ISFE Paper on proposed EU Digital Levy

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Introduction

ISFE welcomes this opportunity to comment on the Commission's proposed digital levy initiative that is intended to "help address the issue of fair taxation related to the digitalisation of the economy".

About ISFE

ISFE represents the video games industry in Europe and is based in Brussels, Belgium. Our membership comprises national trade associations in 15 countries across Europe which represent in turn thousands of video games developers and publishers at national level, ranging from small-to-medium sized enterprises (SMEs) to large global companies. ISFE also has as direct members the leading European and international video games companies, many of which have studios with a strong European footprint, that produce and publish interactive entertainment and educational software for use on personal computers, games consoles, portable devices, mobile phones and tablets.

ISFE's purpose is to serve Europe's video games ecosystem by ensuring that the value of games is widely understood and to promote growth, skills, and innovation policies that are vital to strengthen the sector's contribution to Europe's digital future. The video games sector represents one of Europe's most compelling economic success stories, relying on a strong IP framework, and is a rapidly growing segment of the creative industries. In 2019, Europe's video games industry was worth over €21bn, and the industry has registered a growth rate of 55% over the past 5 years in key European markets[1].

Video games have a proven ability to successfully drive new business models. Digital transformation with the growth of online and app-based gaming accounts today for 76% of the industry's European revenues. Via the emergence of on-demand and streaming services

[1] ISFE Key Facts 2020 from GameTrack Data by Ipsos MORI and commissioned by ISFE https://www.isfe.eu/isfe-key-facts/.

and the launch of new high-performance consoles, together with the strong growth of mobile gaming, the video games industry offers players across Europe and in all age groups the possibility to enjoy and engage with video games. Today, 51% of Europe's population plays video games, which is approximately 250 million people, and 45% of the players are women.

Fair taxation

The Commission claims that the proposed digital levy is intended to "help address the issue of fair taxation related to the digitalisation of the economy". Aside from the fact that use of the word 'fair' to describe the proper tax contribution of digital companies is arbitrary and subjective, it seems that the real purpose of the proposed levy is to help fund ongoing EU operations and to pay for the additional spending incurred during the coronavirus pandemic.

ISFE is concerned by frequent assertions that digital companies pay less tax than more traditional ones, because this is simply not the case. Around the time of the 2018 digital tax proposals from the Commission, academic studies were published by both the European Centre for International Political Economy (ECIPE)[2] and Copenhagen Economics[3] which, based on analysis of empirical data on effective tax rates in various sectors, found that the digital sector did not in fact pay less tax than others. ISFE believes that the perceived problem that the digital levy proposal seeks to address, i.e., that digital companies can shift profits and are undertaxed, should be re-examined in light of up-to-date empirical data, of the ATAD 1 & 2, BEPS and of US tax reform measures that have been implemented in recent years.

Significant measures designed to tax the digital economy through the VAT system have already been adopted by the EU. VAT in fact represents the largest share of tax paid by the video games sector. In the value chain associated with the industry, countries that collect VAT from sales receive by far the largest share of the total tax revenue generated by consumer expenditure. In February 2020, the OECD's Secretary-General reported that EU measures connected to the taxation of the digital economy had contributed additional revenues of some €3 billion in 2015 and €4.5 billion in 2018.[4] It is estimated that the EU VAT directive on e-commerce will bring in an additional €7 billion a year once it is implemented. The new rules are currently expected to come into force on 1 July 2021.

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[2] European Center for International Political Economy, Digital Companies and Their Fair Share of Taxes: Myths and Misconceptions (Feb. 2018), available at https://ecipe.org/publications/digital-companies-and-their-fair-share-of-taxes/

[3] *"The Proposed EU Digital Services Tax, Effects on Welfare, Growth and Revenue"* Copenhagen Economics (9/2018)

[4] OECD, "OECD Secretary-General Tax Report to G20 Finance Ministers and Central Bank Governors," February 2020, http://www.oecd.org/ctp/oecd-secretary-general-tax-report-g20-finance-ministers-riyadh-saudi-arabia-february-2020.pdf#page=14.

Evidence of the taxes paid by digital companies calls into question the arguments in favour of a digital levy. ISFE believes that there should be no incremental taxation of businesses or transactions that are already effectively taxed, and that it is paramount to avoid double taxation in order to have fair taxation in the digital economy.

The OECD process

Despite the Commission's claims that it has considered the work undertaken in the OECD Inclusive Framework to find a global consensus-based solution to address the tax challenges of the digitalisation of the economy, and that this work will be factored into the final design and scope of the digital levy (as it is *"important not to undermine the ongoing discussions at the OECD nor to fuel international trade tensions"*), ISFE fears that the adoption of a unilateral digital levy risks triggering tax and trade disputes that could completely derail the OECD's multilateral efforts. While we welcome the Commission's assertion that the levy should be designed in a way that is *"compatible with the international agreement to be reached in the OECD as well as broader international obligations"*, we struggle to see how this will be possible and how the initiative will not interfere with the ongoing work at OECD level.

If the Commission is seeking to structure the digital levy as an "add-on" to any OECD Pillar I framework, this would appear to us to frustrate the goal of removing unilateral measures in order to secure global consensus. We would suggest, therefore, that the Commission should pause any policy development on this issue until there is certainty as to the success or failure of the Inclusive Framework's activities, particularly as the new US administration continues to ramp up its engagement in the process. The EU should instead be focusing all of its efforts on reaching a globally agreed solution at the OECD, which we believe remains the optimal forum to address tax challenges linked to the digitalisation of the economy.

The three policy options for the digital levy

The Commission has to date identified three policy options for the proposed digital levy:

- A corporate income tax top-up to be applied to all companies conducting certain digital activities in the EU
- A tax on revenues created by certain digital activities conducted in the EU
- A tax on digital transactions conducted business-to-business in the EU

ISFE considers that each of these suffers from serious flaws and would negatively impact businesses and consumers who increasingly rely on digital products and services. A top-up tax on corporate income aimed at digital companies would have to deal with the wide variety of corporate tax rates across Europe and the different definitions of income and relevant deductions. A tax on revenues would continue the return of turnover taxes to Europe. Such taxes are regressive, taxing companies that are less profitable at higher effective rates than more profitable ones. Turnover taxes damage economic growth because they do not take profitability into account, can result in disproportionate taxation, and leave less money available for re-investment in businesses, jobs, and growth. In addition, consumers may directly bear the added costs imposed by such measures through higher fees or prices. Finally, a tax on digital business-to-business transactions would also create economic harm by raising the costs of digitalisation.

Nevertheless, ISFE welcomes the Commission's claims that special attention will be paid in the design of the three policy options to prevent a disproportionate impact on SMEs, and that an impact assessment will be carried out to support the preparation of the initiative and to inform the Commission's decision on establishing the appropriate design parameters. We also agree with the Commission that it will have to develop the policy options on the basis of the following building blocks (but think that the Commission may be grossly underestimating the scale and complexity of this task):

- The scope and definition of digital activities/transactions or companies subject to the initiative/levy
- The relationship with the EU's and Member States' international obligations, including interaction with Double Taxation Conventions and with WTO rules
- Fairness considerations: The initiative's design will have to take into account the impact on SMEs, digital companies with a dominant vs. weak market position, and consumers of digital content or goods
- Potential behavioural reactions: The initiative will have to be designed to mitigate incentives to avoid payment of the digital levy
- Forward-looking design: The initiative's design will also have to take into consideration the future evolution of the digital economy with a view to putting in place a sustainable tax framework and providing tax certainty for businesses.

As the Commission acknowledges in its Inception Impact Assessment, the planned digital levy will have an impact on:

- Businesses engaging and operating in the digital economy, including foreign businesses operating in the EU
- Competitiveness and GDP, as it is likely to affect investment decisions and productivity
- Tax compliance costs, which will depend on the option and design parameters chosen
- Tax revenues
- Consumers
- Digitalisation and trade relations.

While we welcome this acknowledgment of the levy's likely impacts, we are concerned that the Commission is underestimating the scale of these impacts, which we believe would be entirely negative, particularly at a time when the EU should be concentrating on post-pandemic economic recovery efforts. We believe that increasing taxes for companies and consumers during an economic downturn can only harm economic recovery.

User-created value

The Commission asserts that user involvement in digital services represents value creation, but we think that the real value of a digital service is the software and business model that a company creates and supports. Digital companies employ thousands and invest millions to create, support and improve their products and services. They, and not their users, are the ones that create the value.

Ring-fencing the digital economy

ISFE agrees with the OECD's BEPS Action 1 Report[5] that the digital economy cannot be ring-fenced, and thinks that any tax based on this notion will be complex to implement and will put a significant compliance burden on company resources. Rules designed to tax a narrow set of companies will only introduce new distortions and complexities into an already complex tax system.

The digital age may justify global tax rules but the introduction of discriminatory taxes against digital companies without due and careful deliberation is, we believe, the wrong approach. Unilateral measures taken in the absence of coordination with key trading partners will only threaten the progress of multilateral and collaborative work that is a foundation of the changing global economy.

Compliance with international commitments

The imposition of a digital levy may well conflict with other international treaties. Digital service taxes typically violate bilateral tax treaties that assess liability based on an entity's permanent establishment or location. Moreover, they conflict with the commitments made under the World Trade Organization's General Agreement on Trade in Services (GATS) Articles II and XVII. ISFE also believes that a digital levy will violate the WTO's moratorium on customs duties on electronic transmissions that has been in force since 1998. The Commission should fully consider the EU's obligations to the WTO (and other trade agreements) and should ensure that its path forward in this area does not lead the block into violations of its international commitments.

Advancing the Digital Single Market

Digital taxes are a form of trade barrier that could fracture the digital economy and undermine the Commission's Digital Single Market vision. A digital levy will not help the EU to achieve its goals of opening digital opportunities for business and of enhancing Europe's position as a world leader. Instead, we think that it will inhibit trade and disadvantage digital companies across the EU. Now more than ever, it is imperative for the Commission to

[5] http://www.oecd.org/ctp/addressing-the-tax-challenges-of-the-digital-economy-action-1-2015-final-report-9789264241046-en.htm

advance cooperation in facilitating digital trade and the growth of the digital economy. Doing so will increase the ability of small business innovators to grow into new markets and to create more European jobs. We, therefore, strongly encourage the Commission to refrain from moving forward unilaterally with its digital levy proposal.

ISFE would like to thank the Commission for considering our views, and we remain at your disposal should you have any further questions.

ISFE Secretariat, April 2021

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