena from 2006-2011, BNL Group from 2002-2005, Anima SGR from 2008-2013, and BAT Italy from 2003-2011. Today, he chairs the board of statutory auditors of Vodafone Italy, EF Solare Italia (the largest Italian renewables energy Group) and Alitalia holding company Midco.

Tommaso was a member of several treasury committees looking after bank and stock exchange legislation. He served as Italian representative on the tax and legal committee of the European Venture Capital Association and was a member of the direct tax working party of the *Federation Europeenne des Expert Comptables*.

He is also a member of IFA and frequent speaker at international conferences focusing on tax matters.

It firmly states the necessity to amend a number of provisions in the OECD Model Convention (principally Article 5 and 7) to deem a PE to exist where an MNE exhibits "a remote yet sustained and significant involvement in the economy of a jurisdiction". The OECD document also reports the necessity to further examine the impact on other provisions that use the PE concept included in the convention (Articles 10, 13, 15, 21, 22 and 24) and on VAT and social security contributions.

Finally, the OECD document shares certain worries of the EU proposal with reference to the dimension of the enterprises involved.

While the EU proposal indicates specific figures (both with reference to the digital economic presence and the DST), the OECD document requires a system to be designed according to which:

- A sustained local revenue threshold (both monetary and temporal) is identified; and
- A range of additional indicators which, in combination with sustained local revenues, would be taken to demonstrate a link beyond mere selling between those revenues and the MNE's interaction with the economy of a jurisdiction.

Somewhat below the expectations are comments and indications referred to as the "new allocation rules". On one side, they refer to many alternative methods avoiding to choose or simply outline a preference on one of them. On the other side, the OECD document explicitly states that "due to the nature and the variety of the possible approaches that are considered in this work, the scope of the work may need to be adapted as the work progresses".

The work to be done is evidently not easy, but the route seems to be traceable.