# Digital Tax as Political Risk

Ertugrul Akcaoglu, Hacettepe University, Turkey

*This paper examines the rise of the digital tax concept as a political risk for MNEs. An historical and chronological approach is used to demonstrate how and when the international tax system was established, and how it provided a relatively stable environment for MNEs to flourish. The ascent of digital economy however, although in the past decade provided unimaginable opportunities to MNEs, now became the source of the destabilization of the existing international tax system. Not only the OECD is considering significant changes in their model tax treaties; but also, European Union is suggesting a digital tax and a new concept of virtual permanent establishment to recapture untaxed profits of MNEs that operate in the digital economy. States have split views and some are considering unilateral actions. This means that there is a significant political risk for MNEs with respect to international taxation on the horizon.*

Having some kind of risk is a *sine quo non* for all types of businesses. When it comes to the risks in international business, several categorizations can be made. For example, according to Miller (1992, pp. 311-331), MNEs are exposed to five types of international risks: natural, legal, societal, political and governmental. Daniell (2000), however, categorizes such risks as financial, cultural, legal and political.

One can define political risk as potential harm (or, sometimes, potential benefit) to a business operation arising from political behavior. When making a policy decision, a government is motivated by both economic and non-economic objectives. The political environment in a state or a region may compel political actors to substantially alter existing policies with respect to economic factors such as taxes, currency valuation, trade tariffs or barriers, investment incentives, wage levels, labor laws, environmental regulations, development priorities etc. Same can be said with respect to non-economic factors as well. For example, political disruptions such as elections, riots, coups, civil or international wars or terrorism may result in a change in the ruling government. Obviously, uncertainty about government actions drastically affect MNEs' (and all other businesses) investment plans and ability to operate.

In this paper, I aim to point out only one aspect of all political risk categories: governments' changing position with respect to international taxation, and more specifically, with respect to taxation of the *digital economy*. Following a chronological path will provide us why international tax policies in general, and the EU's digital tax proposal in particular might become a major political risk for MNEs that operate in the digital economy.

## How Did the Digital Tax Become a Political Risk?

### *Existing international tax system*

Tax laws change, and they change a lot. Usually minor, but sometimes major changes often occur in tax laws of almost all states. Enterprises, local or not, are used to this fact. The international system of taxation, however, still reflects the principles that were developed in the early 1920s. So, basically, there is nothing new for MNEs with respect to international tax policies of governments. Or, is there?

International juridical double taxation is defined as imposition of compatible taxes in two or more states on the same taxpayer in respect of the same subject matter and for identical periods (OECD, 2017, p. 9). It is a known fact that industrialization and increasing international trade in the late 19$^{th}$ century and early 20$^{th}$ century resulted in double taxation (Kobetsky, 2011, p. 110). It was the International Chamber of Commerce (ICC), which was founded in 1919 at the end of the World War I, that first called for a solution for the double taxation problem, which is considered as the main obstacle to the financial reconstruction and international trade. In 1920, at its Brussels Conference, the ICC requested the League of Nations, the political forum of the period to settle disputes among states, to take measures to prevent double taxation (the Technical Experts, 1925, pp.7-8). As a response, in 1921, the League of Nations appointed a committee of four economists (Professor Bruins, Commercial University, Rotterdam; Professor Senator Einaudi, Turin University; Professor Seligman, Columbia University, New York; Sir Josiah Stamp, KBE, London University) to study double taxation. In its report, which was submitted in 1923 (Economic and Financial Commission, 1923), the committee stated that individuals

should be taxed on their cross-border income in the state to which they have economic allegiance (Vogel, 1998), and according to the committee, economic allegiance had four bases: the place of production of wealth (origin or source), the place possession (location) of wealth, the place of enforcement of rights to wealth, and the place of consumption (residence or domicile) (Economic and Financial Commission, 1923, pp. 22-23). The report concluded that the places of origin (source) of wealth and the places of consumption of wealth (residence) are the main bases of economic allegiance, and in case of double taxation of cross-border income, residence jurisdiction should be the preferred method, source jurisdiction should provide exemptions or tax credits for income derived by non-resident taxpayers (Economic and Financial Commission, 1923, p. 25).

Many consider the 1923 report of the four economists as the basis for the current tax treaties (Kobetsky, 2011, p. 115). Other committees of the League of Nations, further developed the work on double taxation by following their work. However, I should note that the ICC, in close contact with the League of Nations, continued on its study of double taxation. For example, in 1923, at the London Conference the ICC adopted a resolution that the best method to avoid double taxation was to accept residence jurisdiction as the basis of tax on income; source taxation should be restricted to taxing only income that was derived within its territory, and residence state should provide relief for source state taxation (the Technical Experts, 1925, p. 8). Until the end of the World War II, League of Nations further developed its work. In 1928 it released its first draft model tax treaty, which was followed by Mexico (1943) and London (1946) models.

The World War II, of course, was the greatest risk of all for MNEs in all senses, and also was the end of the League of Nations. After the war, the increasing interdependence between Western states clearly showed that a harmonized set of measures to resolve international double taxation was necessary. This time it was the OECD, which was first was established as the OEEC in 1948 to run the US-financed Marshall Plan for reconstruction of a continent ravaged by war and then later transformed into the OECD in 1961, that undertook the work left by the League of the Nations. In 1963 the OECD released its first Draft Convention concerning the avoidance of double taxation, which was later named as Model Tax Convention on Income and on Capital. Since then many changes have been made on the Model Convention and on its Commentary (OECD, 2017, pp. 10-11); yet, the basic principles stay the same when it comes to taxation of cross-border income:

There are two significant articles of the Model with respect to taxation of business income; Article 7 titled "business profits" and article 5 titled "permanent establishment". (I should also note Article 9 titled "associated enterprises" as well.) Article 7 sets a simple rule: only residence state may impose a tax on business profits of an enterprise. Source state, however, may also impose a tax, only if, the enterprise carries on business in that state through a permanent establishment. In that case, the source state's authority to impose a tax on business profits is limited to the profits that are attributable to the permanent establishment. The permanent establishment itself is defined in Article 5, which is, basically, a fixed place of business or a dependent agent within the source state.

The solution of the OECD, which is adopted by most states with respect to taxation of international business income, in essence, was devised by the four economists, the ICC, and the technical experts of the League of Nations in the early 1920s. The existing network of international tax treaties, approximately 3000 bilateral tax treaties, one way or another, is based on the OECD Model Tax Treaty. States either follow it as a basic document of reference in treaty negotiations or develop their own models (such as the US Model Tax Treaty) as a derivative of the OECD Model. Even the United Nations Model Tax Convention between Developed and Developing Countries reproduces a significant of the OECD's Model Tax Convention and its Commentaries. In short, the existing system of international business taxation is almost one hundred years old and relatively stable.

## *The Ascent of the Digital Economy*

Existing international tax system was designed for brick-and-mortar businesses, and for a considerably long period of time, it worked reasonably well. However, with the growth of the Internet in the late twentieth century, the methods of doing business have started to change. The Internet seems not only to make the traditional economy function more efficiently, but also to offer an even more perfect form of free-market exchange (Zekos, 2003, p. 164). Since the mid-90s there has been a significant increase in e-commerce. Retail e-commerce, for example, is expected to reach $4.479 trillion in 2021 according to a research company, eMarketer (eMarketer, n.d.) Online sales have opened up an opportunity for all types of companies; not only the for ones that sell tangible goods but also for companies that provide intangible goods and services, to reach a worldwide market. Revolution of technology has triggered changes in business organizations, and companies of the digital economy, such as Apple, Amazon, Alphabet (Google) or Facebook are formed. "The new/digital economy is defined as one based on knowledge and information, relying on sub-sectors such as entirely digital goods and services and mixed goods that is, physical goods that are sold through the Internet" (Zekos, 2003, p.197).

The existing system of international taxation is not capable of resolving issues regarding business profits derived from the sale of digital and mixed goods and services. I should note that it took a considerable amount of time for states and international organizations to really comprehend the digital economy and to respond accordingly. For example, in 1996 the US Treasury acknowledged that some of the issues posed by the communications revolution were so complex that they could not be dealt with by existing principles; and therefore, international cooperation was likely to be necessary (US Treasury, 1996). In 1997, the White House issued a framework for global electronic commerce, and with respect to taxation stared that "No new taxes should be imposed on Internet commerce. … (G)overnments should cooperate to develop a uniform, simple approach to the taxation of electronic commerce, based on existing principles of taxation." (White House, 1997) In the following years, many states such as Canada (Canadian National Revenue Ministry, 1998a, 1998b), France (Reinhold, 2004, p. 703), Australia (Australian Taxation Office, 1997, 1999), Netherlands (Netherlands' Ministry of Finance, 1998), Japan (Ministry of International Trade and Industry of Japan, 1997), the United Kingdom (Inland Revenue and HM Customs and Excise, 1999) released similar reports pointing out issues and calling for international cooperation. The EU's position was similar (European Commission, 1997a, 1997b). In the end, all states and the EU were looking forward to the OECD's policy decisions on this matter. The "Electronic Commerce: Taxation Framework Conditions" issued by the OECD at the Ottawa Conference in 1998 conveyed the belief of the Committee on Fiscal Affairs of the OECD that "the principles which underline the OECD Model Tax Convention are capable of being applied to electronic commerce" (OECD, 1998). Starting from 1998 to (approximately) until 2005 the OECD worked hard to prove that existing principles, definitions and provisions of international tax treaties (the Model Convention to be honest) could be applicable with respect to e-commerce operations as well (OECD, n.d.). Consequently, the OECD came up with recommendations on the challenges e-commerce poses to the PE concept, which are now set out in paragraph 42 of the Commentary on article 5 of the OECD Model Tax Convention.

There was one state, however, although for a very brief period of time only, that had a different policy approach, or should we say, an attempt to change its international tax policy with respect to taxation of the digital economy. That state was India. In 1999 India established the High-Powered Committee on Electronic Commerce and Taxation. In 2001 the Committee released its first report in which it heavily criticized the existing international tax regime with respect to electronic commerce. The Committee's view was that "applying the existing principles and rules to e-commerce situation does not ensure certainty and reasonable allocation of revenues between residence and source countries." The Committee, therefore, supported the view that "the concept of PE should be abandoned and a serious attempt needs to be made within the OECD or the United Nations to find an alternative to the concept of PE" (Ministry of Finance of India, 2001, pp. 71-72) The Committee suggested to adopt a slightly modified version of Professor Richard L Doernberg's "base erosion approach", and therefore, a low rate withholding tax on all (not only on electronic commerce) gross profits of MNEs in the source state as an alternative to the permanent establishment threshold of the tax treaties (Ministry of Finance of India, 2001, pp. 77-78).

As a response to the High-Powered Committee's report the eComTaxpert Group, basically, a group of experts, most of which are from developed states, and also from MNEs such as IBM, GE and Microsoft, released its report titled "Taxation of Electronic Commerce in India" in 2002 (The eComTaxpert Group, 2002). This report criticized Professor Doernberg's base erosion approach as a radical departure from the international consensus and argued that it was in conflict with the internationally accepted standards on when a jurisdiction has the right to impose an income tax on a non-resident enterprise. The report cautioned that any unilateral move on India's part to adopt such an approach might lead to disputes between India and its various treaty partners, and also might expose India to intricate issues in relation to the WTO (The eComTaxpert Group, 2002, pp. iv-v).

The government of India announced in 2001 that it was not going to adopt the suggested policy changes by the High-Powered Committee; instead, it was going to wait for the developments in the international community. Therefore, for MNEs it was the business as usual; there was no new political risk with respect to international taxation neither in India nor in any other state to the newly rising digital economy during most of the 2000s. Ever expanding globalization and the digital economy, merged with the aging international tax system have created the perfect environment for MNEs to maximize their inherent advantages in tax planning, and the MNEs have taken full advantage of those conditions (Brauner, 2014, p. 57).

## *The BEPS*

Years ago, many authors, mostly from developing states pointed out the fact that the existing international tax rules were not designed for the new digital economy. As Chang Hee Lee, stated in 2004, "(D)igital technology completely destroys the economic and legal basis for the existing rules of international taxation, implying the necessity of a complete overhaul…" (Lee, 2004, p. 21). However, during the 2000s most states (perhaps all states) preferred to wait and see the developments in the emerging digital economy.

No new policies were adopted with respect to taxation of cross-border income of MNEs derived from electronic commerce or other forms of the digital economy. The tax competition between states further lowered the political risk of taxation for MNEs. Then, with the financial crisis of 2008 and its aftereffects on the global economy, governments that seek new or renewed sources of revenue realized (or acknowledged) that MNEs have been using corporate tax planning strategies that artificially “shift” profits from higher-tax locations to lower-tax locations, thus “eroding” the tax-base of the higher-tax locations. For example, in 2013, Facebook who host 1.9 billion, or 83%, of their 2.3 billion global accounts in Ireland, only paid an Irish effective tax rate of <1%, using a double Irish scheme (Financial Times, 2013).

At the same period, major news on illicit tax schemes like Offshore Leaks (ICIJ, 2013), Luxembourg Leaks (ICIJ, 2014), Swiss Leaks (ICIJ, 2015), Panama Papers (ICIJ, 2016) and Paradise Papers (ICIJ, 2017) started to hit front pages of news outlets on a yearly basis.

All of these developments were actually hinting us about governments’ changing position with respect to international taxation. It took almost a decade for the OECD to accept the reality and to take action. The OECD initiated the Base Erosion and Profit Shifting (BEPS) project following the 2012 G20 Summit and at 2015 G20 Antalya summit in Turkey, the G20 heads of states endorsed a package fifteen actions designed by the OECD to be implemented domestically and through tax treaty provisions. (OECD, n.d.) Although all actions are significant for MNEs, I should note that Action 1, “Addressing the Tax Challenges of the Digital Economy” and Action 7, “Preventing the Artificial Avoidance of Permanent Establishment Status” are directly relevant.

The BEPS is about globalization and MNEs, and it is natural that it focuses on the advantages that the digital economy provides to MNEs, which on the other hand are major challenges for the tax authorities of states. Until BEPS states competed between themselves and MNEs benefitted from the tax competition. The BEPS is the starting point for tax coordination between states against MNEs. Obviously, there is more to come.

The success of the BEPS project is questionable. The US and the EU Commission, for example, have been advancing their own anti-BEPS legislation and tax regimes recently.

## *Digital Services Tax, the Final Attempt from the European Union*

Finally, and briefly, I should point out the EU’s attempt to tackle tax issues caused by MNEs. First, in January 2016 the European Commission released an Anti-Tax Avoidance Package as a European response to the finalization of the BEPS project (European Commission, 2016). Later, however, against the suggestions in BEPS Action Plan 1, in March 2018, the EU Commission presented a series of measures aimed at ensuring a fair and effective taxation of digital businesses operating within the EU (European Commission, 2018). The package includes an interim tax, which is a 3% Digital Services Tax on advertising revenues of large internet companies, such as Facebook and Google, and on revenues from digital intermediary activities of online platforms such as Amazon.com Inc., Ebay Inc., and Airbnb Inc. etc. The package also includes a long-term solution based on the new concept of a digital or virtual permanent establishment (“significant digital presence”). However, on April 28, 2018, at the Informal Economy and Finance (Ecofin) Ministers meeting, held in Sofia, Bulgaria, Malta and Luxembourg and some other states of the EU criticized these plans. The finance minister of Malta, Edward Scicluna said that “Malta is in favor of long-term permanent solutions which are agreed to by international consensus under the aegis of the OECD.” In response, ministers of Spain, Italy and France took the position that they would introduce their own levy on digital companies (Malta Today, n.d.; Politico, n.d.).

## Discussion and Conclusion

The digital economy is the result of a transformative process brought by information and communication technologies. It is increasingly becoming the economy itself, and it would be difficult, if not impossible, to ring-fence the digital economy from the rest of the economy for tax purposes. Political leaders, media outlets, and civil society around the world have expressed growing concern about tax planning by MNEs. For MNEs, this might not be anything new. However, there is a growing trend at political heights to review, revise or in some cases to repeal the rules of existing international tax system. The existing system, which was established almost a century ago managed to survive until the 2000s. The OECD was (and to some extent still is) reluctant to react to the developments in information and communication technologies and their exploitation by the MNEs. Yet, in the last 5-6 years, things started to change. Both the OECD and the EU have initiatives to tackle tax planning schemes of the MNEs; several states of the EU proposing a special tax for the digital economy. This means a rejuvenated political risk that did not exist for MNEs during the past 50 years. When considered together with the trade wars on the horizon, one may claim that the next ten years might be considerably riskier for MNEs.

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