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Spain - Plans Regarding Digital Tax

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In 2018, the Spanish government drafted a proposal for the taxation of digital services. This article discusses several of the issues addressed in that draft and provides an overview of the main features of the new digital services tax.

1. Introduction

On 23 October 2018, the Spanish government issued a preliminary draft (the Draft) to regulate a new and specific tax for digital services (Digital Services Tax or DST). After the process of public information was concluded, the Council of Ministers approved the draft law on 18 January 2019. However, it still needs the approval of the Spanish Parliament. Once approved, it shall entry into force three months after its publication in the Spanish Official Gazette.

This initiative arises following the increasing controversy at an international level about the taxation of digital services. Both the OECD (Organisation for Economic Cooperation and Development) and the EC (European Commission) have issued preliminary texts to establish how states should tax digital services.

Spain has followed the taxation model of the EC, which, on 21 March 2018, issued a draft for the Council Directive on the common system of a digital services tax on revenues resulting from the provision of certain digital services (EC Directive Proposal).

Based on the EC Directive proposal, the Draft's purpose is to adopt temporary unilateral measures for the taxation of this sector, as long as an international solution has not yet been reached. The Draft aims to establish a new 3% indirect tax to be levied at entities that provide certain digital services if their users are located in Spain.

However, the Draft's content raises several questions concerning its application, aim and scope. This article will address several of these issues, as well as provide an overview of the DST's main features.

2. Definition of the DST: An Indirect Tax?

The definition of the DST as an indirect tax, as established in the Draft, is controversial. The assumptions and reasonings underlying this definition in the Draft give rise to doubts as to whether the DST is actually an indirect tax.

The Draft's introductory text justifies the indirect nature of the tax based on the fact that the DST is intended to target a certain category of digital services (this category will be addressed in section 3), regardless of the taxpayers' features; e.g. the taxpayers direct economic capacity. Although it is generally accepted that targeting a certain category of services is one of main criteria to define a tax as indirect, in this case it falls short to validate the DST's indirect nature. This is because the DST is aimed at taxing the provider, but unlike as with indirect taxes (where taxpayers can shift the burden onto the final services' recipients), it cannot be charged to users.

Even if the introductory text of the Draft does not mention it expressly, the definition of the DST as an indirect tax appears to result from the fact that it will only be levied when users of the services are located in Spain, regardless of the services providers' location. What contradicts the interpretation of the DST as an indirect tax is that, in this case, the taxpayer remains the services provider, although criteria to levy the tax are the specific services provided and the location of their users.

The DST being defined as an indirect tax has important practical consequences for a discussion that would otherwise remain on a doctrinal level. As the Draft's introductory text suggests, if the DST were to be defined as a direct tax, it could fall within the scope of the double tax treaties (DTTs) Spain has entered into, meaning Spain could lose its capacity to tax the services.

In particular, article 7 of the OECD Model Tax Convention establishes an exclusive right of taxation to the state of residence regarding business profits obtained in the source state, unless the company carries out business activities in the source state through a permanent establishment (PE).

Accordingly, the source state is precluded from imposing a tax on the benefits a non-resident company obtains (except when it has a PE). As the DST intends to tax incomes of entities that provide certain digital services, if the DST were to be considered a direct tax, Spain would only be able to levy this tax when the providers have a PE in Spain.

Taking into account that, due to their business models, providers of digital services rarely have a PE in Spain, the DST could not be applied to any company resident in a country with which Spain has a DTT signed and in force. This would make the DST ineffective, as Spain has already ratified more than 100 DTTs; one of them with the United States, where the main providers of digital services are located.

This being so, it appears that the definition of the DST as an indirect tax is not accidental, and that the Spanish government seeks to leave this tax outside the scope of DTTs. However, Spain must still comply with its existing international obligations. Therefore, it is yet to be seen what the actual extent of the DST will be.

Finally, with regard to the indirect nature of the tax, the Draft provides that it should be compatible with VAT. But this does not seem a very precise condition, as the EC Directive Proposal argues that the DST may lack some of the characteristics of the VAT, but still will be considered compatible.

3. Services Taxed by the Act: The "Digital Interface" Concept and Its Application

The DST is aimed at taxing the revenue from digital services where the user contributes to the creation of value for the services provider in an essential manner. All other transactions are outside the scope of the DST.

The scope of digital services that the Draft covers is directly linked to the so-called "digital interface," a concept that is expressly defined in article 4.5 of the Draft, based on the EC Directive Proposal, and is conceived in comprehensive terms, as will be shown below in issue (1). Therefore, digital interfaces are defined as "[a]ny software, including a website or a part thereof and applications, including mobile applications, accessible by users."

Based on the above, the DST is intended to apply to the gross revenue generated by the following three categories of digital services, expressly listed in the Draft as summarized below in the following terms:

(1) Online advertising services: The inclusion of a digital interface of advertising directed to the users of a given digital interface.

As mentioned, the Draft provides an extensive definition of "digital interface", meaning that the ownership of the digital interface is irrelevant for the purposes of the DST, which includes including in its scope for web-published ads and ads placed in "free" apps in its scope. As the entity that places the advertising does not usually own the interface, according to the Draft, that entity is considered to be providing a taxable service in all cases.

(2) Online intermediation services: This refers to services directed at users of multi-sided digital interfaces – which allow users to interact with one another –facilitating the supply of goods and services between them, or enabling them to locate other users and interact with them.

The Draft excludes certain services where interaction between users is not a key aspect, such as (i) those in which the sole or main purpose of the interface is to supply digital content, communication services, or payment services to users, or (ii) those that provide services through a trading venue, a systematic internalizer or a regulated crowdfunding service provider.

Although at this stage it is unclear whether they will be included in this exception, the exclusions mentioned above could be relevant for important sectors of the digital economy (e.g. providers of audio-visual digital services).

(3) Data transmission services: These include digital services for transmitting data that have been generated by users' activities in digital interfaces.

It is relevant to note that the Draft refers to the digital services that will be subject to DST not expressly as a numerus clausus, without providing a closing clause to determine whether similar digital services may be included within its scope either. Therefore, the current wording of the stipulation might cause controversy if it enters into force.

4. Territorial Scope of the DST: Users vs. Services Providers

The DST is intended to tax digital services when users of those services are located in Spain. The Draft establishes three main allocation rules to determine whether services fall within the territorial scope of the tax. Per service category, this means:

(1) Advertising services: Is the user's device located in Spain when the advertisement appears?

(2) Online intermediation services: The Draft distinguishes two different rules: (i) for services aimed at facilitating the delivery of goods or services between users, the DST will apply if the underlying transaction is made using a device located in Spain; (ii) for other intermediation services, the DST will apply when the user's account, with which the user accesses the digital interface, has been created with a device located in Spain at the time of creating the account.

(3) Data transmission services: When the transmitted data has been generated by a user through a digital interface and the user signs in to that interface with a device that, at the moment the data is generated, is located in Spain.

As a result of the above allocation rules, and following the EC Directive Proposal, the Draft considers the devices' location – indicated by their IP addresses – as the defining factor, as opposed to the location of the user. Therefore, the Draft is intended to tax any usage made within Spanish territory of digital services, regardless of whether profits of this usage can effectively be traced back to Spain.

5. Taxable Base, Tax Rate and Taxpayers

The taxable base of the Spanish DST will consist of gross revenues from the digital services listed in section 3., net of VAT and other similar taxes. Under the Draft, to be taxable, the taxpayer must also meet certain economic thresholds concerning its income.

First, the Draft does not determine the taxable base on the ground of incomes obtained by the service provider directly from users, but instead determines it based on an estimation of the provider's total income.

To this effect, the Draft provides for allocation keys, which introduce proportional rules to calculate the income from the digital services located in Spain, in comparison with the total income the services provider obtains worldwide. These can be summarized as follows:

(1) Online advertising services: The proportion will be established based on the number of times the advertising appears on devices located in Spain, as compared to the total number of times it appears worldwide.

(2) Online intermediation services: Given the different nature of services included in this category, the Draft provides two rules: (i) for services aimed at facilitating the delivery of goods or services between users, the proportion will be established between the number of users located in Spain and the total number of users involved in that service regardless of where they are located; and (ii) for other intermediation services, the proportion will be determined by the total amount of income derived directly from the users when the accounts that allow access to the digital interface were opened using a device that was located at the time of opening the accounts in the territory where the tax is applied.

(3) Data transmission services: The proportion will be based on the number of users that have generated data located in Spain, with respect to the total number of users worldwide.

Several considerations may be made concerning the above rules.

– It can be doubted whether the taxable base should be calculated based on an estimation of incomes generated in Spain, as the fact that a device is located in Spain when taxable services are provided does not necessarily result in an income for the service provider. This criterion makes the DST more of the nature of a direct tax than an indirect tax (see section 2.); however, given that the services provider does not generate an income from the user, another alternative would be scarcely viable.

– Despite the above, it must be noted that determining the taxable base according to an estimation may be difficult to execute both for taxpayers and tax authorities. In fact, under section 10.3 of the Draft, if the taxable base cannot be calculated based on the allocation keys specified in section 4., taxpayers must provisionally calculate it based on "informed criteria." How this concept should be interpreted is yet to be analysed.

– Additionally, a tax on gross revenue could also have negative effects on loss-making companies, which, despite not making profits, would still have to pay the DST. For example, if taxable transactions result in a 10% profit margin on a company's revenue, a tax of 3% on the gross income would be equal to levying the benefits of the company with an additional 30%.

Second, in line with the EC Directive Proposal, the Draft establishes a 3% tax rate.

Third, a company will only be considered taxable if:

– its total annual worldwide revenue for the previous calendar year exceeds EUR 750 million; and

– its total annual taxable revenue in Spain exceeds EUR 3 million.

It is important to note that the Spanish Draft determines that, when a taxable entity belongs to a corporate group, the thresholds should be considered at the group level.

In addition, intra-group services transactions would be excluded from this tax as long as there is a direct or indirect participation of 100%. This provision was not included in the first Draft but it was included after the public information process.

One of the points of criticism on the Draft is that, with these two thresholds, the DST's scope is limited to only a few companies worldwide (i.e. tech giants' advertising services, social networking platforms and e-commerce platforms, most of which are located in the United States).

When issuing its Draft proposal, the EC already claimed to be applying a targeted tax, which is a model the Spanish DST seems to have followed. Although this approach has received heavy criticism for possibly resulting in a distortion of competition, in our opinion, certain thresholds are necessary to avoid other adverse effects (e.g., the economic effects of this tax if applied to start-ups and small businesses). Also, the regional threshold only allows the tax to be levied to companies that have a significant presence in Spain.

Finally, with regard to the main features of the tax, just mention that the accrual of the DST will be immediate, when the taxable event takes place, while the tax return must be submitted quarterly.

6. Formal Obligations and Penalty Regime

The Draft incorporates certain formal obligations that are applicable regardless of taxpayers' tax residence. These include the inscription of taxpayers in a registry; the registration of the transactions by taxpayers; the appointment of a Spanish representative for those taxpayers that are non-residents of the European Union; or obtaining a tax identification number from the Spanish tax authorities, among others obligations. Accordingly, the DST does not only constitute an additional burden for taxpayers, but also an increase of other associated administrative costs.

With regard to the penalty regime, the Draft establishes that taxpayers would cause a serious infringement if they fail to introduce effective mechanisms that identify the location of users in the territory of application of the tax. In this sense, a penalty of 0,5% of the net amount of the turnover of the previous calendar year will be applicable with a minimum of EUR 15,000 and a maximum of EUR 400,000.

It is the other major amendment of the first Draft since its original wording, as the penalty was going to be imposed on both users and taxpayers, whereas with the present drafting, only taxpayers fall under the scope of the penalty.

7. Final Comments

As indicated in section 1., with issuing the new Draft, the Spanish government follows the trend of other countries that have adopted temporary unilateral measures to tax profits that digital services generate within their territories. Several states that have introduced unilateral measures are part of the European Union, including Italy and Hungary.

However, unilateral taxation is usually a problematic step. In all likelihood, measures adopted by several states will turn out to be divergent, eventually resulting in double taxation when, for example, the allocation rules of two regulations differ.

The DST also raises the issue of Spanish internal double taxation resulting from its application despite the existence of other (direct) taxes in Spain aimed at levying income of digital services providers. This is likely to occur, as the Draft does not provide for deductibility of the DST (although it does not exclude this possibility either) from Spanish Corporate Income Tax (CIT).

The potential collection capacity of the DST is more limited than the Spanish government initially estimated. Indeed, although the Spanish government assessed a total revenue recollection of EUR 1,200 million per year with this tax, this amount seems far too optimistic when considering the preliminary studies of the EC, which estimated that the feasible recollection of the tax for the European Union as a whole would be EUR 5,000 million.

The public consultation phase regarding the Spanish DST has recently ended. The Draft will now be presented before the EC, after which it will be submitted to Parliament for approval. However, it is uncertain whether this proposal will be passed by Parliament, as the current government has a very limited parliamentary support.

Moreover, at the European level, there is little consensus among countries for the approval of the EC Directive Proposal, and steps have been taken to reduce the current Proposal's scope to advertising services only.

The European Union Finance Ministers (ECOFIN) first issued a report where it called into question the indirect nature of the tax as defined in the EC Directive Proposal, as well as the legal bases for its development. In another meeting of the ECOFIN, the German Minister of Finance showed reluctance to pass a European tax on digital services before a global solution is found within the framework of the OECD. The German position, alongside the negative positions of Ireland, Sweden and Denmark, has resulted in the French Minister of Finance accepting a delay in the entry into force of the tax until 2021.

Work will soon begin within the EC to redraft the Directive Proposal, reducing the current three taxable categories of services to one, which means that only online advertising services would be

taxed. The new proposal will also change the date and duration of its application: it would enter into force in 2021 and would be applied until 2025.

Provided the Spanish government's aim has been to issue a unilateral and temporary legislation in line with the current EC Directive Proposal, it is reasonable to expect that, if a new Directive Proposal is issued, the Spanish government will adapt the Draft to the new Directive Proposal. However, in case the adjusted Draft's scope is restricted following the new EC line, the practical effects of the DST would also be roughly limited, resulting in an almost residual collection revenue. Consequently, the DST would never achieve the purposes for which it was initially created.

Overall, it seems that now the further development of the Spanish internal procedures is to be awaited, while keeping an eye on European and international actions and changes in this field.

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