

## TAXATION OF DIGITAL SERVICES

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**Abstract:** *Digital services are changing our society and economy, bringing new challenges and problems for tax policy through development of digital economy. Digital companies have new business models, often without a physical presence in different countries, and at the same time they provide services to users whose contribution creates value for these companies that states cannot tax under current rules as traditional services. Also, it is often hard to determine the location of a customer which is important for taxation. There are some important factors influencing taxation of digital service such as significant economic presence from companies and creation of big data by users of different countries. Some countries have introduced their taxes on digital services independently, which means that there is no consensus on the taxation of digital services at the international level. The aim of this paper is to highlight the tax treatment of digital services in the European Union and, consequently, in Croatia. Also, authors will analyze the legal solutions for the taxation of digital services in France, the United Kingdom and the Republic of India, and make proposals for the introduction of taxes on digital services in Croatia.*

**Keywords:** *taxation, digital services, legislation, EU, Croatia.*

**JEL classification:** *H20, H21, H25.*

### INTRODUCTION

The digital economy is a global network of economic activities enabled by the use of information and communication technologies, i.e., the digital economy is an economy based on digital technologies (United Nations, 2020). In its Action 1 report (OECD, 2015), the Organization for Economic Co-operation and Development (OECD for short) identifies six main characteristics of the digital economy that are po-

tentially relevant from a tax perspective. The first feature is the mobility of three main factors (OECD, 2015): the mobility of intellectual property (which forms the basis of the digital economy), the mobility of users, and the mobility of business functions as a result of the reduction in the need for local labor to perform certain functions. We live in an ever-changing world fueled by constant innovations where science fiction often becomes science fact. The greatest changes in recent human history are happening in the last few decades. Innovations, technology and digitization have already altered society and continue impacting not just our lives but virtually all business functions and industries (Tolić, Sabljčić, & Sabljčić, 2022). Another feature is the reliance on data, especially “Big Data.” The third characteristic is network effects. Thank you to the network effect, only an increase in the number of users of a network leads to an increase in the value of that network. A simple website for sharing self-made videos is given as an example. The more users there are, the more content there is and the more attractive the site is to new users. The fourth characteristic is the use of “multi-sided” business models, where multiple groups of people interact through intermediaries or platforms, and the decisions of one group of people influence others through positive or negative externalities. An example is the card payment system, which is more valuable to merchants the more users there are, and the more merchants accept said card system, the more valuable it becomes to users. The fifth characteristic is the tendency to monopolies or oligopolies in certain business models based on network effects. The sixth characteristic is high volatility due to low barriers to entry and rapidly evolving technology. The digital economy has enabled the development of a number of new business models (OECD, 2015). Although most of these models have their counterpart in the “regular” economy, the development of digital tools has made it possible to perform many types of work on a larger scale and over greater distances than was previously possible. Some of the business models include e-commerce, app stores, online advertising, cloud business, payment services, ultra-fast e-commerce, and online platforms with user participation (OECD, 2015). For these new digital business models, the problem is how to determine the location of customers (buyers) and revenue. According to Measure 1 (OECD, 2015), revenues are categorized as follows: Advertising revenue, revenue from the sale of digital content, sale of real and virtual goods, subscription revenue, revenue from services, revenue from licensing of content and technologies, revenue from the sale of user data and customized market research, and revenue from “hidden” costs. The diversity of business models and ways to generate revenue and profits makes it difficult to set firm boundaries for the digital economy. We can argue that the entire economy is going digital and that digital tools are becoming essential for the sustainable operation of modern businesses, making it difficult for governments to tax.

The Inclusive Framework on Base Erosion and Profit Shifting (further in the text: BEPS) created by the OECD (OECD, 2020) has the primary goal of preventing corporate tax evasion by exploiting discrepancies in tax systems. More and more companies are operating internationally and globally, so the actions of tax authorities need to be coordinated at the global level. The OECD estimates that the negative practices of tax base reduction and profit shifting through digital services cost tax authorities a total of \$100 billion to \$240 billion annually, equivalent to four to 10 percent of global corporate tax revenues (OECD, 2020). Although the OECD has taken a number of

measures over the past five years to make the international tax system fairer and more efficient as part of the BEPS program, no concrete action has yet been taken in the area of the digital economy.

Therefore, the aim of this work is to examine the implementation of the taxation of digital services in the United Kingdom, France and the Republic of India, and to research the proposal for Council Directive 2018/0073, which has not been implemented in the European Union. The aim is to find the best practice for the digital services taxation proposal in Croatia.

The paper is divided into six sections. After a brief introduction, the literature review is presented followed by research methodology. Authors have then analyzed examples of good practices regarding the taxation of digital services. In the fifth section, results of conducted research and discussion are presented. The last section refers to conclusion remarks.

## LITERATURE OVERVIEW

According to Noonan and Plehakova (Noonan & Plekhanova, 2020), digital services are the services offered by web platforms that facilitate the exchange of goods and services between third parties. The most prominent providers of this type of service are Google, Amazon, Facebook, Apple, and Airbnb. According to Zuboff (Zuboff, 2019), these platforms are highly digitised and operate businesses in different countries without a physical presence. They rely on intangible assets, mainly intellectual property and Big Data, and create value through people's online interactions. For example, American companies pay for Facebook ads that target French consumers. Facebook profits from these companies and receives its payments in the United States. American companies are willing to pay for advertising on Facebook because they expect it to increase sales in France, and that is only possible if Facebook is used by users from France (Cui, 2019). Thus, the use of Facebook by French users makes Facebook a profitable seller of advertising space. In this interpretation, the concept of "customer-created value" identifies the place of profit (France) differently from the place of payment (U.S.) and differently from the place where tangible assets and employees are located. For this reason, Cui (Cui, 2019) advocates the introduction of a tax on revenues from the provision of digital services. In March 2018, the European Commission put forward two proposals primarily aimed at taxing digital businesses. The first initiative aims to reform corporate taxation so that profits are recognised and taxed when companies interact with customers on a significant scale through digital channels. This proposal is also the desired long-term solution of the European Commission. The second proposal is a transitional solution that covers the taxation of the main digital activities that are currently not taxed in the European Union. In addition to the transitional solution providing immediate revenue to member states, it would prevent unilateral solutions that threaten the concept of the European single market. The proposal provides for an indirect tax to be levied on income from activities where users play an important role in creating value and where it is difficult to apply the current tax rules. Income from the sale of online advertising space, income from digital intermediation activities that enable the sale of goods and services between users, and income from the sale of user-generated data would be taxed. The tax would be levied

by member states in which those users are located and would apply only to companies with total worldwide sales of more than €750 million and total sales in the European Union of more than €50 million. At a tax rate of three percent, the total revenue for member states would be estimated at five billion euros (European Commission, 2018).

According to Beebe (Beebe, 2019), the member states opposing the introduction of the said tax are mainly states with smaller export-oriented economies that are threatened by the loss of tax revenues, such as mainly Ireland, the European headquarters of Google, Facebook and a number of other large corporations. They cite potential double taxation and the violation of existing double taxation agreements as arguments. If one country introduces income taxation while another retains the existing system of profit taxation, this leads to double taxation and makes business development in a country with income taxation more expensive and less attractive. On the other hand, large economies such as Italy, Spain, and France support the European Commission's proposal and believe that user activity creates value and that value must be taxed where it is created (Beebe, 2019). (Russo, 2019) believes that the tax on digital services could likely be passed on to end users and would likely have a similar impact as VAT in the form of price increases for end users. He believes that this tax can indeed be considered VAT on digital services, but at a specific higher rate, and that VAT is superior to digital tax services in terms of efficiency, as the latter could influence business decisions and cause cascading or double taxation. He believes that countries could achieve better results if they made an effort to invest in the VAT system, which is applied more efficiently to digital services, instead of a tax on digital services. (Parsons, 2018) comes to similar conclusions, but also offers additional criticisms. Apart from the fact that he considers a special tax regime for the challenges of the digital economy unnecessary and it is unclear to him why the proposed tax could not be implemented through changes in the VAT system, the rules of which are well known, he also believes that it is not certain that there is actually value in any data collection. He also points to the requirements of the General Data Protection Regulation (GDPR) for deletion of data and believes it is unclear how companies could prove the existence of revenue from such data. He adds that there are many user accounts that are actually inactive, so a minimum activity level should be set for them. He also believes that although the digital services tax is presented as a temporary solution, there is actually nothing in his proposal that would repeal it if someone comes up with a permanent solution. For example, VAT rules from the temporary solution in "the European Union have been "temporary" for over two decades (Parsons, 2018). The European Commission does not offer a more in-depth analysis of who will bear the tax burden once the tax on digital services is implemented. (Bauer, 2018) finds that due to the design of the tax itself, network effects, and the current competitive situation of online platforms, the main burden of taxation will be borne by business customers and end users. In his analysis, (Bauer, 2018) concludes that the more mobile the owners, suppliers, and buyers, the lower the tax burden, and that the greater burden falls on the more immobile businesses. Taking into account the fact that online platforms provide micro and small businesses as well as self-employed people with a low-cost and efficient way to advertise, the question arises whether the introduction of such tax will harm small business entities in the member states of the European Union? (Beebe, 2019) warns of another potential problem with the introduction of a tax on revenues from the provision of digital services. If this tax is targeted at

a narrowly defined industry niche, there is a possibility that it will not achieve its goal of neutrality between digital and traditional businesses. If, on the other hand, it covers a broad range of companies, it may lead to large differences in taxation (Beebe, 2019).

As a kind of alternative to income tax, a withholding tax can be levied. In Croatian legislation, withholding tax is defined by the Profit Tax Act as a tax on profit earned by a non-resident in the Republic of Croatia (National Gazzete, 2022). According to the Act, the payer is liable for the tax, and the basis is the gross amount of remuneration paid by the domestic payer to the non-resident - foreign - recipient. Withholding tax is levied on interest, dividends, profit shares, as well as on copyrights and other intellectual property rights. In recent years, withholding tax has also been applied to certain types of digital transactions, such as the taxation of royalties for online music playback or the taxation of online advertising revenues. Malaysia and Thailand are examples of countries that have introduced these measures (Beebe, 2019).

The OECD discusses the opportunities and challenges of introducing a withholding tax on digital transactions as an alternative to complicated profit distribution mechanisms. According to (Olbert & Spangel, 2017), this proposal is referred to in the literature as an “equalization tax” and should be applied to a wide range of online and remote transactions to tax the profits of digital companies based on their significant economic presence.

The OECD envisions two possible forms of said levy (Olbert & Spangel, 2017): in the form of a tax on the total value of all digital transactions by foreign companies with domestic consumers (a type of consumption tax) or as a tax on the value of data provided by users for the purpose of taxing the value added by the collection of user data. The concept itself presents a number of problems, and the OECD points to the difficulty of imposing such a tax on business-to-consumer transactions, the impossibility of recognizing tax deduction costs, and the conflict with European Union free market principles that provide for equal taxation of domestic and foreign businesses.

(Baez & Brauner, 2015) present a detailed argument for the broad application of withholding tax in the digital economy. Their proposal consists of a global withholding tax rate of, say, ten percent on payments that reduce the tax base of non-residents in all transactions between firms. As a result, all payments not related to digital transactions could be exempt from this tax. Transactions between businesses and consumers would be exempt, as they do not usually reduce the tax base. The proposal is very simple and could be included as a new article in the OECD model. However, it would require global coordination and standard setting, which would require a major effort from the relevant institutions.

The (European Commission, 2018) has put forward a proposal that would allow member states to tax profits earned in their territory even if the company has no physical presence. A company has a taxable “digital presence” if it meets one of three criteria: Annual turnover of more than seven million euros in a Member State, more than 100,000 users in a Member State during the financial year, or more than 3,000 concluded business contracts for the provision of digital services between companies and business users during a financial year. The European Commission argues that the aforementioned rule better allocates the profits earned based on where the user is at the time of consumption of digital content and establishes a real link between the place of profit realization and the place of taxation of the profits. (European Commission, 2018)



presents further details on the concept of significant digital presence in its proposal for a Council Directive of the European Union. A wide range of activities, including the development, improvement, maintenance, protection and use of intangible assets, are considered to be economically significant activities of the company and allow the attribution of profits to a particular tax jurisdiction, even if these activities are physically carried out outside the said jurisdiction. The allocation of profits to the economically significant presence is based on the principle of impartial transaction, and traditional methods of profit allocation also take into account factors such as the number of users and the amount of data collected in the Member State.

In his work, (Cui, 2019) analyzes the need for the concept of a significant digital presence. According to the European Commission's proposal, a digital company is considered to have a significant digital presence if it reaches certain numbers in a country (amount of revenue, number of users, or number of contracts). This requires two conceptual steps: Users are considered intangible assets of the company, and activities related to tangible assets (e.g., servers) and activities of employees outside the country are allocated to intangible assets of the first step. In the second step, the profit is attributed to the activities listed in the first step, under the fiction that these activities are performed by a third party, independent of the rest of the firm. (Cui, 2019) raises the question of how this differs from simply identifying a certain number of transactions within a country, determining the amount of profit generated by those transactions, and taxing that profit in that country. Moreover, the concept of significant digital presence does not answer the question of how much profit is generated by the user's participation and how much of that profit should be allocated to the country in which the user resides.

## **METHODOLOGY**

In accordance with the aforementioned problems regarding taxation of digital services, the primary goal of this paper was to provide answers on the following research questions:

RQ1: What is the most appropriate way for taxing digital service?

In order to provide answer on the first research question, the authors examined the legislation of countries that have implemented digital services taxation. Countries such as the United Kingdom, France, and the Republic of India have introduced digital services taxation. To answer the research questions, the authors will use the method of analysis, description, comparison and compilation. The aim is to show the legislative solutions of the mentioned countries based on the main criteria, i.e. the digital services that are legally considered taxable, the thresholds, the tax rate and tax calculation, and the place of service provision. Finally, some suggestions will be made regarding the introduction of a tax on digital services in Croatia.

RQ2 Is it possible to introduce fair taxation of digital services?

To answer the second research questions, the authors will use the method of analysis, synthesis, description, comparison and compilation. Since digital companies have organized their business model to operate in multiple jurisdictions but have no physical presence, rely on intangible assets, and use their own users' free contribution to create value by collecting Big Data, it is important to analyze important factors such as Big Data and physical presence to answer this research question.

## EMPIRICAL EVIDENCE

In this chapter, the state of taxation of digital services in the Republic of France, the United Kingdom and the Republic of India is analyzed. In addition, the effects of the application of the aforementioned tax has been analyzed.

### Case of Republic of France

The digital economy accounts for 5% of France's GDP, according to 2016 data, and the number of digital companies is estimated at 115,000. The tax on digital services in the Republic of France came into force on July 25, 2019, but will be applied retroactively to revenues generated from January 1, 2019. The government of the Republic of France estimates the annual revenue from the said tax at 500 million euros. Companies whose total annual revenue from taxable activities exceeds 750 million euros worldwide and 25 million euros in France will be taxed. The thresholds set correspond in part to those proposed by the European Commission.

The threshold of the total annual income of over 750 million euros results in the fact that only large international companies that operate successfully on a global level are subject to the said tax (Nappi, 2016). As an example, we can cite the French music streaming platform Deezer, which has over 14 million monthly users and is marketable leader in France, but its total annual revenues are 400 million dollars, and it is not subject to digital services tax.

The digital services tax rate is three percent, which taxes revenues generated in France from the provision of two categories of services: digital interface services and targeted advertising services (United States Trade Representatives, 2019). The following table shows examples of some digital interface services that are taxable, as well as some exemptions from taxation.

**Table 1.** Examples of taxed digital services

Taxed digital service	Not taxed digital service
A small business sells shoes to individuals through the Amazon platform.	The Amazon platform sells shoes from its own inventory.
A natural person sells a bag to another natural person through the eBay platform.	The company sells bags through its own website.
The driver uses the Uber app to provide the ride service.	The driver uses the app of the taxi company to provide the driving service.
A tourist uses the Airbnb platform to rent an apartment from a third party.	A tourist uses a hotel's website to book accommodation at that hotel.
A small business sells DVDs or CDs to individuals through the Amazon platform.	A music streaming application provides a music listening service to a subscriber.

**Source:** authors in accordance to United States Trade Representative (2019)

From the table 1, we can conclude that the digital services tax is not subject to services in which there is no transaction between three parties, i.e., in which there is no digital mediator. Also, transactions whose content is digital multimedia (music and film), communication or financial services are not subject to the tax.

A digital interface service is considered to have been provided in France if a person located in France purchases a good or service through a digital interface (foreign

or French) from a third party (foreign or French). Also, the service will be considered to have been provided in France if a foreign person purchases a good or service from a third party through a French digital interface.

When reporting income from the provision of digital interface services, companies can reduce income only by the amount they passed on to third parties, i.e., sellers of services or goods (United States Trade Representatives, 2019). All other costs, such as storage costs or postage, must not reduce the tax base. The tax base is calculated as the total revenue generated from the services multiplied by the percentage share of those transactions that are related to France. Therefore, it is not the value of transactions provided in France that is calculated, but the percentage of users who are in France and that percentage is applied to the total revenue generated worldwide. This method of calculation can lead to an overestimation or underestimation of the realized income, depending on the average amount of the transaction realized in France in relation to the average amount of the transaction at the world level (United States Trade Representatives, 2019).

The question arises of the efficiency and fairness of the mentioned method of calculating the tax base. Calculating the total realized income at the world level from the activities that enter the sphere of taxation with the tax on digital services in France leaves the impression of extensive accounting work (Arcieri, 2019). The logical alternative was to define as the tax base the value of the realized activities that included users from France, and we can argue that the mentioned method would be fairer and more administratively efficient.

The second category of taxable services, targeted advertising services, refers to the following activities: displaying and evaluating targeted advertising based on data about the user to whom the ad is displayed, and selling user data in connection with online advertising (Arcieri, 2019). Emphasis is placed on targeted advertising using data. Therefore, showing the same ad to all visitors to a particular website is not an activity subject to the mentioned tax. This is in accordance with the basic principle of the legitimacy of the tax on digital services. France justifies the legitimacy of the digital services tax by the fact that its residents create value by providing their data and the monetization of that same data must be taxed in France, therefore advertising services that do not use that same data will not be subject to the digital services tax (Chrisafis, 2019).

The targeted advertising service is considered to have been provided in France if the user was in France at the time the ad was displayed or if the data was collected from the user while he was in France (United States Trade Representatives, 2019). An example of a transaction that would be subject to taxation is the following: the American platform Facebook sells advertising space to a Chinese company, and the ad is shown to a Spanish resident who is in France at the time the ad is displayed.

When reporting income from the provision of targeted advertising services, the tax base includes all income from those activities, and the company has no right to reduce the base for amounts paid to third parties for advertising space. The tax base is calculated as the total revenue generated from the services multiplied by the percentage share of those transactions that are related to France (United States Trade Representatives, 2019).

The introduction of a tax on digital services in the described form, which is primarily aimed at large American multinational corporations such as Facebook and



Alphabet, caused a reaction from the American authorities. They announced the introduction of import duties on French goods, including champagne and cheese. The French authorities therefore decided to postpone the collection of the new tax until the end of 2020. If the OECD reaches an international agreement by the end of 2020, the French unilateral tax will not be applied, and if there is no agreement, France will retroactively collect all tax arrears.

The described situation shows the importance of the multilateral and synchronized action of tax authorities around the world. The unilateral introduction of one's own taxes inevitably leads to conflicts between states and potential trade wars. As most of the corporations to which the digital services tax is applied are in the USA, we can expect strong reactions from the American authorities to any introduction of unilateral taxes whose primary goal is to reduce the profits of American companies (BBC News, 2020)

### **Case of UK**

The Internet sector is one of the most important economic sectors of the United Kingdom. According to data from 2016, the Internet sector consisted of almost 80,000 companies that employed 400,000 people. The total value of the internet sector within the UK's gross domestic product is £45 billion, making it twice the size of the arts, entertainment and recreation sector and three times the size of the agriculture, forestry and fisheries sector. The growth of the Internet sector is faster than the growth of the entire economy. The number of companies grew annually by 6.6% in the period from 2012 to 2016, compared to 2.9% growth in the number of companies in the economy (Hooton, 2019).

Although the growth of the Internet sector was strong, it was not adequately accompanied by the growth of tax revenues. Boccia and Leonardi (2016) states that in 2016, Her Majesty's Revenue and Customs reached an agreement with the Google corporation to pay 11.3 million pounds in taxes for a five-year period starting in 2005. If the stated amount is compared with the estimated profit that Google achieved and considering the dividends paid to shareholders, the applied effective tax rate is three percent instead of the standard rate of profit tax which was 28% in the stated period. Another example is Facebook, which paid £4,327 in tax in 2014 and reported a pre-tax loss of £28.5m despite paying out bonuses to all its employees totaling £35.4m. The above shows that multinational corporations have the means and opportunities to use all legal options to reduce tax liability to a minimum with the help of tax and legal experts (Boccia & Leonardi, 2016).

In order to prevent tax manipulations that result in multinational corporations being subject to extremely low effective tax rates, the UK government, as part of the BEPS programe, enacted the Profit Shifting Act. It is a specific measure aimed at preventing profit shifting and entered into force on April 1, 2015. It is aimed at domestic companies or foreign companies with a permanent establishment that use legal entities or transactions without economic substance to exploit tax disputes. The tax rate is 25%, which is higher than the standard rate of corporation tax of 20%, to further incentivize businesses to report their profits within the UK (HM Revenue & Customs, 2019)

From 1 April 2020, the UK government introduced a digital services tax of 2% of revenue from search engines, social networking services and online marketplaces

that extract value from users located in the UK. It will apply to those businesses whose consolidated revenues from digital activities globally exceed £500m per year, with more than £25m coming from UK users. If we compare the mentioned thresholds with those proposed by the European Commission (750 million euros of annual income and 50 million euros of income generated in the European Union), we can notice that it is a similar order of magnitude. The UK government estimates the expected revenue from digital services tax at £280 million in the first year of taxation to £515 million in 2024, and the total cost of taxation is estimated at £8 million per year (UK Government, 2020). The argument is made that the tax on income from digital services is retrograde and unfair to companies that are just entering the market or are not highly profitable. To reduce the retrograde nature of the said tax, the Government of the United Kingdom decided not to tax the first 25 million pounds of income. Also, there is room for bilaterality in the form of regulations on reducing the tax liability by 50 percent if the other party to the digital transaction is in a country that has established a similar tax on digital services (UK Government, 2020). Taxable income from digital services will be considered any income that a company generates related to a social network, online search engine or online market. If one of the parties in the transaction through the online market is a user from the United Kingdom, all income from that transaction will be considered as income generated by extracting value from the user from the United Kingdom. Advertising revenue is generated from UK users if the ad is viewed or otherwise consumed by UK users (UK Government, 2020).

The government presented the mentioned tax as a short-term solution, believing that the optimal sustainable long-term solution is the reform of international corporate tax regulations, and they strongly support the efforts of the OECD in this direction. The tax on digital services will be abolished when an adequate international solution is established (UK Government, 2020).

### **Case of Republic of India**

The Republic of India, the second most populous country in the world, represents a huge market for digital multinationals. As an example, the social network Facebook had over 300 million users from India, according to data from April 2019.

On February 29, 2016, the Government of the Republic of India introduced, following the OECD framework from the Action 1 report, an equalization levy at the rate of six percent on all payments to non-residents by introduced in France and Great Britain, we can argue that it is a simpler measure to apply. Unlike the French model, it does not require an in-depth analysis of the revenue structure on the part of the service provider, instead the responsibility is shifted to the recipient of the service. When paying for services related to online advertising, he is obliged to establish the recipient's residency and, if the annual transactions with that recipient exceed the given threshold, to suspend the six percent payment in the name of equalizing levy. residents or permanent business units for digital advertising services. It only applies to payments between legal entities, if the total value of transactions in a year is over \$1,500. If possible, a non-resident can reduce his tax base in the country of residence by the specified amount. The equalization levy functions as a withholding tax; every resident and permanent business unit is required to withhold part of the payment at the rate of six percent when paying a non-resident online advertising service provider (EY, 2016).

Comparing the said levy with taxes on digital services as a further measure to tax the digital economy, the tax authorities of the Republic of India have expanded the scope of the equalization levy. From April 1, 2020, the levy will also apply to income from e-commerce services such as the online sale of goods or the provision of services owned by the e-merchant or in which the e-merchant is only an intermediary. The levy is applicable if the recipient of the good or service is a resident of the Republic of India or uses an IP address located in India and if the e-merchant's gross revenue from the sale of goods and services to residents of India or users of IP addresses located in India exceeds \$267,000 (KPMG, 2020).

The equalizing levy represents a short-term tax measure by the Indian tax authorities until a long-term multilateral solution is found, and we can equate it in terms of durability with the taxes on digital services presented in France and Great Britain. One of the possible long-term solutions to the problem of taxation of the digital economy is the introduction into legislation of the concept of significant economic presence, which the tax authorities of the Republic of India did in 2018.

Activities that will constitute a significant economic presence are all transactions related to goods, services and real estate carried out by non-residents, including downloads of data and programs, the total value of which exceeds a certain amount and all types of regular and systematic business activities including interaction with users in India through digital tools (Sarvamangala & Farzana, 2022). The threshold of the total value of business activities after which a significant economic presence would be established has yet to be defined. When drafting the law, the Indian government invited the interested public and experts to a public debate on the height of the thresholds, but these thresholds have not yet been established. Therefore, the concept of significant economic presence is not actively applicable. The reason for this can be found in the fact that it is a bilateral legal concept that requires the coordination of several countries. The Republic of India is postponing the final establishment of the Institute of Significant Economic Presence until consensus is reached by OECD member states (KPMG, 2020).

## **RESULTS AND DISCUSSION**

From the researched literature regarding taxation of digital services and through examples of Republic of France, UK and Republic of India authors can conclude that they are taxing revenues achieved through provided digital services to citizens of their country. And basically, they have introduced some examples of profit tax on revenues from digital service which means that they are not taxing the end consumers of those services. Therefore, based on the good practices of examined countries authors conclude, as answer on the first research question, that taxation of digital services should be based on the revenues from these services.

The limitations of the research are reflected in the fact that, since the legislative solutions in France, United Kingdom and India are more recent, there is not enough data to build on deeper analyzes of the impact of taxes on taxpayers, their decisions or future decisions and plans, nor to the price level for tax-related services, both for the consumers themselves and for companies that use the services of multilateral digital platforms. Also, there are thresholds placed too high and it is not possible to conclude what the actor's behavior would be if they were set to lower levels. Because states

with proposed or adopted taxes concerning digital services obviously are moving in the direction of defining completely new concepts for taxation purposes (expansion of the definition permanent business units with the existence of a significant digital presence in certain criteria and taxation of revenues from digital services), therefore the proposals for the introduction of tax on digital services in Croatia are aimed at criteria and factors that are essential for the introduction, and which Croatia should look at and consider before the potential introduction itself. Croatia should do an analysis and weigh what it is the best thing to do considering many factors:

- If taxation of digital service will be adopted for EU, Croatia would probably not have to do very extensive analyzes because it does not decide on its own but together with others. At the same time, with such solutions, although each vote is equally valid, surely stronger and bigger countries would have a greater influence since Croatia's influence is on the international scene however limited. According to the proposals of two Directives of the European Union which were not accepted, i.e. high thresholds, it could be concluded that they are still more tailored, i.e. adapted to larger and economically stronger members. The question is whether with such thresholds we would even find companies that would be taxpayers in Croatia.
- If it will go unilaterally, Croatia needs to decide through which tax form to do so - through some existing, for example, the Profit Tax Law by extension the definition of a permanent business unit or by expanding taxable benefits through withholding tax, or through a new law. It makes no sense to introduce both at the same time. As for the legislative procedures, probably the extension of the existing law would be easier and take less time. Bringing of a completely new law, by the time the whole procedure goes through, it would probably take much longer. Of course, both provided that the Parliament accepts it.
- After determining through which law to introduce it, Croatia should consider the height of the thresholds. If the thresholds are kept high, there would probably be too few taxpayers covered. The question is whether there is any point in introducing such a tax and wasting time of other resources if what will be gained through such a tax will be less than the cost of tax introduction. Croatia could therefore introduce differentiated thresholds, i.e. threshold classes, such as exists in the Profit Tax Law, and apply a progressive rate or even some to each class progressive absolute amount. In this way, perhaps the tax burden would be better distributed. Of course, the opposition and resistance of both small and large companies should be taken into account because nobody likes paying new taxes. Croatia should therefore be sensitive when defining of what would be taxed and the amount of the tax itself. Heavy taxation of the income they generate a large value, with all the existing taxes and levies, could be understood as a penalty for performance on the market and influence over the company's decisions. That's why they should be careful about it because if the tax amounts does not represent an excessive tax burden, companies will perhaps avoid paying taxes less often and run the risk of non-payment less often. Also, Croatia could perhaps drop some of its existing taxable digital services in accepted or adopted laws from

other countries, eg taxation of data transfer from users.

- If the new tax were to be announced as only temporary until consensus is found on international level, it would probably cause resentment and anger from taxpayers who would not see the sense in adapting their systems for something that is temporary. Also, no one does love tax uncertainty. The new tax would represent an additional tax burden to taxpayers in the form of increased costs of adaptation and training of their financial employees. However, since the situation shows that this is a tax that certainly awaits Croatia, yes a consensual tax would probably not be much different, if the tax were introduced unilaterally from Croatia as a temporary solution, in fact one should be careful about the rhetoric and choice of words, i.e. emphasize to taxpayers that this is a useful preparation for future “permanent” solution and that, although it will probably incur higher initial costs, once it is introduced international consensual solution, systems and employees of taxpayers will to a large extent be prepared and trained and therefore it will be easier for them.
- When defining the main determinants of the law, IT experts should be included. Admittedly, it would be perhaps a little unusual cooperation, because these experts would participate in setting up a system by which they would be taxed. But without their cooperation taxable services, i.e., their measurement, could be defined by the tax authorities too far from reality, confusing and more difficult to apply in practice. Taxpayers could interpret them in their own way and thus having an open space for manipulation.
- The law should determine the mechanisms of control by the tax authorities, i.e., in what way tax officials, when they came to a company to inspect, would carry out the same and verify the accuracy data, i.e., the amount of taxpayers, for example, control of identification and “counting” of virtual one’s user accounts and user devices.

In order to answer on the second research question: *Is it possible to implement fair taxation of digital services*, authors believe that it is hard to comprehend all the problems and solutions on them in order to implement completely fair and objective tax on digital services for all the companies and all the countries, especially if this tax will be implemented internationally. The authors mentioned that factors influencing fairness are big data and physical presence of the digital company in some country. Big data collected by digital companies is digital capital created by users and it is considered as intangible asset of the digital companies. So, that is a key factor of production in digital economy (Koroleva, 2019). So, big data and physical presence or better significant economic presence are connected to the number of users of digital services. If we look at the criteria for establishing a significant economic presence proposed by the European Commission, which are an annual income of more than seven million euros in a member state, more than 100,000 users in a member state during the business year, or over 3,000 concluded business contracts on the provision of digital services between companies and business users during one business year, based on publicly available data we cannot specify the number of potentially covered companies. As a result of the above, we cannot analyze either the structure of the covered companies or their size and assess the effect of the mentioned thresholds. Also, in its proposal, the Euro-

pean Commission presented a single threshold for all member states, which directly benefits larger member states. The reason for this is that a foreign company is more likely to exceed one of the thresholds for establishing a significant economic presence in a country with 70 million inhabitants (like France) and be subject to taxation in that country compared to the Republic of Croatia and its 4 million inhabitants. The concept of significant economic presence is relative to the size of the economy. The authors opinion is that the taxation threshold should be set lower so that each member state has the option of taxation or the taxation threshold should be adapted to the number of inhabitants. If we adjust the mentioned thresholds to the number of inhabitants, taking into account the fact that the average number of inhabitants of a member state of the European Union is about 18 million, the adjusted and rounded thresholds for constituting a significant economic presence in the Republic of Croatia would amount to: annual income greater than 1,500,000 euros or over 22,000 users or over 650 concluded business contracts on the provision of digital services between companies and business users during one business year. In his work, (Cui, 2019) presents an argument about the archaic nature of the concept of a permanent business unit. It states that opponents of a tax on digital services income fail to provide any valid reason why the UK government does not have the legitimacy to tax income. The only argument is the legal absence of a permanent business unit. But that argument further supports the UK government's actions and their claim that the traditional permanent establishment criterion fails to properly capture income from the digital economy, which can be done without using the permanent establishment concept. An important factor in the determination and taxation of permanent economic presence is the fact whether there is an agreement on the avoidance of double taxation concluded with the country in which the company that achieves a significant economic presence is a resident.

## CONCLUSION

Digitalization is the most important trend in the modern economy. Market participants are shifting their business to the virtual world, and the use of social networks for marketing purposes is a prerequisite for most companies to operate successfully. The adaptation of the legal framework, especially tax regulations, to the emergence of the aforementioned social networks and general digitalization is becoming the focus of tax legislation in the countries of the European Union and the world. The tax on digital services represents both an opportunity for tax authorities and a threat for today's largest companies. The estimated billions of dollars in revenue that this tax is expected to bring to state budgets speak to the importance of creating appropriate legal regulations. The responsibility for transforming the tax system adapted to the times of physical business into the tax system of the digital age lies primarily with the multilateral efforts of OECD member countries. As shown in the paper, any unilateral measure taken by one state inevitably leads to restrictive responses from other states and consequently stifles the free market. Consequently, any unilateral measure must be short-term, as an interim solution until the OECD establishes a full tax framework that incorporates the ideas presented of a virtual permanent business entity and changes in the application of transfer pricing. As an appropriate short-term solution, inspired by the examples of the United Kingdom and the Republic of France, and in line with the recommendations of the European Commission, the introduction of a tax on revenues from digital services



is proposed. Such a solution is unilaterally implementable, requires minimal intervention in the legal framework, raises revenue quickly, and is simple to apply. The concept of virtual permanent business entity is a complex tax law institute, the introduction of which requires a clear answer to the question of value creation and the existence of a significant economic presence.

Who creates value in the digital economy and who is more important in the production chain, the consumers or the producers? So far, we have not found an objective answer to this question, but we can conclude that the countries where digital companies are headquartered will have a different position than the countries where these digital companies operate remotely. Significant economic presence, on the other hand, is a digital age concept that will grow in importance over time. Consensus at the international level is necessary to ensure stability for the increasingly numerous and growing digital enterprises.

The authors set up two research questions for their research. The answer on first research question: What is the appropriate way to tax digital services was given through the researched literature regarding taxation of digital services and through examples of Republic of France, UK and Republic of India. Authors can conclude that they are taxing revenues achieved through provided digital services to citizens of their country. Therefore, based on the good practices of examined countries authors conclude, as answer on the first research question, that taxation of digital services should be based on the revenues from these services. In order to answer on the second research question: Is it possible to implement fair taxation of digital services, authors believe that it is hard to comprehend all the problems and solutions on them in order to implement completely fair and objective tax on digital services for all the companies and all the countries, especially if this tax will be implemented internationally.

If we look at the whole issue of taxation of digital services, we can see that this is currently the most important global tax issue. The priority is to create solid foundations, but also to allow the tax system to be flexible and self-developing. Rigid rules and the development of technology are not compatible, but the tax system must provide a complete framework that enables the development of the digital economy, but also allows states a fair share of the revenues generated. As a member of the European Union, Croatia has incorporated all applicable rules on taxation of digital services and trade into its tax system. As for additional taxation of the digital economy, Croatia has the option to wait for a solution at the international level or to introduce the tax unilaterally. Before unilaterally introducing it, Croatia should conduct an analysis and weigh what is best to do, considering many factors, e.g., through an existing or new law. With high thresholds for the application of the tax, as is the case in some countries, there may be no taxpayers in Croatia at all. One option would be to introduce more thresholds, i.e., create tax brackets or earmark the new tax - this would somewhat reduce taxpayer outrage over the new tax. In any case, Croatia should have exercised caution in defining and implementing laws and simultaneously linking the tax and IT professions. The impossibility of reaching a unified solution for the taxation of the digital economy at the level of the European Union, as well as the failure of an international consensus solution at the level of the OECD and even threats of trade wars show how sensitive this issue is.

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