

# DIRITTO E PRACTICA TRIBUTARIA INTERNAZIONALE

DIRETTORE RESPONSABILE

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# THE FRENCH GOVERNMENT REPORT ON TAXATION OF THE DIGITAL ECONOMY

**Abstract:** On the 17<sup>th</sup> of January 2013, the French Government published a report prepared by two experts on the taxation issues of digital economy<sup>1</sup>. The report concludes a mission assigned to the authors in July 2012, to develop a study about the digital economy and to formulate proposals about how to tax the digital economy players operating in France or selling goods and services to French customers. The report is split into five main sections: Analysis of the new digital economy; The concept of “free work”; Tax implications of the new digital economy; Consequences for the French economy and Proposals. This article summarizes the key elements of the report and its proposals. The article also provides some comments about strengths and weaknesses of the report and its possible impact on the on-going discussions on the subject in other Countries and international organisations, and in particular within the context of the OECD project on Base Erosion and Profit Shifting.

SOMMARIO: 1. Analysis of the new digital economy – 2. The concept of “free work” – 3. Tax implications of the NDE – 4. Consequces for the French economy – 5. Proposal – 6. – Strengths and weaknesses of the report – 7. Conclusion

## 1. – *Analysis of the new digital economy*

In the first section of the report, the authors analyse the key features of the digital economy. However, although formally addressing the entire digital economy sector, they mainly focus on what could be defined as “new” digital economy (NDE). In fact, according to the authors, the traditional digital economy was not creating disruptive effects on taxation because it was still, to a large extent, based on relatively traditional business models. On the other side, the NDE is characterized by players that operate in radically new ways for which the traditional approaches (in particular with reference to taxation) are no longer applicable.

In practice, the authors focus most of their analysis on the biggest multinational players currently dominating the NDE: Amazon, Apple, Google

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<sup>1</sup> P. Collin, N. Colin, *Mission d'expertise sur la fiscalité de l'économie numérique*, 2013.

and Facebook. Examples and analyses often refer explicitly to the experience of these four Companies.

The authors clearly consider that we cannot view the NDE as a traditional “sector” of the economy: on the contrary, the NDE players tend to operate cross sectors, progressively embedding traditional sectors of the economy into innovative business models. The authors define the dominant NDE players as large “eco-systems” that do not match with any traditional classification; these big players (and their smaller followers) base their business model on radically new paradigms:

- they develop a privileged relationship with their customers/users;
- they do not hesitate to enter new sectors where they can exploit the relationship they have established with their users;
- they develop multi-faceted businesses, of which certain facets are often characterized by the fact of being free for the users;
- they make an extensive use of digital technologies and constantly innovate their applications;
- they are often characterized by fast growth and a certain instability/uncertainty of their market;
- they represent a new model of competition (Amazon, Apple, Google and Facebook have all a different profile in terms of main business, but at the same time they compete among themselves on specific segments and, more generally, on a global basis);
- one key element is their capability to generate “traction”, i.e. a fast development of their users base;
- they optimize the exploitation of data collected from/about their users;
- they have an easy access to capital markets allowing them to subsidize their growth;
- they are often structured from incorporation in a way that allows them to optimize the tax treatment of their income; from this starting point it is then easy for them to keep an optimized structure because most of their activity is “intangible” and therefore it doesn’t normally require significant “business restructuring” actions to adapt their model to their evolution;
- they often do not distribute dividends to their shareholders.

## *2. – The concept of “free work”*

The authors consider that the core element of the NDE is represented by the huge amount of users’ personal data that are collected and exploited by

the companies operating in the New Digital Economy (NDE players). These data allow the NDE players to: measure and improve the performance of their applications, personalize their services, provide users with recommendations for their purchases, develop new applications and orient their future strategies. These data can also be of further value for the NDE players by making them available to others who can use them to develop services or applications for the same type of users.

Users' data can be collected either by observing the behaviour of users on the internet or by obtaining their direct participation (e.g. when they provide opinions on products or services they have tested); in the authors' view, data collected in this way are the result of the fact that the users implicitly "work for free" to produce these data from which the NDE players derive significant economic benefits. Hence the concept of "free work" that, according to the authors, surpasses the traditional theory of the firm, based on which a company has only two alternatives for producing goods or services: 1. produce internally, or 2. subcontract to a third party supplier. According to the authors, today a NDE player has often the real alternative option to create a nice application attracting users that will "work for free".

Explicitly the authors have created this definition of "free work" as a new concept, apparently with two main purposes:

- facilitate the communication and the illustration to non-specialists about what they consider to be the core element of the NDE;
- create an economic category that can be instrumental to implementation of tax provisions adapted to the NDE.

The authors also observe that the subject of users' data is linked to the issues related to protection of personal data; they also observe that some business models already imply that personal data collected are then made available to the users themselves and consider that such models should be encouraged because they bring a series of benefits: a better protection of personal data, an incentive to personalizing the services, encouraging innovation and realising productivity gains.

### *3. – Tax implications of the NDE*

The authors observe that the traditional tax optimization models that are used in other sectors produce exponential effects in the case of the NDE; this leads to:

- a general erosion of the tax base in the developed Countries;
- an asymmetry in favour of the USA due to the fact the majority of the large NDE players are U.S. multinationals (in practice the authors

consider that the limited amount of taxes paid by NDE players is paid essentially to the U.S. Tax Authorities);  
- a difficulty to measure the size of these tax issues.

The authors consider that the current tax rules are not adapted to deal with the features of the NDE. Only in the area of VAT, the rules have been adapted and will progressively bring to a taxation based on the rules of the destination Country (i.e. the Country where the service is consumed).

With reference to the corporate income tax, the authors consider that the current rules are not adapted to deal with the NDE. France has a territorial system, under which only resident companies are taxed or permanent establishments in France of foreign Companies. The authors consider that under the current OECD model tax treaty and commentaries, e-commerce activities do not represent a permanent establishment in France, unless managed through fixed installations in France (for example because the server running the application is located on the French territory).

Also other forms of local taxation do not apply in the case of the NDE, for example the tax on television services.

The authors also consider counterproductive certain proposed forms of taxation like a proposed tax on “e-advertising”.

Despite growing interest and debates on the subject, the authors do not find that other Countries’ examples exist, so far, of dealing effectively with this issue; however they note the fact that the OECD project on Base Erosion and Profit Shifting (BEPS) could bring answers to these issues.

#### *4. – Consequences for the French economy*

The authors consider that the development of the NDE has negative consequences for the French economy.

First of all, the intermediation models promoted by the NDE reduce the local taxable base: this is due to the fact that the NDE players, acting as intermediaries (for example between a hotel and the client booking a room online) absorb a growing portion of the profit of the transactions that they intermediate; the authors also identify another source of base erosion in the fact that the NDE favours the participation of private individuals competing with professional sellers in the offer of goods or services.

Secondly, the NDE tends to expand to all sectors of the economy. The sectors initially impacted were the most adapted to the features of the NDE like: advertising, retail sales, media-entertainment and tourism; new sectors appear to be progressively impacted like: banking, telecommunications, automotive, local utilities, energy, manufacturing, education and health.

Thirdly, the authors' analysis of available data brings them to conclude that the NDE overall destroys jobs without improving the taxable base as a result of its productivity gains.

Finally the authors observe that the current structure of R&D tax incentives in France favours traditional forms of R&D, not adapted to promote the development of local players of the NDE.

### 5. – *Proposal*

The authors formulate three sets of proposals for adapting the tax system to the characteristics of the NDE:

1. Adapt the corporate income tax rules in order to establish a right of taxation on the profit generated by the exploitation of local users' data and by the "free work" of local people. The authors recognize that this objective cannot be reached unilaterally, but requires a renegotiation, at OECD level, of the definition of permanent establishment in order to create a new model adapted to the NDE and including a definition of permanent establishment based on the existence of an activity of regular and systematic monitoring and collection of data from local users. The authors also observe that the new definition of permanent establishment would not be sufficient to ensure that significant profits can be attributed to the local permanent establishment, considering that a large portion of the profit could be absorbed by the reward of intangibles located abroad. The authors consider therefore that a parallel review of the transfer pricing rules would be required in order to ensure that an appropriate value will be attributed to the local contributions. It is not too clear whether the authors consider that the solution should be found within the frame of the arm's length principle (in fact, there is a quite surprising statement in the report about the fact that, in the authors' view, the taxation of multinationals is to a large extent negotiated, due to the difficulty of an objective analysis of the share of taxing rights of the involved jurisdictions).

The authors do not analyse in details the OECD draft of revision of Chapter VI of the OECD Transfer Pricing Guidelines on intangibles<sup>2</sup>, therefore it is not clear whether the proposed solutions are viewed as consistent with the arm's length principle.

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<sup>2</sup> Discussion Draft – Revision of the special consideration for intangibles in Chapter VI of the *OECD Transfer Pricing Guidelines and related provisions*, OECD, June 2012.

2. Recognizing that negotiations about a new definition of permanent establishment will probably take a long time, the authors propose interim solutions of taxation that would provide France with a “negotiation asset”.

The authors propose a taxation of data collected on the basis of the regular and systematic monitoring of local users’ activity; the taxation could be based on a fixed amount for each user and the amount would be variable in order to incentive virtuous behaviours of the NDE players in terms of: information to the users, data protection and accessibility for the users to data collected about them.

3. The third set of proposals is aimed at the reform of the current model of R&D tax incentives in France in order to adapt it to the type of R&D that would allow the emergence of French players in the NDE.

## *6. – Strengths and weaknesses of the report*

The report is a relatively large document (nearly 200 pages), supported by a very large bibliography and a large number of interviews conducted by the authors; although very well structured and documented, the report somehow has some of the same features as the digital economy that it analyses, i.e. it is very “contemporaneous” in the sense that most of the documents referred to are articles or web-publications rather than traditional economic studies. This may be an inevitable consequence of the fact that the analysis focuses on a subject that is new and very dynamic, however, limited effort is made to quantify the issue: despite the obvious difficulties in measuring the impacts and even the size of the NDE, it would appear natural that the authors try at least a simulation of quantitative effects of the issues that they have identified and of the solutions that they propose. In fact they seem to say that the expected benefits of their proposals for the tax base are limited in the short term, but it is important to act quickly in order to promote virtuous behaviours and prevent further deteriorations.

In addition, from an economic standpoint, it would have been worthwhile if the report had included some sizing of the positive effects that the NDE brings:

- the free services or applications that are made available to the users;
- the better information on prices and on the quality of goods and services allowing better purchasing choices;
- the effect on transparency of markets, leading to higher competition in the market, generally benefitting to consumers;

these elements seem to be considered mainly as negative effects on the taxable base of the Country, but not really appreciated for the positive economic effects for the users.

The authors also note that many NDE players realize losses either in their start-up phase, or because they simply fail to become profitable; however the authors do not address the issue of how losses should be taken into account and what jurisdiction should grant the loss deductibility.

Finally, while the analysis of the permanent establishment aspects is very structured and recommends a consensus approach within the frame of the OECD work on the subject, the short term measures that are proposed appear to be potentially unilateral.

## 7. – Conclusion

The report represents a remarkable effort to conduct a systematic analysis of the impacts of the NDE and the related taxation issues. It appears to be a relatively unique document of this nature at this stage and, as such, it is likely to influence the discussions about the taxation of NDE players that is perceived more and more widely as a critical issue.

In fact, the report comes at a time when a series of events related to the leading NDE players (Governments enquiries, news about aggressive tax audits, press campaigns) have spread a general feeling that “there is a problem”. The most notable result of this environment is the fact that the OECD has included the issue of “*application of treaty concepts to profits derived from the delivery of digital goods and services*” within the list of issues to be addressed as part of the BEPS project<sup>3</sup>.

Hopefully the report, rather than promoting unilateral initiatives of the French Government, will represent a reference for other studies that will support a better understanding of the issues and the promotion of international standards adapted to the new issues, if needed. In fact, not necessarily the challenges brought by the new digital economy require revolutionary solutions: most of the standards that have reasonably well supported the taxation of the expanding multinational business for decades may actually be adapted to cope with the NDE features, obviously with the adaptations that the OECD regularly brings to the interpretation of its standards in order to adapt them to new realities (e.g. with the current projects of revision of the Commentary to Article V of the Model Tax Treaty and of revision of Chap-

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<sup>3</sup> Addressing Base Erosion and Profit Shifting, OECD, January 2013.

ter VI of the OECD Transfer Pricing Guidelines). At first view, there is only one topic that is likely to require some kind of new conventional definition: this relates to the fact that, with the development of cloud computing, there could be situations where significant value drivers of a business cannot be associated to any specific territory on the basis of the existing conventional rules about taxing jurisdictions<sup>4</sup>.

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<sup>4</sup> The conclusions set forth herein are based on independent research and publicly available material. The views expressed herein are the views and opinions of the author and do not reflect or represent the views of Charles River Associates or any of the organizations with which the author is affiliated. Any opinion expressed herein shall not amount to any form of guarantee that the author or Charles River Associates has determined or predicted future events or circumstances and no such reliance may be inferred or implied. The author and Charles River Associates accept no duty of care or liability of any kind whatsoever to any party, and no responsibility for damages, if any, suffered by any party as a result of decisions made, or not made, or actions taken, or not taken, based on this paper. Detailed information about Charles River Associates, a registered trade name of CRA International, Inc., is available at [www.crai.com](http://www.crai.com).