INTERNATIONAL TAX REVIEW

Do tech companies hold the solution to taxing the digital economy?

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Contributed

The digital revolution has transformed business models, entire economies and the lives of people around the globe. It has also tested the concept of traditional corporate tax rules, designed largely in the first half of the 20th century. These rules are now unfit for our increasingly digitalised and globalised world.

As the business models of digital companies have increasingly allowed them to create value in countries without any physical presence, traditional tax concepts such as residence, nexus and profit allocation seem to have become out of date. Moreover, as international commerce has transcended national borders, the digital world has exploited gaps in the dated tax system to avoid taxation on cross-border transactions.

Organisations and individual countries are working simultaneously to tackle this issue, and yet they are still struggling to find a solution. The approach thus far has been fragmented but the solution must be a concerted effort. Reaching a consensus has proved considerably difficult, and, no matter how innovative or intelligent the individuals tackling this issue, the legacy of 'traditional' corporate income taxes has complicated the identification of an effective, efficient, fair and sustainable solution.

But what if there is another party who should be more closely involved in drawing up this new taxation world? One that is regularly involved in this new type of cross-border business, understands the value chain and can provide more radical thinking. What if that party were the largest tech companies themselves?

What has happened so far?

In 2015, the OECD recognised these challenges and took on the task of finding a solution within the framework of its BEPS project. The BEPS project aims to equip governments with domestic and international instruments to address tax avoidance and ensure that where economic activities are generating profits, they are taxed where the value is created. Alongside the OECD's work, countries also began working on their own interim unilateral solutions, further complicating the situation.

Simultaneously, the EU proposed its own interim digital tax strategy, aiming for a coordinated tax policy across the EU. Likewise, governments in separate member states proposed further, uncoordinated unilateral initiatives.

This has created a sort of 'race' to find a solution to the tax challenges posed by the digitalisation of the economy.

Later, however, the EU laid to rest its attempts to tax the largest digital companies, agreeing to freeze their measures until the end of 2020 when the OECD aims to deliver a long-term solution. Whilst this action decelerated the race to find a solution between the EU and the OECD, the EU solution was strong and promising.

Thus, over the past few years, there has been more discussion about how to tax the digital economy than any other tax matter. Yet despite lengthy debates, we are still facing a situation in which there is no consensus on how we can fairly approach the situation. Consensus is crucial to the solution given the borderless nature of digital businesses.

The issue of a revenue-based tax solution

Although countries across the globe have been working together under the umbrella of the OECD, there is still a lack of agreement from individual governments on a global solution. Companies, on the other hand, at least agree that unilateral solutions are not the right solution.

In their separate proposals, the EU and its member states reached the conclusion that a revenue-based tax on certain digital activities or services, including transmitting collected user data, selling online advertising space and creating certain online marketplaces from non-resident companies, is the best option.

However, while a revenue tax is widely claimed to only target larger tech companies, it could indeed easily capture start-ups and smaller businesses. Imposing a revenue tax on start-ups that may make little or no profit in their first few years will hurt their chances of ever reaching the point when they will become profitable. It could also create a risk of the tax being passed onto customers or users, as start-ups hike up their prices to compensate for the loss. Furthermore, in the most extreme scenario, if all the companies targeted by the revenue tax increase their prices, there could be an effect on inflation. Aggregated together, the impact could be large.

How could tech companies help?

The OECD, the EU and countries worldwide should look to the group that they are trying to find a solution for – the tech companies. One could argue that these companies, more than anybody else, understand the value chain as well as the technical aspects of the digital economy. Further, in light of fostering a discussion on profit-based tax (as opposed to revenue-based tax) and the identification of a solution that is reasonable and administrable, they could provide significant input into the discussion.

Finding a solution would be even more important to them considering that in the absence of one, a proliferation of unilateral measures would most likely lead to chaos, potential double or multiple taxation and a considerable increase of their compliance costs.

For example, tech companies could help to further understand how much value should be attributed to each part of the value chain, and how that can be measured from an internal standpoint. User participation translates into value for digital businesses through data, which can be derived from users' direct contributions on their platforms. This is an activity that the OECD and others are trying to tax. Facebook, for example, could help understand how best to measure and collect the value created when they retrieve user data and use it for advertising purposes.

This input could help to avoid the growing discussion that user contribution leads to an unbalanced profit allocation compared to other activities, for example R&D, which should still retain a fundamental importance and value in the overall picture. R&D functions innovate new tools to analyse data so that it is useful to the business, which in turn creates value. Without the technology R&D teams develop, valuable data would remain unusable. Likewise, such advanced technology couldn't be used if there was no data in the first place. The tech companies are the ones that, more than anyone, can provide input in understanding the balance between the two and between those and the other, more traditional, business functions.

Tech companies could also help better understand, through numerical examples, how what they do contributes to the local economy of the locations they operate in. Tech companies are operating in an environment where there is much debate and pressure around the low volume of taxes they pay and the possible threat to employment that they create. Sharing numbers on, for example, the number of new jobs created and the overall volume of taxes (not only corporate income taxes but also indirect taxes and payroll taxes) paid would help create a platform for a more serene discussion between stakeholders.

With so many companies in the digital sphere operating numerous, distinct and sometimes multiple business models, tech companies could help those trying to solve this issue to understand in detail how they work, and therefore design better taxation mechanisms to do those business models justice. For example, Amazon and Alibaba could explain the online retailer model, Facebook could explain the social media model that relies on advertising revenues, Netflix and Spotify could explain the subscription model and Airbnb could explain the collaborative platform model.

It seems that if a revolutionary proposal is likely to come from any group, that group should have a deep knowledge of innovative business models, be exceptionally creative, and have a thorough understanding of how technology could help collect a 'new tax'. There is no one better than the tech companies to do this.

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