26 November 2017

WEB TAX AMENDMENT
88.0.1 (second revision)

A DIGEST

This amendment is a revised version of Bill no. 2526, introduced on September 14, 2016 by the Chair of the Senate Standing Committee on Industry. It is no coincidence that the amendment is signed by the sponsor and rapporteurs of that bill and by the Chair of the Senate Standing Committee on Finance. The decision to refer this bill to both the Finance and the Industry committees, rather than just the former as would have been customary, goes to the credit of the President of the Senate, who perceived that tax optimization practices performed by digital multinationals run against the principle of tax fairness, as enshrined in Article 53 of the Italian Constitution, and introduce a degree of market distortion. For good measure, the increasing erosion of the tax base affects public revenues and the future funding of public policies.

Tax optimisation practices distort competition:

a) between *over the top* (OTT) service providers and companies operating in non-material services: for example, the advertising market has developed in such a way to benefit companies like Google and Facebook, that base their revenues and tax bases in countries of convenience to the detriment of European companies which instead pay taxes in the country where they generate their earnings and revenues: according to the European Parliament rapporteur on the proposal for a directive on *Common corporate tax base-CCTB*, Google's tax avoidance practices have cost Italy €370ml in taxes in 2013-2015; in the same period, Facebook avoided €179ml. In Ireland, Google has less than 5 million users and a turnover of €23bn, while in Italy it has 38 million users and a turnover of 70 to 80 million Euro. The same happens with Facebook (Paul Tang, Henri Bussink, *EU tax revenue loss from Google and Facebook*, September 2017);

b) between OTT service providers and companies providing or distributing goods and services other than digital or non-material but undoubtedly no less useful to society, as can be easily surmised when one compares real and online trade;

c) between OTT companies and other companies in terms of access to capital markets, which is way more advantageous for digital platforms with a monopoly positions; this is shown by the fact that the top 14 real economy MNCs are rated by capital markets 1.3 times their consolidated shareholders' equity and 12.9 times their revenues, while the same values for the top 14 digital companies are, respectively, 5.5 and 34 (our analysis from *WebSoft, Software & Web companies (2012-2017)*, Mediobanca, 14 November 2017) ;

d) between consolidated OTTs and perspective new competitors, that are almost invariably taken over by the former owing to their financial power, as shown not only by the high rating given them by stock markets (see *c)* above) but also by the sheer size of their liquid assets; it is worth noting here that the top 14 digital companies enjoy €124bn of net financial assets, while the top 14 real economy companies have €496bn of net financial liabilities (our analysis from *WebSoft, op. cit.*).

The unfair advantage of OTT companies in countries where they operate is all too evident.

This is a relatively new challenge, which however is spreading rapidly. We will just note incidentally that it combines with the widespread practice of major companies – especially holding companies – to migrate towards countries with more benevolent tax systems and company legislations which are more protective of owners' interests. One such example is Google: in 2015 Google paid taxes equal to 16.8% of consolidated profits (equal to 4.4% of the turnover). 46% of the consolidated turnover is produced in the US, where the company pays 92% of its taxes (source: Ufficio parlamentare di bilancio*, Audizione informale sul ddl 2526 presso le commissioni Finanze e Industria del Senato*, 15 March 2017). In previous years, the percentages were roughly equivalent but the amounts were considerably smaller. In 2016, sales skyrocketed. This deserves careful consideration. This huge increase is not due to goods or services developed in California; it was produced by the use of personal data gathered in countries where Google and other digital companies operate and which are, by and large, obtained in the countries of origin. Personal data is the oil of the digital age (*Regulating the internet giants, The world's most valuable resource is no longer oil, but data*, The Economist, 6 May 2017). The situation is baffling. Oil companies used their prospection and extraction technologies to obtain crude oil, which was then refined, again using their own technologies, and finally marketed. Yet, they could not exempt themselves from paying royalties to the countries where the wells were located. Initially, these royalties were very small, but after some decades, following the introduction of profit sharing agreements by the great Italian manager, Enrico Mattei, and the establishment of OPEC and a centralised supply channel, royalties increased. For personal data instead, digital companies pay nothing, because if oil was and is owned by a few, personal data are fragmented and virtually unprotected by domestic and international laws. Digital companies are therefore even more rapacious than American robber barons in the late 19th century. The use of personal data does not produce a cost for companies using this new commodity in order to make profits. This poses a challenge to democratic governments that regulators must tackle. Taxes could be levied on data, just like royalties were paid on oil. Economists are still debating where and how value is created and how it should be distributed: research and production, or sales and marketing, with all the consequences this will have on the allocation of the added value.

The unfair tax advantage of OTT companies is not wholly and necessarily the outcome of a violation of laws in force or sophisticated tax avoidance schemes. It is also a consequence

of the economy going digital, a process enabling companies to find loopholes in legislation applicable in the international tax environment. When the legislation currently in force was developed, business could be conducted abroad only following the establishment of local offices, with their own staff and real estate requirements. As is well known, international regulations establish that a company based in, say, Ireland can be required to pay taxes in a foreign country, say Italy, only on condition that they have a permanent establishment in the foreign country. It follows that if such physical establishment does not exist (because it is not necessary for the sale of digital services or because it can just be avoided), Italy then cannot tax profits made in its territory: those profits will be taxed in Ireland, under Irish legislation and maybe even on the basis of an agreement made between such company and the Irish Government. This situation has engendered a transition from international treaties against double taxation to international systems allowing double non-taxation and the ensuing re-routing of profits towards tax havens.

This is a well-known challenge, not just among international tax legislation experts, but also in international organisations and European institutions. The OECD and the European Commission have recently tackled it. The Commission's communication of 21 September 2017 announced that action will be taken, should international organisations, first and foremost the OECD, fail to reach a definitive and satisfactory solution. This communication follows up to the joint declaration of 7 September by the governments of France, Germany and Spain, soon supported by other member countries, to finally tax digital companies. In this document, the Finance Ministers recognize that "being able to appropriately tax companies operating in the digital economy is a major challenge for the European Union" and that "We should no longer accept that these companies do business in Europe while paying minimal amounts of tax to our treasuries. Economic efficiency is at stake, as well as tax fairness and sovereignty". The four countries therefore urge the Commission "to explore EU law compatible options and propose any effective solutions based on the concept of establishing a so-called 'equalisation tax' on the turnover generated in Europe by the digital companies".

Although it is preferable that the OECD takes unambiguous, effective and definitive action on such issues, it is however possible and useful to develop a domestic regulation, notwithstanding the European Commission's exclusive authority on VAT. This is in line with what the Italian President of the Council of Ministers explained in Parliament. On this backdrop, we propose an amendment to introduce a web tax in Italy.

Our goals are the following:

a) use foreign electronic invoicing (as soon as it becomes operational) and foreign sales information reporting to enable tax authorities to step up their fight against tax avoidance, with particular regard to permanent OTT organisations;

b) give substance to and follow up on the positions expressed by leading member States, by introducing a tax on transactions relating to the delivery of digital services, without prejudice to persons already paying their income taxes in Italy.

Let us now explain the individual paragraphs in detail.

Under the first two paragraphs, buyers of digital services – as defined in paragraph 10 – should notify such transactions to the tax authority, *Agenzia delle Entrate*, in the framework of the foreign sales reporting system, in such way as shall be notified by the Head of the Agency. This procedure does not place any additional burden on tax payers, it only changes the way in which information is to be provided to the tax authority.

Under paragraph 3, if a person not resident and without a permanent establishment in Italy receives over 1,500 payments for an overall amount exceeding €1.5 ml, the Agency (*Agenzia delle Entrate*) shall summon such person in order to ascertain in an adversary process a number of facts, including whether such business was conducted through a permanent establishment in Italy under Article 162(2)(*f*) and (*f-bis*) of TUIR (the Tax Code), as amended by paragraph 7.

Paragraphs 4 and 5 set out how a non-resident person under paragraph 3 may be summoned and be subject to verification by the Agency. If a permanent establishment is present, Article 1-*bis*(5) and following of Law no. 50 of 2017 (adopting the benefits and sanctions of voluntary disclosure procedures) shall be applicable in order to ensure accurate and complete information.

Paragraph 6 lays down that such supervision shall be performed by the Milan office of *Agenzia delle Entrate*, owing to the presence there of skilled personnel specialising in tax avoidance in the digital economy sector.

The amendment to Article 162 of TUIR proposed under paragraph 7, aims to update the requirements of a permanent establishment, adapting them to the development they would ordinarily undergo following future OECD documents (Commentaries). In this framework, the definition of place of extraction of resources should be remodelled, based on the fact that prospection and search can be construed to refer not merely to natural resources dug out of the ground but to resources of any kind (Article 162(2)(f)). New paragraph *f-bis* of Art.162(2) is a specific anti-avoidance clause in case the presence, however cleverly disguised, of a permanent establishment in Italy of a non-resident operator is disclosed (see comment to paragraph 3 above).

Moreover, the OECD Document of 5 October 2015 hints at the dangerous and manipulative nature of actions staged by MNCs in order not to be recognised as a permanent establishment in a conventional sense. The wording of new letter *f-bis)*, added to Article 162(2), serves the purpose of considering a digital operator as permanently present in the territory based on stability, recurrence and size of its business, despite the precautions it may have adopted. This is, therefore, a specifically anti-avoidance clause, not dissimilar in its substance from the UK's Diverted Profit Tax. Precisely for this reason, this provision does not in any way clash with the present regulation. In fact, it fully complies with it. The burden of proof, i.e. demonstrating that an organisation was put in place in order to hide the actual presence of the non-resident operator's business will rest on the tax authority.

We are fully aware that some may question the compliance of these two provisions with the European Treaties and bilateral agreements against double taxation. But we'd rather emphasize the latest and most promising developments of European court rulings on the fight against tax avoidance as shown, by way of example, in European Court of Justice judgment C-6/16 of 7 September 2017. This ruling lays down that a provision aiming at fighting fraud or abuse is consistent with the Treaties. It follows that Italy, should it come to it, will be able to provide legal, and even more easily, political justification for this approach.

Paragraph 8 establishes administrative sanctions against a non-resident person who fails to comply with the summons of *Agenzia delle Entrate*. No criminal sanctions have been envisaged, under the principles governing criminal matters. There is full awareness that, in the presence of a flow of money from Italy towards a non-resident person who even refuses to be interviewed by the tax authority, investigations must be started by the Agency (also through inferential verification) and, if necessary, by the tax police.

The digital business, however, deserves careful consideration, because it is a growing area of taxable income which is totally unregulated. Also other countries have developed their own approach to taxing digital companies. India, for example, has introduced a so-called *equalization levy*, limited to the advertising market. The European Commission, through the aforementioned document of 21 September, has underlined the need to levy an ad hoc tax. Also for these reasons we believe it is time to introduce a general tax on transactions relating to fully dematerialized digital assets. We do not fail to notice that e-commerce is vastly important in many respects, although Amazon, by far the leading company in the sector, registers meagre profits in relation to sales ($2.3bn against 136bn in 2016). And yet, at least in this first stage, the decision has been made to confine the scope of application only to digital services.

Paragraph 9 establishes a tax on digital transactions relating to services provided through electronic means to persons resident in Italy by non-resident persons. Resident persons shall

not include farms, small enterprises, young entrepreneurs and natural persons. Services must be provided through electronic means and mostly though information technologies.

Paragraph 10 vests the Economy and Finance Ministry with the authority to issue an order detailing which services shall be subject to the tax under paragraph 9. This selection is way less easy than it might seem and must be constantly updated to keep abreast of fast-growing developments in the various business sectors and in relation to services provided to customers and the way in which such companies are organised. Hence the requirement not to crystallize a list of such services in the primary legislation. Such services are anyway defined in broader terms in Article 9 and therefore the measure complies with the requirement of Article 23 of the Constitution whereby taxes may only be levied by law.

Paragraph 11 sets the tax rate. A 6% rate is applied to each individual transaction. The rate was established on the basis of a fair assessment of the assumed effects of a tax on earnings against a tax on assumed corporate income.

All enterprises, wherever they may be located, be they resident or not, providing the digital services discussed here, shall be subject to this tax, with the exception of small enterprises and young entrepreneurs (para. 12).

Para. 13 regulates how the tax shall be paid. Resident companies and permanent establishments in Italy of non-resident persons shall comply through their income returns. Non-resident persons without a permanent establishment shall pay the tax under the provisions of paragraphs 15.

Resident companies and permanent establishments in Italy of non-resident persons providing the services under paragraph 10 above shall be granted a notional tax credit equal to the tax owed. The tax credit thus accrued may be subtracted from corporate income tax due and, if part of it remains unused, may be discounted from the regional tax on production activities (IRAP). Any remaining credit may not be reimbursed (paragraph 14).

Non-resident persons without a permanent establishment operating in digital services under paragraph 10 shall pay the tax through a 6% rate withheld (to be later recovered) by the brokers who lace the payment on behalf of their Italian customers. Such services may of course be subject to a charge, surely not be paid by the customer.

Paragraph 16 regulates tax assessment and collection and relevant sanctions, while paragraph 17 vests the Agency with the development of reporting mechanisms.

The tax shall be levied as of January 2019 (para. 18), to enable the Agenzia delle Entrate, the Economy and Finance Ministry and brokers to be equipped for the requirements of previous paragraphs.

Under the final paragraph, the Economy and Finance Minister shall report yearly to Parliament on the enforcement of these new provisions – which are new in Italy and beyond – and to provide regularly information on the financial flows of the digital market supervised by the Agency. The Economy and Finance Ministry's Finance Department shall include a report on the financial effects of the enforcement of this new legislation into the Update to the Economic and Financial Document to be submitted to Parliament in September 2018.

Under a conservative estimate included in the explanatory memorandum to the Bill compiled by the Government, the income from the new tax is expected to account for €112ml yearly as of the year 2019. The amount collected shall be paid into the Fund for Urgent Requirements.

We believe that the reform introduced through this amendment is only a first step towards a governance of the digital economy. The Government and civil society, each in their different roles, may contribute to this development decidedly and responsibly, provided as much information as possible will be made publicly available.