EDITORIAL

Digitalization in a Broader Tax Perspective

1 Introduction

The tax challenges resulting from the digitalization of the economy are mostly framed and perceived in connection with corporate income taxes and how these are avoided and/or end up in the hands of the wrong fisc. While these challenges are very real, there are other challenges, and perhaps also opportunities, arising from digitalization, in different spheres of taxation. Two of these are the tax gap (i.e. the difference between tax that is commensurate with the relevant economy and the prevailing tax rules compared with tax actually collected) and tax as a means of redistribution of income and wealth in a society that is perceived as increasingly unequal and where the middle class is said to be under threat. All three spheres are briefly addressed in this editorial.

2 Digitalization and corporate income tax

A policy note and a public consultation document published by the OECD on 23 January 2019[1] and on 13 February 2019,[2] respectively – addressing the tax challenges of the digitalization of the economy – confirm a direction of travel that became increasingly visible following the issuance of the Final Reports under the OECD/G20 Base Erosion and Profit Shifting (BEPS) project in October 2015. The itinerary is slowly but surely moving from BEPS to a reallocation of taxing rights and – it seems – the gradual exit of capital import neutrality. The published documents identify the two pillars in focus by the Inclusive Framework. The first pillar concerns the allocation of taxing rights, while the second is euphemistically said to address remaining BEPS issues. Reaching consensus on Pillar 1 is, in fact, the major challenge. The documents seem to acknowledge, albeit 'without prejudice' and reluctantly, that it is conceptually not doable to shoehorn reallocation of taxing rights in existing nexus and transfer pricing and profit allocation concepts.

Some would observe that this is indeed trying to put a square peg in a round hole. The Policy Note reflects the difficulty by referring to proposals 'that would allocate more taxing rights to market or user jurisdictions in situations where value is created by a business activity through participation in the user or market jurisdiction that is not recognized in the framework for allocating profits'. The note further mentions that 'the Inclusive Framework recognizes that the implications of these proposals may reach into fundamental aspects of the current international tax architecture' and that 'in all cases, these proposals would lead to solutions the go beyond the arm's length principle'. In connection with the 'user participation' proposal and the 'marketing intangible' proposal, the Consultation Document speaks of 're-conceptualisations of assumptions underlying the existing framework about the location at which an enterprise acts'. The content of the Policy Note and the Consultation Document could bode nothing short of a revolution in the international tax architecture.

While the terms 'formulary apportionment' and Common Consolidated Corporate Tax Base (CCCTB) are not mentioned, it seems clear that between the lines resemblance with features of formulary apportionment and the CCCTB is present, in particular where the Consultation Document refers to fractional apportionment in the context of the significant economic presence proposal and to the residual profit split in the context of the two other proposals – and in respect of all, the reference to a 'global approach to the determination of profit'.

Also, nexus will be revisited, and the documents indicate that the concepts of 'significant economic presence' and 'significant digital presence' will be explored, with possible ramifications for tax treaties. This is further elaborated on in the Consultation Document, where it speaks of 'amending or supplementing the Article 5 definition of

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1 OECD, *Addressing the Tax Challenges of the Digitalisation of the Economy: Policy Note*, OECD/G20 Base Erosion and Profit Shifting Project (OECD Publishing 23 Jan. 2019).

2 OECD, *Addressing the Tax Challenges of the Digitalisation of the Economy – Public Consultation Document*, OECD/G20 Base Erosion and Profit Shifting Project (OECD Publishing 13 Feb. 2019).

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"permanent establishment", allied with changes to the distributive rules in Articles 7 and 9. (…) [T]hose existing provisions look at transactions between enterprises or parts of an enterprise, whereas the new proposals look at the combined profit of multiple entities within an MNE group'. A sequel to the Multilateral Instrument (MLI) may be in sight if any solution needs swift and consistent implementation. While the pressure to resolve the current tension in the system is enormous, so is the challenge to come to a redesign of the international tax architecture. There will be challenges from a conceptual perspective. There is inherent tension between fundamental principles underpinning the OECD Transfer Pricing Guidelines and the authorized OECD approach underpinning the attribution of profit to a permanent establishment on the one hand, and the concept of any form of formulary apportionment on the other hand.

But there is also a significant revenue redistribution at stake. Unlike the BEPS Project, where many in the Inclusive Framework stood to gain revenue, a redesign of nexus and profit allocation, could result in a significant shift in revenue from residence jurisdictions to market jurisdictions. The BEPS Project was politically an easy undertaking in the domestic political arena of the members of the Inclusive Framework, but a reset of the system that could result in a significant revenue shift will be more difficult to achieve.

Pillar 2 as expressed in the Policy Note and expanded on in the Consultation Document, dealing with '[strengthening] the ability of jurisdictions to tax profits where the other jurisdiction with taxing rights applies a low effective rate of tax to those profits', reflects the continuing significant influence of developments in the United States. The Policy Note, in fact, acknowledges that influence by referring to 'more recent developments such as US tax reform'. Indeed, with the base erosion and anti-abuse tax (BEAT) and the global intangible low-taxed income (GILTI) rules introduced with US tax reform, the domestic tax base is protected by effectively denying deduction for part of outbound service payments and by setting a minimum taxation threshold for worldwide income.

It might be easier to reach consensus on this second pillar, but its policy impact could nevertheless be significant. This pillar effectively could put an end to capital import neutrality, notwithstanding its promise that the pillar 'does not change the fact that countries or jurisdictions remain free to set their own tax rates or not to have a corporate income tax system at all'. It is of utmost importance that any proposal produced under this pillar – and probably even more so than in respect of the first pillar – address the risk of double taxation. The risk of double taxation is evident where deduction of payments is denied, less evident but no less real in the case of minimum taxation with severe restrictions on crediting the foreign tax. If these risks are not adequately addressed, it is not only likely that double taxation will arise, but also that tax structuring to avoid this result would continue with all systemic risks, real and perceived, that this planning would entail.

Possibly, the first detailed features of both pillars, and indications as to the chances of any solution being within reach, will become visible following the May meeting of the Inclusive Framework and the ensuing progress report to the G20 finance ministers in June 2019.

3 Digitalization and the tax gap

Corporate income taxes as a percentage of total revenue average approximately 9% in OECD countries.[3] While this percentage fluctuates somewhat over the years, it is, in fact, remarkably constant. By the OECD's own estimates, base erosion and profit shifting could entail between 4% and 10% of corporate income tax.[4] Effectively, based on those percentages, BEPS is approximately 0.36–0.91% of total tax revenue in OECD countries. Measured against GDP, lost revenue as a result of BEPS is 0.12–0.342%. While that percentage range is not negligible, certainly not when reflected in absolute amounts, eliminating BEPS – certainly, after the significant implementation and administration costs resulting from the BEPS project – will not significantly move the international tax needle.

On the other hand, the tax gap (i.e. the amount of revenue that ought to be collected given the state of an economy and its tax system as compared with tax collected) is enormous. A study published in December 2018 in the Journal of Money Laundering Control[5] researched the tax gap in thirty-five countries, and its findings reflect tax gaps varying from 13.5% of GDP (not of total revenue!) in Italy to 1.7% in Luxembourg. While actual outcomes differ, other reports, including a recent report by Tax Research UK for the Socialists and Democrats Group in the European Parliament[6] and reports by the

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3 OECD, *Revenue Statistics 1965–2017* 19 (OECD Publishing 5 Dec. 2018), https://read.oecd-ilibrary.org/taxation/revenue-statistics-2018_rev_stats-2018-en#page31 (accessed 11 Mar. 2019).

4 OECD, *Reforms to the International Tax System for Curbing Avoidance by Multinational Enterprises* (OECD Publishing 5 Oct. 2015), http://www.oecd.org/ctp/oecd-presents-outputs-of-oecd-g20-beps-project-for-discussion-at-g20-finance-ministers-meeting.htm (accessed 11 Mar. 2019).

5 K. Raczkowski & B. Mróz, *Tax Gap in the Global Economy*, 21(4) J. Money Laundering Control 567–83 (2018).

6 R. Murphy, *The European Tax Gap*, A report for the Socialists and Democrats Group in the European Parliament (Jan. 2009), http://www.taxresearch.org.uk/Documents/EUTaxGapJan19.pdf (accessed 11 Mar. 2019).

European Commission[7] and several countries,[8] corroborate the impression that the tax gap caused by the 'informal economy' is a multitude of the tax gap caused by BEPS.

It understandable, but no less remarkable that the international attention and energy devoted to BEPS is so disproportionate to its relative monetary importance, and that there is so little attention to the far more significant portion of the tax gap caused by the informal economy. One could even argue that the continuing focus on BEPS potentially exacerbates the tax gap, if one believes that those participating in the informal economy justify their behaviour based on the belief that 'big business' gets away with tax dodging and small and medium-sized enterprises and citizens end up picking up the tax bill. With the BEPS Project now largely in implementation mode, it may be time to turn more attention to digitalization and the tax gap.

While digitalization poses additional challenges in the tax gap context, one could think of the dark web, as well as bitcoin and other digital currencies, digitalization also offers an opportunity of significant reduction of the tax gap. The informal economy is characterized, amongst other things, by cash settlement of transactions taking place in that economy. As society increasingly turns cashless, detection risk of tax fraud ought to increase. Nevertheless, there are no signs that the tax gap actually decreases as a result of digitalization. Are countries and international governmental organizations doing enough in this respect? Are governments nudging society towards online payments? Are payment data sufficiently mined to match these data with transactions? How are internet traffic and online transactions monitored? Is blockchain technology sufficiently used to identify suspect transactions?

Against the background of the significance of the tax gap, meaningful investment in digital means to reduce that gap is justified. Of course, increased use of digital technology raises serious and legitimate privacy issues that need to be addressed. However, those legitimate concerns need to be balanced against the enormous damage to society caused by the tax gap and perhaps also be viewed in light of the fact that many citizens seem to be less concerned about data usage when they search the internet or post items on social networks and their data are used for advertising purposes or are plainly visible anywhere, than in the context of national security issues and underreporting of taxable income and/or transactions.

4 Digitalization and the Shrinking Middle Class

In a recent book, *The Globotics Upheaval*, Richard Baldwin explores globalization, robotics and the future of work. While the effects of globalization on manufacturing jobs are widely known, Baldwin addresses a new phase of globalization in which service and professional jobs are no longer sheltered from globalization. White-collar workers increasingly compete with robots and with global 'telemigrants'. The effect could be significant downward pressure on the income of the middle class, that is, the middle class in developed countries.

A working paper on digitalization of the economy and its impact on labour markets, published in 2016, concludes that 'There seems to be an emerging consensus concerning an increased polarization of the society of tomorrow, with a shrinking middle class, a strong increase in low income workers and households, and the explosion of a tiny minority of "superstars" whose wealth levels are literally exploding'.[9]

Many have voiced concerns about rising inequality, among other things resulting from the 'network effect' connected to digitalization. Concerns about inequality in society are not a new phenomenon, but in the last few years there is an increasing body of literature about income and wealth inequality. Thomas Piketty's *Capital in the Twenty-First Century*, published in 2013, created a splash in the world, but there is also the wealth of work by Nobel Prize winner Joseph Stiglitz, in particular his 2012 book *The Price of Inequality: How Today's Divided Society Endangers Our Future.* More recently, books have been published, including Mariana Mazzucato's *The Value of Everything: Making and Taking in the Global Economy* and Anand Giridharadas' *Winners Take All: The Elite Charade of Changing the World*, as well as the works of Robert Reich, including his book *Saving Capitalism: For the Many, Not the Few.*

According to various reports by the OECD, the gap between rich and poor keeps widening and the OECD points to social and political concerns and economic concerns resulting from this development.[10] At the same time – and this is not a paradox, more than a billion

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7 Center for Social and Economic Research, *Study and Reports on the VAT Gap in the EU-28 Member States: 2018 Final Report*, TAXUD/2015/CC/131 (Sept. 2008), https://ec.europa.eu/taxation_customs/sites/taxation/files/2018_vat_gap_report_en.pdf (accessed 11 Mar. 2019).

8 *See* e.g. US: IRS, *Tax Gap Estimates for Tax Years 2008–2010* (Apr. 2016), https://www.irs.gov/newsroom/the-tax-gap (accessed 11 Mar. 2019); UK: HM Revenue & Customs, *Measuring Tax Gaps 2018 Edition: Tax Gap Estimates for 2016–17* (June 2018), https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/715742/HMRC-measuring-tax-gaps-2018.pdf (accessed 11 Mar. 2019).

9 C. Degryse, *Digitalisation of the Economy and Its Impact on Labour Markets*, Working Paper 2016.02 European Trade Union Institute (2016), at 50,https://www.etui.org/en/Publications2/Working-Papers/Digitalisation-of-the-economy-and-its-impact-on-labour-markets (accessed 11 Mar. 2019).

10 *See* e.g. B. Keeley, *Income Inequality: The Gap between Rich and Poor*, OECD Insights (OECD Publishing 15 Dec. 2015), https://read.oecd-ilibrary.org/social-issues-migration-health/income-inequality_9789264246010-en#page1 (accessed 11 Mar. 2019).

people have been lifted from extreme poverty in the twenty-five years from 1990 until 2015, according to estimates by the World Bank Group.[11] Perhaps, to an extent, inequality and decreasing poverty are two sides of the same coin: Jobs that move from developed to developing countries increase inequality in the first group and reduce poverty in the latter group.

How does globalization affect tax and how does tax affect inequality? In OECD countries, by far the largest amount of revenue is raised from the financial middle and upper class, through income taxes and consumption taxes. Where income taxation is based on, for example, the ability to pay, it is – by definition – a redistribution instrument. Redistribution of income and wealth is, in many countries, an important goal, and in any event an effect of income tax, and in rare cases of net wealth taxation. One could debate some of the findings in the literature mentioned above, but even if one were to take the findings as a given, it is questionable whether 'taxing the rich' would alleviate the looming problem of the 'shrinking middle class [and] a strong increase in low income workers and households'. Certainly, in many OECD countries the difference between the top 1% and the bottom 1% is by far not as extreme compared with the global top 1% and bottom 1%, and in these OECD countries income taxes, social security premiums and value-added taxes are for a very large part generated by the middle class. That potentially presents an enormous challenge, if that middle class were to indeed shrink as a result of further robotization and 'telemigrants' as predicted by Baldwin.

Some of the above-mentioned authors and the politicians mentioned below indeed suggest increased taxation of the rich. After decades of – in many countries – decreasing income tax rates, decreasing gift and inheritance tax rates, or abolition of these taxes altogether, and in light of increasing attention on inequality as evidenced by the above-mentioned literature, there will inevitably develop more support for a reversal of the trend. The significant support for a plan by US Senator Elizabeth Warren for a 2% wealth tax for those with USD 50 million or more in assets and the plans by Representative Alexandria Ocasio-Cortez to tax income above USD 10 million at 70% are evidence of that possible reversal. While somewhat different in nature, the recent yellow jacket movement in France has a strong tax angle to the discourse, as well. The tax world cannot turn a blind eye to these developments.

It is upon academics and policy makers to respond to the challenges, not only of perceived and real inequality, but – far more threatening to stability in society – that of the shrinking middle class and accordingly shrinking tax revenue, if job related predictions with respect to the digitalization in the third and fourth industrial revolution were to become reality.

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[11] World Bank, *Poverty – Overview*, www.worldbank.org/en/topic/poverty/overview (accessed 11 Mar. 2019).