

Analyzing the Italian Digital Services Tax Through European Glasses

by Raul-Angelo Papotti and Martha Caziero



Raul-Angelo Papotti



Martha Caziero

Raul-Angelo Papotti is a partner and head of the tax department with Chiomenti in Milan, and Martha Caziero is a PhD candidate in business law and research and teaching associate at the Institute for Austrian and International Tax Law of Vienna University of Economics and Business.

In this article, the authors consider the broad goals and technical details of Italy's digital services tax. In doing so, they compare Italy's legislation with the European Commission's proposed digital services tax.

A time gap between social and economic developments and the related legal response is intrinsic to any juridical system, but the speed of technological developments in our era seems to be making this gap even wider than before. In the tax arena, closing this gap is pivotal, and it will require the input of numerous stakeholders.

Since the inception of the OECD's base erosion and profit-shifting project — and even more so since the issuance of the final report on BEPS

action 1 in 2015¹ — the taxation of the digital economy has been one of the key topics of discussion in the international tax field. More recently, in the context of the two-pillar program aiming at finding a long-term solution by the end of 2020, the OECD released a consultation document focusing on new profit allocation and nexus rules.²

Amid this ongoing debate, the Italian Budget Law for 2019 introduced a digital services tax — an outgrowth of a similarly named proposal from the European Commission with which it shares several technical problems. The Italian DST is not yet in force because of the Italian government's (likely intentional) delay in approving the implementing regulations that were expected a few months ago. However, the DST may become effective with the Budget Law for 2020.

Background: The OECD, EU, and Italy

The action 1 final report outlines three potential solutions to the problem of the tax bias between digital companies' residence jurisdictions and the market jurisdictions in which the companies operate: a new concept of digital permanent establishment, a withholding tax, or an equalization levy. Under traditional principles, entities only owe corporate income tax to the market jurisdiction if a PE exists.

In its long-awaited interim report in March 2018, the OECD declared that the member states had not reached a consensus on digital taxation.

¹ OECD, "Addressing the Tax Challenges of the Digital Economy, Action 1 — 2015 Final Report" (2015).

² For discussion of the OECD's unified proposal, see Ryan Finley and Stephanie Soong Johnston, "OECD Unified Approach Proposes Sharp Break With Current System," *Tax Notes Int'l*, Oct. 14, 2019, p. 111. For discussion of Italy's response, see Johnston, "Italy, Austria Push Ahead With Unilateral Digital Taxes," *Tax Notes Int'l*, Oct. 14, 2019, p. 175.

However, this year the OECD went further: It launched a public consultation on three proposals to address the tax challenges of the digital economy. The OECD followed that announcement with the establishment of a comprehensive two-pillar program aimed at finding a long-term solution by the end of 2020.³ The first pillar focuses on new rules for establishing nexus and profit allocation, while the second deals with new rules to ensure that multinational enterprises pay a minimum tax, and to protect states' tax bases from MNEs shifting profits to low-tax jurisdictions.

In the EU, the Economic and Financial Affairs Council meeting held on December 4, 2018, demonstrated that the European Commission's original proposal on a DST (COM(2018) 148 final, issued along with the proposal on significant digital presence, COM(2018) 147 final) failed to gain the support of EU finance ministers. On December 13, 2018, the European Parliament proposed: (i) widening the scope of application of the proposed DST to cover the supply of digital content; (ii) possibly increasing the digital tax rate from 3 percent to 5 percent in the future; and (iii) providing a sunset clause (that is, an expiration date) to make sure that the DST remains a temporary measure. Since that time, the EU finance ministers have also considered a narrower digital advertising tax.⁴ Notably, at a hearing before the EP on October 3, EU Commissioner-designate for the economy (and former Italian Prime Minister) Paolo Gentiloni declared that he is rather optimistic about the OECD reaching international consensus on the taxation of digital economy by next year, but he added that the European Commission would be ready to take action if the OECD did not.⁵

³ OECD, Programme of Work to Develop a Consensus Solution to the Tax Challenges Arising from the Digitalisation of the Economy (2019). For a critical analysis of the proposals, see Johnston, "OECD Aims for Outline of Global Digital Tax Deal by Year-End," *Tax Notes Int'l*, June 3, 2019, p. 1009.

⁴ See Elodie Lamer, "EU Moves Toward a Digital Advertising Tax," *Tax Notes Int'l*, Feb. 11, 2019, p. 653.

⁵ See Teri Sprackland, "Next EU Tax Commissioner to Prioritize Environmental Policy," *Tax Notes Int'l*, Oct. 7, 2019, p. 59.

On the domestic front, on December 30, 2018, the Italian Parliament approved the Budget Law for 2019,⁶ introducing a DST that is almost identical to that proposed by the European Commission. Italy took this path despite the international debate pointing toward the need for a new understanding of nexus somehow unconstrained by physical presence, and for some way to reallocate a portion of digital companies' profits to the users' jurisdictions.

The new law was supposed to enter into force in June, but the Ministry of Finance has not published any implementing provisions. Therefore, although we often refer to it in the present tense in this article since the law has been passed, the Italian DST has not actually entered into force yet.

Fundamentals of the Italian DST

When the Italian Parliament drafted its DST, it followed the lead of the European Commission's earlier proposal.

Both DST proposals are attempts to address the problem of big digital companies that do business without creating a PE in the source state. As enacted (but not yet in force), the Italian DST only applies to entities that carry out business activities, on a stand-alone basis or at group level, with a worldwide turnover of at least €750 million, and a turnover of at least €5.5 million from the supply of specified digital services in the Italian territory during the relevant tax period (that is, a calendar year).

Like the European Commission's proposal, the taxable base for the Italian DST is the gross revenue from the supply of the covered digital services, net of VAT and other indirect taxes. Specifically, Italy's DST encompasses the following when they occur in Italy:

- the placement of advertising targeting users on a digital interface;
- the provision of a multisided digital interface to users; and
- the transmission of data collected from users.

⁶ Italy's Budget Law for 2019 also repealed the web tax that the Budget Law for 2018 introduced but that had never entered into force.

Supplies of digital services can be either business-to-business (B2B) or business-to-consumer (B2C), but intragroup transactions are excluded.

It is not clear whether the implementing regulations will provide other specific exclusions. In all likelihood, the regulations will adopt the exclusions that the European Commission included in its proposal. Article 3, paragraph 4 of the European Commission's proposal excludes the supply of digital content, payment services, or communication services, as well as the supply of any services by a trading venue, a systematic internalizer (a specific type of investment fund), or a regulated crowdfunding service provider, from the scope of the DST because users' interaction with the digital technology is merely ancillary to a different supply.

The Italian tax rate is 3 percent, once again falling in line with the European Commission's proposal. The rationale for the rate goes back to the goal of closing the gap between the corporate taxation of digital and traditional firms. The European Commission estimated that the profit margin for most digital companies is around 15 percent and found that the EU's average corporate income tax rate is 21.3 percent; thus, the proposed tax rate of 3 percent ($3/15 = 20$ percent).

Every taxable person must pay the Italian DST quarterly and file an annual DST return (or, more accurately, will be required to do so once the law enters into force). Nonetheless, for simplification purposes, groups may select one company to carry out all the DST obligations related to the different group entities.

Nonresident companies that do not have an Italian VAT number or any Italian PEs will need to request a special DST identification number and use it to file a yearly DST tax return. If an Italian resident company belongs to a group that includes nonresident members that are liable for the Italian DST, the resident company will be jointly liable with its nonresident affiliates for the payment of the DST. Finally, Italian VAT rules apply to assessment, penalties, and collection insofar as those rules are compatible with the DST.

A Hybrid Tax

The application of the DST to gross revenues from the supply of digital services undoubtedly

raises some concerns regarding the tax's economic and legal implications.

Regarding the economic implications, applying the DST to the gross revenues means that a taxable person must pay the Italian DST regardless of its marginal profit or whether it has made any profits. Digital companies are not necessarily profit-making; many digital entities have low profit margins or are even loss-making.⁷ Regardless, the Italian DST only applies to entities whose worldwide and Italian revenues exceed set thresholds, encompassing therefore only companies of significant scale.⁸ This does not necessarily imply, however, that the DST complies with the ability-to-pay principle laid out in the Italian Constitution.

Turnover taxes do not take into account expenses. Yet some taxes based on turnover, such as the European VAT, compensate for that by granting a right of deduction. In contrast, the DST applies to gross revenues without granting any right of deduction or recourse similar to the ones under the VAT regime.

Despite resembling a consumption tax, the DST is not designed or structured to be borne by final consumers — instead, it is to be borne by service providers. As a result, it cannot qualify as either a consumption tax or an income tax.

Any Breach of Tax Treaties or VAT Rules?

The most important consequence of its hybrid nature is that the DST falls outside the scope of VAT legislation and double tax agreements. Discussing the DST proposed by the European Commission, the EU Council's Legal Service maintained that the tax did not qualify as an excise duty, an indirect tax, or any "other form of indirect taxation" within the meaning of article

⁷ Regarding the negative impact that gross basis taxation may have on digital companies, see Wolfgang Schön, "Ten Questions About Why and How to Tax the Digitalized Economy," 72(4/5) *Bull. for Int'l Tax'n* 278 (2018); and Georg Kofler, Gunter Mayr, and Christoph Schlager, "Taxation of the Digital Economy: 'Quick Fixes' or Long-Term Solution," 57(12) *Eur. Tax'n* 523, 531 (Dec. 2017).

⁸ European Commission, Impact Assessment on the Proposal for a Council Directive laying down rules relating to the corporate taxation of a significant digital presence and the Proposal for a Council Directive on the common system of a digital services tax on revenues resulting from the provision of certain digital services, SWD(2018) 81 final (Mar. 21, 2018), p. 66 (hereinafter, the impact assessment).

113 of the Treaty on the Functioning of the European Union.⁹

This verdict is not surprising, since the European Commission was trying to draft a new equalization levy that would not breach any DTAs or (obviously) any EU legislation.¹⁰ This intent is confirmed in Annex 11 of the impact assessment, which specifically analyzes the DST's compatibility with EU law.

One of the necessary corollaries of the DST falling outside the scope of DTAs is that double taxation may arise.¹¹ Point 27 of the preamble to the DST proposal clearly states that the European Commission's proposal is based on the expectation that the member states of residence would allow the DST taxable persons to deduct any DST paid, whether paid domestically or abroad, from their corporate income tax base.¹²

Indeed, under the ordinarily applicable Italian corporate tax rules governing the deductibility of (noncreditable) taxes, a DST levied abroad on the revenues generated by Italian resident companies should be fully deductible from the corporate tax base. Further, the Italian DST is generally deductible for the purpose of determining the taxable base for Italian corporate income tax.

Finally, regarding a potential breach of VAT rules, one may wonder whether a DST on revenues is a prohibited parallel turnover tax under article 401 of the VAT directive (2006/112/EC). The answer seems to be undisputedly negative.¹³ To fall foul of that prohibition, the asserted parallel turnover tax must have the essential characteristics of VAT. The Court of

Justice of the European Union has repeatedly held that:

the essential features of VAT are as follows: VAT applies *generally* to transactions relating to goods or services; it is *proportional* to the price of those goods or services; it is charged at *each stage* of the production and distribution process; and finally it is imposed *on the added value* of goods and services, since the tax payable on a transaction is calculated after deduction of the tax paid on the previous transaction.¹⁴ [Emphasis added.]

There is no need to proceed with a comprehensive analysis of the four elements: The condition that the tax apply on the added value is patently missing from the DST.

Thus, the DST does not violate the VAT directive and it does not breach DTA obligations.

Any Economic Drawbacks?

Because the DST applies to B2B transactions without any right of deduction (albeit being a deductible expense for income tax purposes), it may generate the so-called cascading effect¹⁵ that occurs when a tax is applied several times throughout a supply chain, and since it is not deductible from the tax due (unlike the VAT), the DST will become a cost for the businesses, which will then shift the burden to final customers.¹⁶

Because — in economic terms — deductibility from the corporate income tax base has a very different impact than full deductibility from the

⁹ Council of the European Union, Opinion of the Legal Service 12922/18 (Oct. 8, 2018). See also Stephanie Soong Johnston, "EU Legal Service Questions Basis of Digital Services Tax," *Tax Notes Int'l*, Oct. 15, 2018, p. 311.

¹⁰ See Jeremy Cape, "Is the European Commission's Digital Economy Proposal the Work of Daft Punks?" *Tax Notes Int'l*, May 14, 2018, p. 863 (stating "The DST has been designed to operate outside the traditional global DTT network").

¹¹ Daniela Hohenwarter and her coauthors hold that "within a coherent DST system, international double taxation is theoretically impossible," but a double burden may arise — and may occur in domestic or cross-border cases. Hohenwarter et al., "Qualification of the Digital Services Tax Under Tax Treaties," 47(2) *Intertax* 140 (2019).

¹² Point 27 of the preamble to the European Commission's proposal.

¹³ See, e.g., Kofler, Mayr, and Schlager, *supra* note 7, at 531; and International Observatory on the Taxation of the Digital Economy, "Request for Input on Work Regarding the Tax Challenges of the Digitalised Economy: Input Statement" (Oct. 13, 2017) (contained in OECD, "Tax Challenges of the Digitalised Economy: Comments Received on the Request for Input" (Oct. 25, 2017) (input statements)).

¹⁴ *Bozzi v. Cassa Nazionale de Previdenza ed Assistenza a favore degli Avvocati e dei Procuratori Legali*, C-347/90 (CJEU 1992), at para. 12. See also *Banca popolare di Cremona Soc. coop. arl v. Ag. Entrate Uffo Cremona*, C-475/03 (CJEU 2006), at para. 28; and *Dansk Denkavit ApS and P. Poulsen Trading ApS v. Skatteministeriet*, C-200/90 (CJEU 1992), at para. 11.

¹⁵ Jan B. Schober et al., "Tax Challenges of the Digitalised Economy," Loyens & Loeff N.V.'s Input Statement (Oct. 13, 2017):

Firstly, levied on a gross basis it would basically constitute a contemporary version of the cascading turnover levies, or sales levies, that have been replaced by VAT in many countries already since the mid-1950s. Such tax would likely not be creditable against corporate income tax under current rules. The reason for the abolishment of these taxes in favour of introducing VAT was because of these taxes' distortive properties.

See also Sullivan & Cromwell LLP, "Digital Economy Taxation," newsletter (Mar. 27, 2018); and Cleary Gottlieb, "The European Commission Is Attempting a Radical Change to How Digital Transactions Are Taxed Throughout the EU," memorandum (Oct. 20, 2017).

¹⁶ Kofler, Mayr, and Schlager, *supra* note 7.

DST due, a portion of DST remains a nondeductible cost in practice.

In B2B transactions, this nondeductible portion becomes a burden that may be shifted several times over the supply chain before finally being included in the purchase price that the end consumer pays for services supplied by the DST taxable person, thus resulting in an undesired distortive effect.

It is worth noting that on this specific point, the commission argues (and we agree) that the amount of B2B transactions that would fall within the scope of application of the EU DST is negligible since the threshold focuses on business models with a large user base — that is, companies that mainly enter into B2C transactions.¹⁷

Discriminatory Scope of Application?

The Italian DST would cover service providers resident in Italy, in other EU member states, or in third countries if the providers' overall revenues exceeded specified thresholds, namely a worldwide turnover of €750 million and an "Italian digital turnover" of €5.5 million. Notably, some commentators have recently argued that DSTs' high revenue thresholds may trigger a breach of article 107 of the TFEU since they result in de facto discrimination toward non-EU resident companies.¹⁸

Needless to say, if Italy's DST had only applied to nonresident companies, it would have been incompatible with the EU's fundamental freedoms. If it had applied only to third-country residents, it would have probably violated the WTO's General Agreement on Trade in Services.¹⁹

The plain wording of the Italian DST provisions does not provide for any exclusion for the supply of digital content, payment, or communication services — services that the European Commission's proposal explicitly excluded. While the implementing regulations may provide for a similar exclusion, we believe that it is technically necessary for the law itself to

be amended to reflect a similar exclusion. In the directive proposing a DST, the European Commission thoroughly explains that the rationale behind these exclusions is that user interaction is, in these cases, only ancillary to a different (main) supply.

While the number of MNEs supplying digital services that involve placing advertising targeted at users on a digital interface and the making available of a multisided digital interface is relatively low, the number of MNEs that sell users' data extracted from their digital interface might be quite high. As to the first category of taxable services (targeted advertising), one may think about Google or Instagram. As to the second (multisided digital interfaces), since there are no explicit exclusions, one may think about Airbnb, Facebook, Instagram, PayPal, Satispay, WhatsApp, Telegram, Tinder, and Spotify. Even without explicit exclusions, the authors think companies like Netflix or Sky — companies with services that merely provide digital content and do not allow any users to interact — would not be covered. In contrast to those limited lists, as to the third category (supplying data on users extracted from a digital interface), one may think about every company — not only so-called digital companies — that sells data on users generated from a digital interface. The scope of application would be far reaching.

Which Revenues?

The Location Question

Since user interaction is the value creator, revenues from the supply of digital services would only be taxable when the users are in Italy.

Unlike the European Commission's proposal, the Italian DST does not specify the technical criteria for identifying the users' locations. It is reasonable to suggest that the authorities will look to users' IP addresses or use another, more precise geolocation method.

In terms of which services are in the scope of the DST, the Italian DST does provide rules for how to determine where users are located that depend on the type of service provided. Specifically:

- in the case of targeted advertising, users would be considered to be located in the

¹⁷ Impact assessment, *supra* note 8, at 74.

¹⁸ See Ruth Mason and Leopoldo Parada, "Digital Battlefield in the Tax Wars," *Tax Notes Int'l*, Dec. 17, 2018, p. 1183.

¹⁹ Kofler and Julia Sinnig, "Equalization Taxes and the EU's 'Digital Services Tax,'" 47(2) *Intertax* 176 (2019).

- Italian territory if the advertising was displayed on a device located therein;
- if a digital interface facilitates transactions among users, the users would be considered to be located in Italy if they entered into a transaction using a device therein;
 - if a digital interface that does not facilitate transactions among users is made available, users would be considered to be located in Italy if they created an account to access the digital interface from within the Italian territory; and
 - in the case of data transmission, users would be considered to be located in Italy if they used a device therein to access the digital platform from which their data were collected.

Value Creation and Multi-Sided Interfaces

Still, determining the taxable revenues from the making available of a multisided digital interface is a challenge. Unlike the other taxable supplies, the making available of multisided digital interfaces does not imply any payment of consideration by the recipient/user. While revenues from the transmission of data and targeted advertising can be determined by looking at the consideration received, the same does not apply when a service is supplied for free. In other words, what are the revenues deriving from the making available of a multisided digital interface if nobody pays for it (and nobody is prepared to pay for it)? It seems clear that the supplier obtains only an indirect economic return, but the question remains: How should Italy calculate this indirect revenue when determining the DST taxable base?

To verify whether the DST's Italian revenue threshold has been exceeded and calculate the taxable base for multisided digital interfaces, the Italian DST prescribes looking at the number of transactions that occurred among users, or the number of accounts created in Italy by users in order to interact with other users.

But it seems to us that there is a step missing. If the real value lies in the data provided by users' accounts and interactions, how much does a transaction or an account contribute to the value of a digital company if no fees are paid for the digital service supply?

One valuation option involves a variation of the residual profit-split method: After allocating the taxpayer's revenue to other identifiable sources, the residual could be split among all accounts (or transactions) across all relevant jurisdictions. Accordingly, it would be possible to obtain the value of each single account (or transaction), including those registered in Italy, and determine how much of the global revenues should be allocated to Italy. In practice, however, this method would be challenging to apply. It would create a higher administrative burden for taxpayers and would be difficult for the tax authorities to monitor, especially if it involved nonresident taxable persons without any Italian affiliates.

Regardless of the revenue allocation model used, the practical difficulties seem to stem from the hybrid nature of DST: It was created to solve an income tax gap problem, but it is more akin to an indirect tax on something that resembles sales.

Recall that the European Commission's DST proposal was merely a short-term solution to a revenue gap. The long-term proposal involved a material change to the traditional concept of a PE — a change that would encompass all digital companies that do not need any physical presence in the jurisdictions where they operate. According to article 4, paragraph 3 of the proposal:

A "significant digital presence" shall be considered to exist in a Member State in a tax period if the business carried on through it consists wholly or partly of the supply of digital services through a digital interface and one or more of the following conditions is met with respect to the supply of those services by the entity carrying on that business, taken together with the supply of any such services through a digital interface by each of that entity's associated enterprises in aggregate:

- (a) the proportion of total revenues obtained in that tax period and resulting from the supply of those digital services to users located in that Member State in that tax period exceeds EUR 7,000,000;
- (b) the number of users of one or more of those digital services who are located in

that Member State in that tax period exceeds 100,000;

(c) the number of business contracts for the supply of any such digital service that are concluded in that tax period by users located in that Member State exceeds 3,000.

A thorough analysis of this proposal is beyond the scope of this article. It is, however, worth mentioning that article 5 of the proposal notes that the rules for allocating profits to a significant digital presence are built on the existing authorized OECD approach for PEs. The proposal would amend the functional analysis to better reflect the functioning of digital business models — for example, the “significant people functions” analysis would be replaced by “economically significant functions” related to data and users — and the profit-split method would be the default allocation method.

Final Thoughts: Justification to Tax?

In general terms, the trend (if any exists) of introducing equalization levies like the Italian DST seems to rely on the assumption that users’ jurisdictions have a right to tax revenues that nonresident digital companies generate from users in their territories.²⁰

If users are merely consumers, then users’ jurisdictions are market jurisdictions. However, the claim that market jurisdictions have a right to tax revenues of service providers simply because they offer a sales market is not justified by the benefit principle.²¹ The production of value that benefits from the infrastructure of a given country occurs where the income-producing activities are performed — not where users are located. If every market country claimed a right to tax service providers’ income based on the idea that the providers would not have made any profit without a sales market, then a related argument could also be made: Production countries could

claim a right to a portion of the VAT levied by market jurisdictions on the grounds that the buyers could not have consumed the product unless the source countries provided the infrastructure needed to produce the service.²²

From a different perspective, if the supply of digital services through digital platforms is viewed as an activity performed through a virtual PE with users’ contributions playing a material role in the value creation, then users’ jurisdictions can be seen as traditional source countries, and users who provide digital companies with their personal data can be seen as “unconscious contributors” of significant assets.²³ The European Commission’s long-term proposal of a significant digital presence relies on the assumption that the provision of digital services through digital platforms may create a virtual PE for nonresident companies with data and users playing a key role in the value creation.

In Italy, we will need to wait for the government to approve the implementing ministerial decree — which we hope will be accompanied by guidelines from the tax authorities — or for amendments to the current provision in the Budget Law for 2020, to see how the DST will apply in practice. When flushing out the many points left unresolved in the Italian Budget Law for 2019, Italy will likely follow the European Commission’s proposal that inspired the DST as a whole. This being said, it could not be excluded that the Italian Budget Law for 2020, which will be approved by the end of year, will amend the Italian DST. This strategy, even with all the above-mentioned technical criticisms, may be seen as a positive attempt to ensure a harmonized approach and preserve legal certainty for businesses that operate in the EU. ■

²⁰ For a comprehensive analysis of the concept of value creation, see Johannes Becker and Joachim Englisch, “Taxing Where Value Is Created: What’s the ‘User’s Involvement’ Got to Do With It?” 47(2) *Intertax* 161 (2019); and Itai Grinberg, “User Participation in Value Creation,” 4 *British Tax Review* 407 (Nov. 2018).

²¹ Eric C.C.M. Kemmeren, “Should the Taxation of the Digital Economy Really Be Different?” 27(2) *EC Tax Review* 72 (2018).

²² *Id.*

²³ See Yariv Brauner and Pasquale Pistone, “Some Comments on the Attribution of Profits to the Digital Permanent Establishment,” *Tax Notes Int’l*, Apr. 1, 2018, p. 87. According to Brauner and Pistone, these unconscious contributions are adding real value, especially compared with data processing.