



# COMMISSION EXPERT GROUP ON TAXATION OF THE DIGITAL ECONOMY

## Report

All members of the Expert Group contributed as independent experts not representing their employers or organisations. The views set out in this report are those of the members of the Expert Group and do not necessarily reflect the official opinion of the Commission or of the employers and organisations for which the members of the Expert Group work.

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## **PREFACE**

The *High Level Expert Group on Taxation of the Digital Economy* was established by Commission Decision C(2013)7082 final of 22 October 2013. The Group had a chair and six members that were selected following a call for applications. The Group was composed as follows:

- Mr Vítor Gaspar (Chair), Special Advisor to the Banco de Portugal;
- Mr Pierre Collin (member); Membre du Conseil d'Etat, France;
- Mr Michael Peter Devereux (member), Professor at Oxford University, UK;
- Mr Jim Hagemann Snabe (member), co-CEO of German based SAP AG;
- Ms Tea Varrak (member), Innovation and Business Centre 'Mektory', Estonia;
- Ms Mary Walsh (member), Independent Consultant, Ireland;
- Mr Björn Westberg (member), Professor at Jonkoping International Business School, Sweden.

The Group met four times in Brussels to complete its work: on 12 December 2013, on 14/15 January 2014, on 13/14 March 2014 and on 24/25 April 2014.

During the term of the Group Mr Pierre Collin was appointed as member of the cabinet of Mr Moscovici, Minister of Finance in France. He continued participating in the Group's meetings and contributed to the Group's analysis. However, to avoid a potential conflict of interest, Mr Collin did not intervene in the establishment of the Group's final conclusions.



## **EXECUTIVE SUMMARY**

The economy is becoming digital. Digitalisation is the process of spreading of a general purpose technology. The last similar phenomenon was electrification. Digitalisation of products and services shortens distances between people and things. It increases mobility. It makes network effects decisive. It allows the use of specific data to such an extent that it permits the satisfaction of individual customer needs – be it consumers or businesses. It opens up ample opportunities for innovation, investment, and the creation of new businesses and jobs. Going forward it will be one of the main drivers of sustainable growth.

The High Level Expert Group on Taxation of the Digital Economy (henceforth “the Group”) believes that digital technology offers great opportunities for Europe. Europe can boost its prospects for growth and jobs if it realises the Digital Single Market and if it taps the digital potential of the Single European Market. The Group is also persuaded that digital technology offers the means to strengthen the fight against tax evasion and avoidance, while, at the same time, lowering administrative and enforcement costs. Hence it is feasible to have a tax system that is capable of collecting tax revenues effectively while, at the same time, enhancing entrepreneurial risk taking. The Group discussed extensively the principles that should guide international taxation. It identified economic efficiency, distributional equity as well as efficiency and effectiveness in tax administration and enforcement as fundamental. More specifically tax systems should be simple, stable and, as far as possible, neutral. The application of these principles leads to some general conclusions:

- First: there should not be a special tax regime for digital companies. Rather the general rules should be applied or adapted so that “digital” companies are treated in the same way as others.
- Second: digitalisation strengthens the case for simple, stable and predictable tax rules. Digitalisation lowers the costs for small and medium size enterprises to access the Single Market. Hence, a well-coordinated tax system, simple to comply with and to administer and inspired by best practices becomes a necessary condition for digital technology to realise its Single Market potential. Tax barriers for small and medium sized enterprises (SME) operating in the Single Market should be removed.
- Third: tax incentives and credits should be approached with caution and be carefully assessed both ex ante and ex post. In general any departure from neutrality and simplicity should be justified on grounds of market failure including the benefits of positive externalities. In addition it is also necessary to argue that tax instruments are effective and, indeed, the most effective instrument to tackle market failure.

The Group welcomes the general consensus that the destination principle – that is taxation at the place of consumption – is the way forward for VAT. Theoretical reasoning and empirical evidence point to international tax neutrality for VAT. Hence the Group is of the view that the Commission and Member States, in the field of taxation, should commit to eventually apply the destination principle to all goods and services. At the same time the Group supports the incremental approach proposed



by the European Commission. In this approach the overall goal is pursued through a series of initiatives that are carefully designed and monitored over time.

The Group welcomes the implementation, in 2015, of the place of supply rules and of the mini One Stop Shop (MOSS). These new rules and procedures should provide, as experience accumulates, the basis for further developments. In particular the Group encourages Member States to coordinate their audit actions so as to avoid the accumulation of excessive burdens on businesses. This aspect is fundamental for further developments.

The Group is also of the view that a broader One Stop Shop (OSS) should be considered so as to encompass all B2C supplies of goods and services. A functional and generalised OSS approach would considerably lower the cost for SMEs doing business in the European Single Market. Tax administration and enforcement would be crucial for success. Legislative initiatives, cooperative procedures and a significant amount of trust among national tax administrations would be required.

One example where digital technology could be instrumental is the termination of the small consignments exemption. The abolition of the exemption could be envisaged in the context of the introduction of a broader OSS. It would ensure a level playing field between EU and non-EU suppliers.

These considerations are also relevant at the global level. The Group is of the view that the destination principle should apply globally. To this end the destination principle could apply to all cross-border B2C transactions. Consideration should be given to extend international tax treaties to consumption taxes. The EU encourages work at global level to amend the model tax convention. Information exchange is another area that deserves careful work at global level.

The Group recognises that the increased mobility associated with digital technologies exacerbates challenges faced by current direct tax systems. In particular, there is a perception that some multinational companies are in a position to avoid or circumvent taxation. That is a main motivation for the project on Base Erosion and Profit Shifting (BEPS) which is being conducted under the aegis of the OECD. Given the nature of changes in the business environment and the political priority for immediate action at international level, the process of adapting international rules should be evolutionary in nature to achieve the best chance of success.

The Group considers that it is in the best interest of the EU if Member States speak with one voice in the G20/OECD BEPS project to support a successful conclusion. In order to achieve this, it would be necessary for Member States to agree on a common position.

The Group is of the view that the only immediate practical way forward at the global level is via the G20/OECD BEPS project. The Group recommends that priority should be given to three specific areas:

- Counter harmful tax practices;
- Review transfer pricing rules; and
- Restore the taxable nexus connections.

*1. Counter harmful tax practices:*

- In line with the principles of the Code of Conduct (business taxation), the Commission should encourage EU Member States to pursue gradual global recognition and adoption of the notion that attracting foreign investment and business activity should not be an excuse to compromise on international partnership and cooperation.
  - Concerning hybrid mismatches, the Group recommends that the global implementation of the technical solutions that are being developed in the context of the G20/OECD BEPS project be guided by the notion that all countries have an obligation neither to facilitate nor encourage the use of mismatch arrangements.
  - Concerning Controlled Foreign Corporation (CFC) provisions, the Group takes the view that, in the context of international trust and cooperation, countries have a responsibility to apply their CFC and other anti-avoidance measures if the tax base of partner countries is being eroded.
  - Concerning circumvention of withholding taxes through treaty shopping, the Group believes that countries have an obligation to work cooperatively to prevent base erosion, by disclosing relevant information to affected countries. Also, in negotiating bilateral tax treaties, treaty partners must consider how the provisions might be abused and must seek to ensure as far as possible that the treaty contains remedies that can counter abuse.

*2. Review transfer pricing rules:*

- The Group recommends that the Commission and the Council undertake a fundamental review of transfer pricing standards in order to:
  - enable tax administrations to ignore the intercompany transfer of IP in extreme circumstances such as a lack of economic substance and the creation of a tax benefit as the main purpose; and
  - examine the feasibility of disregarding the contractual allocation of risks and related attribution of profits amongst group entities if the risks are actually borne by the group as a whole and the allocation therefore lacks economic substance.

*3. Restore taxable nexus provisions:*

- The Group believes that there is no convincing argument why the collection of data via electronic means in a country should in itself create a taxable presence in that country.
- The Group believes that, given the business models applied in the digital economy, the way in which the concepts relevant for establishing taxable

presence are defined and applied should be reviewed. The Group suggests that the review should focus on two elements:

- The Group supports work within the G20/OECD BEPS Project considering whether and under what circumstances sales of goods or services of one company in a multinational group should be treated as effectively concluded by dependent agents.
- When defining exceptions to the concept of a PE, the Group recommends taking into account that the digitalisation of the economy may have changed the distinction between auxiliary activities and core activities.

In the OECD the EU should support the simplest solutions to achieve these ends, bearing in mind the need to apply the same approach across all BEPS actions and the importance of respecting the Single Market principles. Once there is agreement on BEPS actions, the EU should implement the most simple and effective solutions between its Member States on the assumption that the OECD may agree to a number of options. In any case, partial, piecemeal changes to the existing tax system should be managed to avoid adding additional layers of complexity.

While underlining the importance of a successful implementation of the OECD BEPS Action Plan, the Group is of the view that, from a longer term perspective, it would be important to consider the possibility of more profound changes in international corporation tax that go beyond addressing the immediate challenges.

For example, the EU should examine to what extent the new international standards and in particular movement towards transfer pricing profit split methods would justify additional simplification within the EU, particularly if the new rules generate significant costs. This could be done in the Council in the context of the continuing examination of CCCTB proposals.

Given the pace of technological development and the need to avoid creating barriers to trade more fundamental changes to the corporation tax system such as a destination based cash flow system could also be looked at, combining, if appropriate, various different building blocks to create an acceptable and workable system on the basis of the principles of neutrality and simplicity.

Despite on-going research on a destination based cash-flow tax, much more information and analysis would have to be gathered before a policy line could be agreed. This will also require a common understanding and acceptance of the notion of unacceptable tax practices applied by jurisdictions. In the Group's view, the consideration of radical proposals could assist in thinking about conceptual issues and underlying evolutionary dynamics that the current debate on BEPS leaves aside.

## LIST OF ACRONYMS

B2B	-	Business to Business
B2C	-	Business to Consumer
BEPS	-	Base erosion and profit shifting
CCA	-	Cost contribution agreement
CCCTB	-	Common consolidated corporate tax base
CFA	-	Committee on Fiscal Affairs
CFC	-	Controlled Foreign Corporation
CJEU	-	Court of Justice of the European Union
CoR	-	Committee of the Regions
CTPA	-	Centre for Tax Policy and Administration
DSM	-	Digital Single Market
ECB	-	European Central Bank
EESC	-	European Economic and Social Committee
EP	-	European Parliament
EU	-	European Union
G20	-	Group of 20, an economic forum consisting of 20 of the world's largest economies, including the EU
GDP	-	Gross Domestic Product
GPT	-	General Purpose Technologies
ICT	-	Information and Communication Technology
IP	-	Intellectual Property
MOSS	-	Mini One Stop Shop
OECD	-	Organisation for Economic Co-operation and Development
OSS	-	One Stop Shop
PE	-	Permanent Establishment
PIT	-	Personal Income Taxation
PWB	-	Program of Work and Budget
R&D	-	Research and Development
SCAC	-	Standing Committee on Administrative Cooperation
SCIT	-	Standing Committee on Information technology
SEC	-	Security and Exchange Committee
SSC	-	Social Security Contributions
SME	-	Small and Medium-sized Enterprises

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- TEU - Treaty on European Union
- TFEU - Treaty on the Functioning of the European Union
- UN - United Nations
- VAT - Value Added Tax

## **1. DIGITAL ECONOMY: FACTS, TRENDS AND DEVELOPMENTS**

### **1.1. Characteristics of the digital economy**

The digital economy is the result of the transformational effects of new General Purpose Technologies (GPT) in the fields of information and communication. It has implications beyond the Information and Communication Technology (ICT) sector, impacting all sectors of the economy and society: retail, transport, financial services, manufacturing, education, healthcare, media etc. Furthermore, the internet empowers people by enabling them to create and share ideas, giving rise to new content, entrepreneurs and markets as well as new opportunities for innovation and employment. The Group believes firmly that the digital economy offers great opportunities for Europe including solutions and opportunities to radically simplify tax administration and collection. Nevertheless, the digital economy also poses new challenges to which our tax systems will need to adapt.

Defining what constitutes the digital economy has proven problematic, because of the ever-changing technologies of the ICT sector and the widespread diffusion of the digital economy within the whole economy; it can no longer be described as a separate part, or subset, of the mainstream economy. However, it is possible to characterise it through a set of key features: mobility, network effects and use of data.

#### *1.1.1. Mobility*

The digital economy allows a new unprecedented level of mobility. Digitalisation has made intangible assets more important than physical production; since a digital product can be replicated at almost no cost once its blueprint<sup>1</sup> has been developed, the location of development of this blueprint is where value is often created.

Digitalisation has allowed companies to reduce core business costs. Factors of production are more mobile; ICT driven cost reductions enable firms to outsource many corporate functions to territories with lower costs. Digitalisation enables firms to benefit from lower workforce costs per unit of value because many processes can be automated.

The geographic mobility of products has greatly increased since the cost of storing and transporting digital products is virtually zero. This enables companies to operate in markets anywhere in the world, exposing local markets and firms to additional competition. Tax authorities may see a reduction in tax receipts because indirect taxes are difficult to collect and the foreign producer does not have a presence for direct tax.

Digitalisation has enhanced mobility between products; analogue versions are losing market share to digitised products (e.g. media content, 3D printing). The migration from ICT hardware ownership towards cloud-based ICT services has enhanced the mobility between goods and services. Consumers are increasingly able to access and

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<sup>1</sup> Legal protection could be by reference to a patent, a trademark, a copyright or trade secret.

utilise services for a limited period rather than buying outright. This blurring of the distinction between the producer and consumer (the "prosumer") could cause challenges for tax authorities since identifying producers becomes more difficult.

#### *1.1.2. Network effects*

Digitalisation pushes down marginal cost of products and an equal pressure applies to prices. New digital companies may have low gross margins on their products, and to be profitable they need huge scales of operation in order to cover fixed costs. Rapid growth to a large scale is a necessary feature of their business model which becomes sustainable thanks to the lowering of geographical barriers (as seen above). Since the room for competition in price is limited, the competition occurs in the quality and utility of the products, allowing price above marginal cost as monopolistic competition theory suggests.

New digital companies engage in a fierce race to innovate in order to create better or new product lines; small differences in quality can cause millions of consumers to switch, translating into potentially huge profit differences. This winner-takes-all model - where companies compete dynamically for the market (i.e. defining new markets through innovative products) rather than in the market (i.e. increasing market share) - creates monopolies and high volatility since these monopolies are highly contestable through innovation.

The 'winner-takes-it-all' model is particularly visible in the creation of dominant platforms through network effects, whereby consumers enjoy more utility from a product the more other people use that product.

A specific type of network effect is increasingly prominent: the two-sided network, whereby two groups of users interact with each other<sup>2</sup> - the utility to one group of users increases with the size of another group of users<sup>3</sup>. All major digital players provide digital platforms (e.g. online marketplaces) where the two sides of the market can meet and they charge fees to both or (more usually) one group of users. The reduction in transaction costs (both fixed and marginal) allowed by these platforms and the enlargement of the potential market through their networks has allowed a growing number of firms to offer their products thereby increasing customer choice.

#### *1.1.3. Importance of data*

ICT continuously drives down the cost of collecting, storing and analysing data following Moore's law<sup>4</sup>. This has helped to reduce transaction costs, many of which

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<sup>2</sup> The interaction can be by reference to a transaction in which case it would be a two-sided "market".

<sup>3</sup> In the old economy an example of this model is the credit card business where the credit card holders enjoy larger utility the greater the number of merchants that accept it as a payment and vice versa, the more merchants accept it, the larger the number of users.

<sup>4</sup> Moore's law is a prediction made sixty years ago by Intel's cofounder Gordon E. Moore that the number of transistors on integrated circuit would double every two years. The prediction turned out to remain quite accurate in the decades to follow also because it's taken as an objective in development plans of micro-processors' manufacturers. Other digital quantities like the data storage and processing capacity, the number of pixels in digital cameras follow this empirical law.

are information related, making many more market transactions possible than previously.

ICT has also driven down costs for consumers in terms of price and choice via the emergence of competing online market-places offering a wide range of products.

Consumer behaviour - web-clicks, online purchases, search engine entries, peer-reviews of products and so on - has contributed to the accumulation of vast amounts of data, referred to as Big Data, which offers additional possibilities in an increasingly digitalised economy. Online platform providers process and analyse Big Data to find meaningful correlations in order to specifically target products and services to individual consumers.

Furthermore, Big Data has helped digital firms develop innovative goods and services, with lower costs associated with innovation, in terms of measurement, experimentation, sharing and replication than in the pre-digital age. It is now possible to measure and analyse phenomena to an extent never imaginable before, thus making it easier to run controlled experiments and measure their success with great precision. Digitalisation enables companies to run hundreds of controlled experiments every day. An innovation can then be shared easily and developed further within an organisation or community – and quickly replicated on a vast scale.

Digitalisation enables enterprises to increase competitiveness by meeting individual customer needs more accurately and by optimising value chains.

## **1.2. Defining and measuring the digital economy**

Digitalisation has emerged in recent years as a key economic driver that accelerates growth, transformation and value creation. It is evident that digitalisation has had a dramatic effect on the economy as a whole, and it is likely that this tendency will accelerate in the future. However, attempts to measure the impact have proven problematic.

Booz & Company's econometric analysis estimates that, despite the unfavourable global economic climate, digitisation created a 193 billion USD boost to world economic output and created 6 million jobs globally in 2011.<sup>5</sup> On the macro side, Van Ark et al. (2014)<sup>6</sup> calculated that 64% of the growth in labour productivity in the US between 1995-2007 was led by ICT (and complementary) investments. The equivalent contribution in the EU15 was only 57% and for a much lower total.

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<sup>5</sup> *Digitization for Economic Growth and Job Creation: Regional and Industry Perspectives*, Booz & Company ([http://static.wamda.com/web/uploads/resources/BoozCo\\_Digitization-for-Economic-Growth-and-Job-Creation.pdf](http://static.wamda.com/web/uploads/resources/BoozCo_Digitization-for-Economic-Growth-and-Job-Creation.pdf))

<sup>6</sup> van Ark B., van Welsum D. and Overmeer W. (2014), "Unlocking the ICT growth potential in Europe: Enabling people and businesses - Using Scenarios to Build a New Narrative for the Role of ICT in Growth in Europe", a study prepared for the European Commission (DG CNECT) by The Conference Board.



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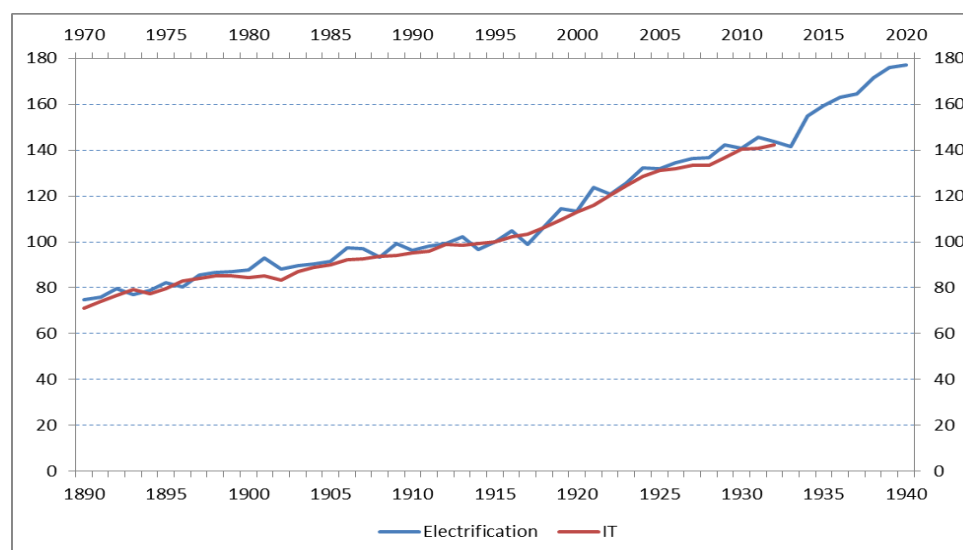
*Table 1: Comparison of EU and US ICT growth impacts (1995-2007)*

	<b>EU15</b>	<b>US</b>
GDP growth	2.2	3.1
Labour productivity growth	1.3	2.0
<b>Contributions to Labour Productivity growth:</b>		
• IT investment/hour	0.4	0.7
• Multi-Factor Productivity from ICT production	0.3	0.5
• Multi-Factor Productivity from ICT use	0.1	0.1
% points IT contribution to Labour Productivity growth	0.7	1.3
Total IT as % of Labour Productivity growth	57%	64%
Total IT as % of GDP growth	34%	41%

Source: Van Ark et al. (2014)<sup>7</sup>

Syverson (2013)<sup>8</sup> compared labour productivity growth during the electrification era and the IT-era (Figure 2) with an impressively similar pattern.

*Figure 1: Labour productivity Growth during the Electrification Era (1890-1940) and the IT Era (1970-2012) in the United States (1915=100 and 1995=100)*



Source: Calculations based on Kendrick (1961) and US Bureau of Labour Statistics data.

<sup>7</sup> Byrne D.M., Oliner S.D., and Sichel D.E. (2013), "Is the Information Technology Revolution Over?", International Productivity Monitor, No. 25, Spring. Mas M. (2012), "Productivity in the Advanced Countries: from Expansion to Crisis," in: Matilde Mas and Robert Stehrer, eds., Industrial Productivity in Europe. Growth and Crisis, Edward Elgar, Cheltenham. Van Ark B. (2013a), "Recent Changes in Europe's Competitive Landscape and Medium Term Perspectives: How the Sources of Demand and Supply Are Shaping Up", The Conference Board Economics Program Working Paper EPWP 13-05, The Conference Board, New York. Van Ark B. (2013b), "Europe's Productivity Performance in Comparative Perspective: Trends, Causes and Recent Developments", in D.S. Prasada Rao and Bart van Ark, eds., World Economic Performance. Past, Present and Future. Edward Elgar Publishing, pp. 290-316.

<sup>8</sup> Syverson C. (2013), "Will history repeat itself? Comments on 'Is the Information Technology revolution over?'" , International Productivity Monitor, Vol. 25, pp. 25-36.

The analysis referred to above by Booz & Company reveals that an increase of 10% in a country's digitalisation score fuels a 0.75% growth in its GDP per capita. Creating digital markets and boosting digitalisation can yield significant economic benefits and lead to substantial social benefits to societies and communities. Digitalisation has the potential to boost productivity and enhance competitiveness. In the current economic environment digitalisation can play an important role in assisting policy makers to enhance competitiveness and spur economic growth and employment.

### **1.3. Trends in the digital economy**

ICT-driven innovations which affect the whole economy will exert a further competitive pressure on businesses which will be forced to invest in knowledge. A strategy based on cost reduction will not survive in markets based on innovation. A global reach will be necessary for products displaying both very low marginal costs and network effects. Increasingly, micro-multinationals<sup>9</sup> will come to the fore, particularly in terms of job creation.

Emerging trends in ICT (see Annex 1) will increase the move towards this model by promoting greater use of technology at the expense of other factors of production. Cloud technology, 3D printing and the Internet of Things will reduce fixed capital investment costs of starting a business - lowering barriers to market access. Conversely, technologies such as advanced robotics, autonomous vehicles and automation of knowledge work (by expert systems) will have a profound impact as many jobs will be replaced by machines.

Digital entrepreneurs and key specialists in the emerging business models will be critical in the future workforce. This will require a mix of entrepreneurial, creative, problem-solving and specialist skills. Work patterns and job contracts will change: the traditional working model is likely to be replaced by flexible working patterns adapted to the needs of the business; remuneration may be more correlated to the fortunes of the enterprise and careers may well involve shorter periods in a given company than in the past.<sup>10</sup>

### **1.4. Digital challenges for the EU**

The completion of the Single Market - and the Digital Single Market (DSM) in particular - will be key to enabling job and value creation. To maximise the benefits that can be derived from a DSM, existing barriers must be overcome and it is essential that no new fiscal barriers are raised to companies wishing to exploit the huge opportunities open to them. Factors limiting the capacity of the EU to create and attract new companies, such as digital start-ups, include:

- A lack of entrepreneurship and of entrepreneurial culture: Indeed, there is evidence that Europe lacks entrepreneurial skills to move new research results

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<sup>9</sup> See: <http://www.lisboncouncil.net/publication/publication/67-the-rise-of-the-micro-multinational-how-freelancers-and-technology-savvy-start-ups-are-driving-growth-jobs-and-innovation.html>

<sup>10</sup> Another element is that increased competition would mean shorter lifespan for companies.

into start-up business development in *Further lessons from ICT innovative industries* cases.<sup>11</sup>

- A lack of an appropriately skilled workforce, which calls for a new education strategy for preparing young generations for the skills needed in the digital age and a training strategy to upskill those already in the workforce and those involuntarily unemployed.
- A lack of access to finance: Venture Capital finance (and Business Angel financing which is found extensively in digital start-ups) is scarce and fragmented.
- A rigid labour market: Micro-multinationals need only very few people to run efficiently and they must be able to draw on the best talent. Hence, rigid labour markets may create barriers.

These topics clearly go beyond the mandate of the Group, but are nevertheless critical in order for the EU to be able to leverage the digital opportunity.

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<sup>11</sup> New ICT sectors: Platforms for European growth? (Reinhilde Veugelers), <http://www.bruegel.org/publications/publication-detail/publication/745-new-ict-sectors-platforms-for-european-growth/>.

## 2. INTERNATIONAL TAXATION IN THE DIGITAL ECONOMY

In this Chapter we identify relevant guiding principles for international taxation that underpin our analysis of policy options. We then describe the relevant business models in the digital economy and their implications for value added tax (VAT) and corporation tax. Finally, we describe the current international debate about taxation and the digital economy.

### 2.1. Principles of taxation

We focus on three guiding principles for international taxation: (1) economic efficiency, (2) distributional equity and (3) efficiency and effectiveness in compliance and administration.

#### 2.1.1. General economic efficiency

Most taxes affect the behaviour of economic agents – individuals and businesses. A starting point in identifying a good tax system is one that minimises these effects on behaviour – such a tax generally results in "production efficiency".<sup>12</sup> This is an important starting benchmark for the design of international tax systems. Not all distortions to behaviour harm the economy; in principle, governments could use the tax system to encourage activities that create value for society (such as expenditure on R&D), or to discourage activities that harm society (such as polluting activities). But, in the absence of a clearly-defined and well-specified goal, distortions result in a cost to society.

Some effect on economic activity is inevitable in any tax system; but the costs created by taxes depend on the design of the tax. Some forms of taxation create minimal distortions. For example, a tax on the economic rent earned on an investment<sup>13</sup> should, in principle, not affect the scale of the investment. Nevertheless, even such a tax will affect location decisions if the proportion of economic rent taken in tax differs between locations.

#### 2.1.2. Economic efficiency in an international setting

In an international setting, two broad types of distortion give rise to departures from production efficiency that arise in addition to those in a domestic setting: firstly, the international location of economic activity or income and secondly, the differential treatment of competing agents. Any such distortions to competition imply deviations from efficiency in production.

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<sup>12</sup> Under certain conditions, notably that pure profits are taxed at 100% and there are no restrictions on the distorting tax instruments, then this should be a feature of optimal tax systems: see Diamond, P.A. and Mirrlees, J.A. "Optimal Taxation and Public Production I–II", *The American Economic Review*, March, June 1971, 61, pp. 8–27 (Part I: Production Efficiency) and 261–278 (Part II: Tax Rules). Further conditions apply in an open economy: see Keen M. and Wildasin D. "Pareto Efficient International Taxation", *The American Economic Review*, March 2004, 94, pp. 259–275.

<sup>13</sup> This concerns the return over and above the minimum required rate of return.

The effects of taxation on the location of economic activity depend on the mobility of economic agents, capital, goods and services. The more mobile such factors, the more probable it is that differences in taxation between locations may affect location choices. At one extreme, natural resources are immobile.<sup>14</sup> At the other, the location in which intangible assets are owned can be very mobile.<sup>15</sup> This suggests that to minimise distortions to the location of economic activity taxes on income or spending should be levied in locations in which that income or spending is relatively immobile. For example, consider the taxation of income of an individual who saves in financial assets in many countries. Leaving aside tax administration and compliance, a tax on worldwide income from her savings levied in her residence country should have no effect on where she saves; the tax can only be escaped if she decides to move to another country. By contrast, a tax levied in the location in which she saves is likely to affect her choice of where to save.

Taxes can also affect where real economic activity occurs and even where income is declared for the purposes of taxation. Multinational companies, under existing national and international tax rules can shift profit – and hence tax revenue – between countries. Such profit shifting is considered to be particularly widespread in the case of companies making intensive use of digital technologies in their international activities. While digital companies may be more extreme in this regard, these issues also arise elsewhere.<sup>16</sup>

The second type of distortion arising at an international level is a distortion to competition between businesses.

We illustrate competition between businesses with an example. Suppose two similar companies, X and Y, are resident in two different countries and compete with each other in a third country Z. The competition may involve selling similar products to final consumers in Z, or, say, acquiring a particular target company in Z. If X and Y are subject to tax at different rates in their residence countries, then competition may be distorted. For example, a tax advantage to X may enable X to undercut Y's price in selling to a final consumer, or allow X to pay a higher price for the target company. By contrast, if tax were levied only in country Z, then both countries would face the same tax rate on their activities in Z and these distortions to competition would be avoided.

A different form of competition is tax competition between governments as they attempt to attract either economic activity or related tax revenue. Nominal corporation tax rates over the last 30 years in the EU and elsewhere have dropped significantly; for example, across 28 countries in the OECD or G20, the average rate fell from around 47% in 1983 to around 27% in 2012.<sup>17</sup> It is generally agreed that

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<sup>14</sup> Although, even in the case of natural resources, there may be important international spillovers (e.g. associated with a common pool of oil or natural gas).

<sup>15</sup> The mobility of intangible assets could for example be restricted if there is a tax charge upon the intercompany transfer of such assets, also known as 'exit tax'.

<sup>16</sup> Highly mobile intellectual property is found in other industries such as pharmaceuticals as well.

<sup>17</sup> See Bilicka K. and Devereux M.P. (2012) "CBT Corporate Tax Ranking 2012", Oxford University Centre for Business Taxation report, p. 25.

one important factor in this gradual decline is competition between governments for economic activity and related tax revenue. However, tax competition may also take a more invidious form, such as more generous treatment of foreign source income, or of income related to mobile income generators such as the ownership of capital and intellectual property (IP) that is unrelated to real economic activity. While such tax competition seems very likely to have reduced aggregate corporation tax revenue, it may have benefitted those jurisdictions competing unfairly for mobile economic activities. Unless there is enforceable international regulation or coordination, unfair tax competition seems inevitable in an international tax system in which the location where corporation tax is levied is based in relatively mobile income generators.

By contrast, there has been little evidence of tax competition between Member States due to VAT rate differentials. A fundamental reason is that VAT is generally levied in the country of the consumer. Since the place of taxation generally cannot be influenced by the enterprise, there is no point in governments competing over VAT rates in order to attract internationally mobile business activities. A lower VAT rate in one country has an effect on the welfare of a neighbouring country only in relation to cases of cross border shopping, which may limit the VAT rate differential between neighbouring Member States. Beyond this, VAT rates within the EU are already subject to some form of harmonisation.<sup>18</sup> However, in the area of electronically supplied services, distortions of competition have been reported<sup>19</sup> in Business to Consumer (B2C) transactions which should in principle disappear in 2015 when the new rules on the place of supply of telecommunications, broadcasting and electronic services will generalise the place of supply at the place of the consumer.

### *2.1.3. Distributional equity*

It is vital that tax systems should be fair, and should be seen to be fair. This fairness has two dimensions – sharing tax revenues between countries, and sharing the cost of tax amongst individuals. Since this report concerns distributional equity in an international setting, however, it does not address the latter. This is justified under the assumption that equity across people is dealt with at national level.

The distribution of tax revenues between countries from taxes levied on international flows of goods, services, capital and labour has been the subject of considerable debate and to some extent has driven concerns about the taxation of the digital economy. It has been argued that countries should be entitled to tax income originating within their borders, because it is the “place of income-originating

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<sup>18</sup> The Council Directive 2006/112/EC sets a common system of VAT applied in all Member States. Concerning the rates, it provides in its Articles 93 to 130 and Annex III a legal framework for the application of VAT rates in the Member States, in particular a similar structure. This allows some flexibility to the Member States in the application of VAT rates but within certain boundaries. As a general rule, Member States must apply a standard rate of VAT of at least 15% to the supplies of goods and the supplies of services. However, they may apply one or two reduced rates of not less than 5% to an exhaustive list of supplies of goods or services mentioned in Annex III to the VAT Directive. However, electronically supplied services are explicitly excluded from the scope of reduced VAT rates.

<sup>19</sup> This is partly because of the application by some Member States of lower standard rates or reduced rates to electronically supplied services, the latter generally not allowed under the VAT Directive.

activity”.<sup>20</sup> However, this begs the question of what such an activity is. Although it could easily incorporate, say, production as well as sales, it must be remembered that the entire revenue from indirect taxation typically accrues entirely to the place of consumption, thereby allocating a significant share of aggregate tax revenue on cross-border transactions to the countries where the sales take place.

It has also been argued that under a principle of “inter-nation equity” each country should be allocated an equitable share of the tax base from cross-border transactions.<sup>21</sup> However, it is not easy to define what is an equitable allocation of, for example, the profit of a multinational group that operates in many producing and consuming countries. But a result in which some enterprises succeed in avoiding tax on a substantial part of their global income is generally regarded as unfair. In a world in which countries have different interests, a stable international tax system requires the consent of different countries, and an essential element of that is that it should be regarded as providing a fair distribution of revenues.

#### *2.1.4. Compliance and administration*

The costs of administration and compliance are a necessary feature of taxes. It is clearly a reasonable aim for a tax system that such costs should be kept to a minimum, whether the tax is domestic or international. The costs of complying with, and administering, international elements of tax, such as VAT and corporation tax, are particularly high, as both tax payers and tax authorities typically need to take into account international flows and rules. In some circumstances, the administrative costs of collecting tax may be smaller if they are borne by the tax authority of one country even though the revenues accrue to another country.<sup>22</sup> Clearly, such a degree of cooperation between tax authorities in different countries necessarily requires mutual trust and respect.

Administrative and compliance costs depend on the methods used by tax authorities in implementing a tax, but they also depend on policy choices in the design of a tax. An example of the importance of policy choices is where a tax treats two similar activities in different ways. Where this happens, taxpayers will have an incentive to choose the more lightly-taxed approach, and tax authorities need to police the borderline between them. A classic example is the tax advantage to debt finance over equity finance in corporation taxes. Such distinctions can create substantial administrative and compliance costs, as taxpayers, tax authorities and the courts attempt to distinguish between very similar contracts. These costs can be important in a domestic context, but they are likely to multiply in an international context as the choice of financial instrument may become a vehicle for tax planning.

Two other issues are also important from the perspective of administration. The first is fairness in the administration of taxes; taxpayers should be treated alike. The

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<sup>20</sup> Musgrave R. and Musgrave P. (1972), “Inter-Nation Equity”, in *Modern Fiscal Issues: Essays in Honour of Carl S. Shoup* (University of Toronto Press), pp. 63-85.

<sup>21</sup> See footnote 20.

<sup>22</sup> This is the rationale for the mini One Stop Shop, to be introduced for collecting VAT on supplies of electronic services in the EU from 2015.

second is transparency; taxpayers should be able to have a reasonable understanding of how the tax system operates. This could be taken further; in principle, transparency should extend to a reasonable level of stability – taxpayers should be reasonably certain how the tax system will operate in the future. Even apart from the normative case that taxes should be fair and transparent, lack of either is likely to lead to greater economic inefficiency.

## **2.2. Business models in the digital economy**

### *2.2.1. Description of relevant digital business models*

In considering how VAT and corporation tax should be applied in an international digital economy, it is useful to describe the typical business models that are applied in the digital economy. We distinguish three separate models set out below.<sup>23</sup> In these models, we distinguish two types of locations:

- D – the Destination countries: the places where the final goods are consumed.
- S – the Source countries: they comprise the set of different locations of the activities of the business. This includes marketing, sales, distribution, support, R&D, production, financing, management and other locations where the business owns assets and/or operates.

There are two more important locations, but they are not distinct in the different business models:

- P – the Parent country, where the parent company is resident and usually the location of the headquarter activities of the business.
- F – the Financing country or countries, the place of residence of individuals and companies who provide finance to the business, either as shareholders or debt holders.

#### 1) Physical e-Commerce models

This first model is the traditional e-Commerce business model from the 'physical' world. A physical product is made in S and sold online to a customer in D. Because the product is physical, the location of sales, distribution and support is typically in the same country as the customer, i.e. also in D, even though it may have been produced elsewhere.

#### 2) Digital e-Commerce and cloud models (product or service delivered digitally)

In the second model, the "product" is not physical but digital. It is either distributed over the web as a product or it is kept at a central data centre and distributed as a service. For the digital e-Commerce models, the main difference compared to the

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<sup>23</sup> The OECD in its Public Discussion Draft "*BEPS Action 1: Address the Tax Challenges of the Digital Economy*" of 24 March 2014 has made a similar description but identified more models. The Group concentrated on distinguishing the important features of these models from a tax perspective.



physical model is that a digital product can be distributed and supported from locations that are very distant from D. Similarly, for cloud services consumers access the central data centre from a location of their choosing (D), but the central data centre itself can be located in any S country provided there is internet access. Moreover, several customers can consume the same "product" at the same time (public cloud service), so the marginal cost of gaining additional customers is low. In model 2, the digital nature of the transaction – whether product or service – makes the S countries largely independent from the location of customers in the D country. Examples of these models are downloading in return for a fee or online streaming services in return for a fee.

### 3) Multi-dimensional models

The third model combines two or more dimensions. The first concerns a free digital service for a group of users in country D1. This dimension generates value by selling advertising seen by users in D1 within a second dimension possibly located in another country, D2. In the first dimension also typically data are collected from the users in D1 which allows the advertisements to be better targeted. The irrelevance of location is even more pronounced in the multi-dimensional model: the physical location of users in the first dimension can be different to the physical location of business customers in the second. Moreover, both are independent of S, the location of the service provider. Examples of these multi-dimensional business models include search engines, social networks or other free digital service websites combined with advertising business.

#### *2.2.2. Digital business models and their tax implications*

The different locations where business activities take place are relevant in determining where VAT and corporation tax are to be levied.

#### VAT

The fact that VAT is generally thought of as a tax on consumption and is even defined as such in Article 1(2) of the VAT Directive<sup>24</sup> implies that it should reasonably be levied in country D – the destination country. If the tax is levied in D, then the location of the activities of the business are not relevant for VAT. Consequently, in choosing the set of source locations the business will not be affected by the tax. Furthermore, if the tax is levied in D, businesses competing with each other to sell to consumers in D will all face the same rate of VAT thus avoiding distortion of competition. Therefore, it is reasonable to continue to implement VAT on sales of goods and services in the destination country. From 2015, in the EU sales of digital products to final consumers in country D will be subject to VAT in country D.

#### Corporation tax

Corporation tax is broadly a tax on corporate revenues, net of costs of labour, capital consumption/depreciation and other inputs. Under existing international tax

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<sup>24</sup> Council Directive 2006/112/EC.

standards, corporation tax is broadly levied in the set of "source" countries, S, in each of which the parent company P will have incorporated a separate subsidiary company. Tax may in some circumstances be levied in country P<sup>25</sup>, and indeed D, although only if there is a permanent establishment (PE) there. Corporation tax being levied in S is sometimes justified on the grounds that it can be seen as a form of "benefit" tax; the business uses publicly provided goods and services in countries in which it operates, and it should make a contribution to their costs through taxation.

In the multi-dimensional business model above, the business typically extracts information from users in D1 and uses this information to target advertisers in D2. The business provides the free use of its service such as a search engine or social network and 'in exchange' the user provides the information. This is, in effect, a barter arrangement. It is not obvious that the business creates any profit in the first dimension, and even if it does, it monetises it in the second dimension.

Allocation of profit across the different source locations puts pressure on the proper functioning of international corporation tax systems. These challenges are made more difficult by the key features of the digital economy described in section 1.1: mobility, network effects and data. They relate to how digital businesses create value initially and subsequently generate revenues from this value. Combined, they impact on the application of traditional methods to allocate profits from international business operations to the activities and functions that have generated the profits.

Addressing these challenges is part of the wider international debate about whether international (digital) corporations pay their fair share of tax within the combined project of the G20/OECD Project on base erosion and profit shifting.

### **2.3. The G20/OECD 'BEPS' project**

#### *2.3.1. BEPS general*

Following a series of press publications and parliamentary hearings, the international community led by the G20 has initiated a project on Base Erosion and Profit Shifting (BEPS).<sup>26</sup> The fundamental idea behind the project is that national and international corporation tax laws and standards may not have kept pace with the way global corporations run their business. As a result the locations to which taxable profits are allocated for corporation tax purposes differ from those where the actual business activity takes place. It is that discrepancy, as well as problems in identifying where relevant business activities take place, which the project aims to address.

The OECD BEPS Action Plan lists 15 separate actions. They are organised as separate elements that address the overall politically undesirable BEPS effects, e.g. excessive deduction of interest, harmful tax competition, treaty shopping or transfer pricing aspects related to intangibles. The G20/OECD BEPS Project primarily

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<sup>25</sup> Tax could arise in country P if the income of S is taxable in P under CFC rules, see section 5.2.1.2.

<sup>26</sup> See the BEPS Report: OECD (2013), Addressing Base Erosion and Profit Shifting, OECD Publishing. <http://dx.doi.org/10.1787/9789264192744-en> and the BEPS Action Plan: OECD (2013), Action Plan on Base Erosion and Profit Shifting, OECD Publishing. <http://dx.doi.org/10.1787/9789264202719-en>.

concerns corporation tax; nevertheless, there are also significant issues related to VAT in particular in relation to the digital economy.

### *2.3.2. BEPS and the digital economy*

Many of the high profile cases that have caused the public anxiety driving the political G20 BEPS agenda concern digital companies<sup>27</sup>. There is a perception, supported by some of the publically available data, that BEPS is especially prevalent in the digital economy.

Annex 2A and 2B provide an overview of the corporation tax charge in relation to income and sales for a sample of the largest digital and non-digital companies.<sup>28</sup> They all concern US multinationals because the data published under US public financial reporting rules are the only publicly available tax data that allow such comparison.<sup>29</sup> The data demonstrate that both samples of companies generally pay more tax on their US based earnings than on their non-US source earnings, but the difference is more pronounced for digital companies than for non-digital.

This difference and the prominence of digital economy related enterprises in discussions related to tax planning and BEPS, particularly in the EU, can be explained by a combination of elements:

- Digital companies are young and dynamic.

Even the largest digital firms are young enterprises. This has allowed them from the outset to structure their business in a tax optimised form, often locating the group's entities and its IP in locations with low corporation tax or VAT rates and/or with access to favourable double tax conventions. Mature companies often need to engage in costly and burdensome restructuring to achieve similar results involving legal and financial risk, which often causes internal resistance.

- Digital companies rarely pay out dividends<sup>30</sup>

Not paying dividends leads to tax advantages. Many of the digital global giants are US companies. In the US tax system, foreign profits are not subject to US

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<sup>27</sup> See for example the US Senate's Permanent Subcommittee on Investigations hearing on "Offshore Profit Shifting and the U.S. Tax Code - Part 2 (Apple Inc.)": <http://www.hsqaq.senate.gov/subcommittees/investigations/hearings/offshore-profit-shifting-and-the-us-tax-code -part-2>

<sup>28</sup> Using the FactSet, Google Finance, Morgan Stanley Research table of the top 25 digital economy companies by market value in 2013, financial data of seven of the top ten companies, available in US Securities and Exchange Commission (SEC) filings – Form 10 - K, were reviewed. In order to provide a comparison, SEC filings were also reviewed for seven of the largest non-digital economy companies (excluding oil).

<sup>29</sup> For non-US companies listed on the US stock exchange, there are no comparable data. These companies also file tax related information, but the requirements are different: it is not uniform across non-US companies and it is not uniform with the information contained for US companies.

<sup>30</sup> This is sometimes assumed to be the prevailing entrepreneurial culture in the digital economy. However, it is true that several large digital companies are starting to behave like "normal" companies and started to pay dividends. The difference in dividend policy therefore seems to be more one of young companies versus mature companies.

taxation until they are distributed. Not paying dividends to shareholders means there is no need to repatriate cash from foreign operations, thus effectively allowing the deferral of taxation on foreign profits. In theory this is a temporary deferral, but in practice almost permanent deferral seems to be the rule rather than the exception.

- Mobility: absence of physical presence in the market and mobility of profit drivers (IP)

Important business functions in digital companies take place on the web. As a result, they do not need a distinct physical presence in the markets in which they operate. This allows digital businesses to avoid creating a taxable presence in these markets. At the same time, some of the current international tax standards allow them to allocate a significant part of their global revenues to their internally developed IP and to locate this IP for tax purposes in locations that do not impose taxation.

- The nature of successful businesses in the digital economy

Several digital economy business/revenue models have been extremely successful in rapidly developing monopoly like positions and in rapidly generating significant revenues from the collection, processing and marketing of free individual data. In other words, the digital economy includes some extremely successful businesses that have generated enormous wealth in a short time frame. This makes the application of BEPS schemes correspondingly more beneficial for digital companies.

The Actions listed in the OECD BEPS Action Plan will to a large extent help to address these concerns. Nevertheless, the G20/OECD considers that the specifics of the digital economy including indirect tax issues merit listing the digital economy as a separate Action item number 1 in the OECD BEPS Action Plan. The OECD has been asked to deliver an in-depth report identifying tax challenges raised by the digital economy and the necessary actions to address them. A Task force on the Digital Economy has been set-up and released a Discussion Draft for public consultation on 24 March 2014<sup>31</sup> with public comments due by 14 April 2014.<sup>32</sup> The final report is due in September 2014.

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<sup>31</sup> See: <http://www.oecd.org/tax/discussion-draft-action-1-tax-challenges-digital-economy.htm>

<sup>32</sup> See: <http://www.oecd.org/tax/comments-action-1-tax-challenges-digital-economy.htm>

### 3. DELIVERING DIGITAL EUROPE

#### 3.1. Introduction

Young innovative companies are an essential engine for growth and jobs in the EU. In terms of (fast) growing companies, the EU performs worse than many of its global competitors.<sup>33</sup> One of the five targets of Europe's 2020 strategy is that 3% of the EU's GDP will be invested in research and development (R&D)<sup>34</sup>. Such policy targets are an important starting point. But it has also been convincingly argued that the EU will need a shift in mentality<sup>35</sup>, changing its view towards success and failure and rewarding entrepreneurial risk-taking rather than punishing it.

The fundamental barrier hindering the growth of EU digital businesses is regulatory fragmentation leading to the lack of a truly integrated DSM in the EU. Combatting fragmentation in European digital markets is a priority if the EU is to benefit from the new opportunities for innovation and employment that the digital economy brings. In addition, access to science and basic R&D and also access to skills to translate new research and innovation results successfully into start-up business development are key factors when delivering digital Europe.<sup>36</sup> Other identified barriers include gaps in education, deficiencies in data protection law and access to finance constraints.

The Group considers it important that tax systems contribute to the wider policy objectives, not disproportionately punishing entrepreneurial risk taking. For example, starting a new business is likely to be accompanied by initial losses in the start-up phase and uncertainty as to the timing and size of any future return on investment. Tax systems that take such realities into account when establishing rules for the tax treatment of losses would in general be more encouraging towards the development of young, innovative businesses including digital start-ups<sup>37</sup>.

Tax policy can be a powerful instrument in achieving economic policy objectives. In the Group's view the principles of simplicity and neutrality for tax systems should have priority over the introduction of specific tax measures. Overall coherence, stability and a level playing field within the (Digital) Single Market will set the

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<sup>33</sup> The following examples illustrate this point. Firstly, Europe shows a low performance in terms of business dynamic and growth. According to "Innovation Union Report" 2011 ([http://ec.europa.eu/research/innovation-union/pdf/innovation-union-communication\\_en.pdf#view=fit&pagemode=none](http://ec.europa.eu/research/innovation-union/pdf/innovation-union-communication_en.pdf#view=fit&pagemode=none)), in all European countries providing relevant data, high-growth enterprises represent less than 10% of all businesses, and young high-growth enterprises (less than five years old, i.e. 'gazelles') less than 1%. Secondly, in Europe less than 10% of business ideas take off. Few Europeans set up their own business, although many express an interest in doing so. The 'Eurobarometer Survey on Entrepreneurship 2012' found that 58% of Europeans would rather be an employee than self-employed; more than half of those who have never run a business say that it never crossed their minds to do so. Moreover, several indicators show limited business dynamism in the EU ([http://ec.europa.eu/public\\_opinion/flash/fl\\_354\\_en.pdf](http://ec.europa.eu/public_opinion/flash/fl_354_en.pdf)).

<sup>34</sup> See [http://ec.europa.eu/europe2020/europe-2020-in-a-nutshell/targets/index\\_en.htm](http://ec.europa.eu/europe2020/europe-2020-in-a-nutshell/targets/index_en.htm).

<sup>35</sup> Startup Manifesto - Help internet-driven economic growth transform the lives of millions (2013) <http://startupmanifesto.eu/files/manifesto.pdf>

<sup>36</sup> See footnote 11.

<sup>37</sup> This concerns for example the degree to which business losses can be deducted against other income.

conditions in which innovative ideas have the best chance of becoming a success. A well-coordinated tax system, simple to comply with and to administer and inspired by best practices is essential in the Single Market to stimulate the creation and growth of all businesses, including digital.

Finally, the Group concluded that digitalisation can also be seen as an opportunity to create a better tax administration and to develop less burdensome tax compliance rules.

## **3.2. Policy options**

### *3.2.1. General policy options*

The Group has taken as its starting point the simplicity and neutrality of tax systems, minimising economic distortions inherent to any real tax system. Neutrality, a general simplification of tax rules and better coordination or alignment of rules between Member States is of most aid to all businesses in the EU including in the digital economy. This levels the playing field and reduces the administrative burden in the EU.

The Group also notes that these general goals are particularly urgent in the digital era. It is now possible to get easy access to millions of users and/or customers worldwide which greatly increases the opportunity for start-up companies to expand rapidly becoming so-called "micro-multinationals". Start-up companies can develop into global leaders in a time frame not formerly considered possible. However, due to the importance of network effects for success or failure, new digital ideas, products and services of start-ups only stand a chance of becoming successful if they rapidly grow and attract large volumes of customers and users. Complex, uncoordinated and fragmented tax regulations make it extremely burdensome particularly for small companies and start-ups to operate throughout the EU and create a barrier for innovative technologies to spread rapidly. A functional DSM also creates the need to work towards an EU tax environment that accommodates to the greatest extent possible cross border activities. Taxation can and should make a real contribution to providing the environment that allows digital start-up companies to achieve scale by urgently removing the tax barriers to the Single Market.

The Group believes that the most valuable contribution from a tax policy perspective would be a drastic simplification of rules and procedures to cut down red tape and allow entrepreneurs to focus on business rather than administrative compliance. The Group favours a coherent and consistent EU tax policy over country specific measures both in the field of indirect taxation and in the area of direct tax. The compliance elements of the proposal for a Common Consolidated Corporate Tax Base (CCCTB), which builds on the one-stop-shop idea for indirect tax compliance (see 4.2.1) is the type of measure that potentially brings simplification for all start-ups in the EU including digital.

More generally, the Group supports initiatives to reduce the complexity of tax rules and of rules for new business registration, to reduce the administrative burden related to compliance by creating convenient online portals, to ensure that the tax rules are certain and predictable, to minimise the impact of unintended side-effects

of new regulations and to continue work on coordinating or harmonising tax regulations across the EU to help new entrepreneurs to expand internationally.

The Group is fully aware that within the EU institutional framework it is extremely difficult to agree on a common policy in taxation matters (see Annex 3: International tax policy - the Institutional Framework). Still, it urges Member States to realise that, especially in the digital economy, such improvements must be made by all Member States in order to be effective. This requires a coherent EU policy in taxation matters.

### *3.2.2. Specific tax measures*

In discussing possible ways to improve the tax environment for young innovative companies, especially digital companies, several specific measures have been reviewed: the use of R&D tax incentives, the taxation of employee stock options and taxation of capital gains. The Group takes the general view that tax incentives move away from the principles of simplicity and neutrality especially when introduced in an uncoordinated manner. They therefore need very compelling evidence not only of market failure but also of the appropriateness of using tax expenditure to correct the market failure. Moreover, all young and innovative companies are concerned by the specific topics reviewed; they are not specific to the digital economy. Since this goes beyond its mandate, the Group has not considered policy recommendations for such specific tax measures.

- R&D tax incentives

R&D tax incentives are generally distinguished between those targeting R&D input by providing beneficial tax treatment for R&D expenses and incentives targeting the R&D output by providing beneficial tax treatment for income from R&D.<sup>38/39</sup> The Group believes that especially expenditure based R&D tax incentives, provided they are designed well and are evaluated regularly, could address some constraints faced by young innovative companies, including digital.

- Employee stock options

The Group considered the specific area of the tax treatment of employee stock option schemes in order to determine whether it creates barriers for digital start-ups following suggestions received from stakeholders and the Start-up

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<sup>38</sup> See for example work done by European Commission or its expert groups: *Evaluation and design of R&D tax incentives: report of the CREST expert group on fiscal measures*, European Commission, March 2006. *Towards a more effective use of tax incentives in favour of R&D*, European Commission, COM (2006) 278, *Report of the Expert Group on R&D Tax Incentives: evaluation comparing practices in R&D tax incentives evaluation*, European Commission (October 2008), *Expert Group on Impacts of R&D Tax Incentives: design and evaluation of tax incentives for business research and development – good practice and future developments*, European Commission (November 2009) as well as work done by the OECD: *Supporting investment in knowledge capital, growth and investment*, OECD (2013).

<sup>39</sup> *Intellectual Property Box Regimes: Effective Tax Rates and Tax Policy Considerations (Lisa Evers/Helen Miller/Christoph Spengel) (2013)*, ZEW Discussion Paper 13-070, Mannheim, <http://ftp.zew.de/pub/zew-docs/dp/dp13070.pdf>

Manifesto<sup>40</sup> highlighting this issue. Since emerging businesses such as digital start-ups often lack the financial means to pay high salaries, it may be necessary to offer alternative remuneration such as employee stock options to attract the human talent they need. Concerns have been expressed that in some Member States the immediate taxation of stock options upon granting represents a disincentive for making them available.

Annex 4 provides an overview of the general tax and social security treatment of stock options in the EU Member States. Although the treatment differs in detail amongst Member States depending on the type of stock option scheme, both as regards the timing of taxation and regarding the amount that is subject to tax, it appears that most Member States do not tax employee stock options at the moment they are granted. In all but one Member State, stock options are free of social security contributions at the moment they are granted. Most Member States tax the gain realised upon the exercise of the option as employment income, five of which apply reduced rates.<sup>41</sup>

- Capital gains taxation

Another specific issue raised by stakeholders has been the tax treatment of capital gains. Arguably, capital gains taxation could reduce the incentive for business angels to exit their investment, reducing the incentive to sell the more mature elements of their portfolio and reinvest in new innovative ventures.<sup>42</sup> To attract funding for emerging digital businesses, the capital gains tax burden on investors may be more relevant than the corporation tax burden on any future corporate profits.<sup>43</sup> An overview of the general tax treatment of capital gains for individuals within the EU has been included in Annex 5 for information purposes.

### 3.2.3. *Creating a digital environment for taxation*

The Group wants to underline the importance of seeing digitalisation not just as a challenge for tax systems but also as a solution and an opportunity to create a better tax administration and to develop less burdensome tax compliance rules, both for indirect and for direct taxation. The Group emphasises the need to reduce the compliance burden i.e. a clear understanding of the applicable law and ease of payment of taxes. This is particularly relevant for the digital economy whereby many

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<sup>40</sup> See <http://startupmanifesto.eu/>

<sup>41</sup> However, it may be administratively difficult to value the benefit at the moment of exercise if the shares lack a true market value. Moreover, if the employee is unable to sell the shares in order to realise funds to pay the tax, this can raise financing issues.

<sup>42</sup> A review of tax obstacles facing the Venture Capital industry when investing across borders be it in digital or in other businesses, was done by the Commission (Commission Communication of 7 December 2011 "An Action Plan to Improve Access to Finance for SMEs", COM(2011)870 final. No particular evidence was found that cross border Venture Capital investments are hampered by tax issues.

<sup>43</sup> Capital gains tax is also important for another reason. Traditionally, digital businesses do not pay dividends, so shareholders/investors will not generally be subject to personal income tax on dividend returns from digital businesses. Rather they will be subject to capital gains taxes (and possibly wealth taxes). However, the number of possible scenarios in a global context with different types of shareholders residing in various jurisdictions makes it impossible for the Group to address issues related to the overall effective tax rate within its mandate.



transactions take place without human intervention. On this basis, the Group encourages Member States to consider the potential of digital technologies in improving the effectiveness, efficiency and user experience of tax administration. The Group would for example encourage Member States to agree to the commitment in the Communication on the Future of VAT to develop a web portal providing the necessary information for business engaging in trade in the Single Market.

There are many senses in which it is true to say that "tax administration is tax policy" and there are many opportunities to apply digital technologies to offer smarter and more user friendly tax administration systems whether through payment of taxes by business and individuals, or using risk analysis to ensure that audit resources are targeted at non-compliant taxpayers and the burden on compliant business is minimised. Digital technologies also enable tax administrations to be more efficient and effective.

## 4. VAT POLICY OPTIONS

### 4.1. Issues related to VAT

#### 4.1.1. Introduction

Ensuring that VAT is fully effective for transactions in the digital economy presents challenges. It should however first be clarified what we understand, from a VAT perspective, by "transactions in the digital economy". A distinction here needs to be made between a) supply of electronic services<sup>44</sup>, b) supply over the internet of services other than electronic services and c) supply of goods ordered on line. The VAT treatment depends on the type of supply. It is also relevant to consider who the recipient of the good or service is i.e. whether the customer is a business or an end consumer. This is relevant in terms of both the place of supply (country of taxation) and deductibility of VAT.

The Group welcomes that there is a general consensus that the destination principle i.e. taxation at the place of consumption is the way forward. Pursuing the destination principle will ensure economic efficiency, and therefore neutrality issues should not arise in respect of VAT. It is notable that the EU has been to the forefront globally of pursuing this objective.

#### 4.1.2. Business to Business (B2B) transactions

Under existing rules, intra-EU supplies of goods and services to business are taxed in the Member State where the goods are received or where the business receiving the service is established<sup>45</sup>, and therefore, ordinarily no distortion of competition should arise. The OECD Task Force on the Digital Economy in its draft report<sup>46</sup> has identified situations in which no or an inappropriately low amount of tax is collected on remote digital supplies to exempt businesses or multi-location enterprises that are engaged in exempt activities. In an EU context, this could manifest itself by a branch in a Member State with a low VAT rate purchasing supplies destined for use in a branch located in a Member State with high VAT rates. The Group acknowledges that this issue is primarily one of compliance, that it is not unique to the digital economy, notes that the OECD guidelines on applying the destination principle to B2B<sup>47</sup> should assist with addressing this issue and suggests that the EU VAT Committee examines whether there are significant BEPS issues from such exempt supplies which need to be addressed. A further issue which may need consideration in a B2B context is cloud computing. Cloud computing may present challenges in terms of place of supply, the nature of the service and compliance. If issues emerge, these should be

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<sup>44</sup> Supplies delivered over the Internet without any need for a physical presence, such as electronic music, books or videos. The list of these services is defined in Annex II of the VAT directive.

<sup>45</sup> On a cross-border basis, the reverse charge mechanism is applied to the supply of services, which means that the recipient of the service accounts for the VAT.

<sup>46</sup> Draft for public consultation <http://www.oecd.org/ctp/tax-challenges-digital-economy-discussion-draft-march-2014.pdf>

<sup>47</sup> International VAT/GST Guidelines (April 2014) <http://www.oecd.org/ctp/consumption/international-vat-gst-guidelines.pdf>

examined by the VAT Committee to ensure that there is certainty for business and tax administrations.

VAT is an end consumer tax, and generally speaking, each business in the supply chain can deduct the input VAT it is charged.<sup>48</sup> The costs of the goods and services are incorporated into the end product (the value added along the supply chain) and reflected in the price to consumers, which is generally subject to VAT.

**Example – "The Social Network Model"**

A bicycle shop in Member State A decides to advertise via an online social networking platform established in Member State B. Using the data supplied for free by the users of the platform e.g. geo location and interests, potential customers in Member State A receive targeted advertisements via the social network platform for the bicycle shop in their local city/town. This is akin to a local radio or a free newspaper advertisement in the traditional economy. While business models vary, the bicycle shop is normally charged for this advertising. The bicycle shop has to account for VAT on the supply of advertising services on a reverse charge basis, but it can take a corresponding deduction of the VAT charged. The advertising cost is built into the price of the end product (the bicycle) and therefore VAT will accrue to Member State A which in this case is the place of consumption.

This example supports the case for taxing supplies based on the destination principle and is relevant for BEPS as it ensures that tax from the value added accrues to the Member State of consumption.

*4.1.3. Business to Consumer (B2C) supplies of electronic services*

Currently, the VAT treatment of supplies of electronic services differs between intra-EU supplies and supplies to and from third countries. Taxation of electronic services supplied B2C within the EU is in the Member State in which the supplier is established and not at destination, while in relation to supplies from third countries, taxation in the Member State of destination (i.e. where the customer is established) has been the rule since 2003.

Under the current place of supply rules, supplies of telecommunications, broadcasting and electronic services are taxed at the place of establishment of the supplier. These rules have led to a cluster of businesses establishing themselves in Member States with the lowest rate of VAT, from which they can supply electronic services across the EU at a more advantageous VAT rate than a business established in the Member State of the consumer. While this distortion raises concerns, the Group notes that such services will be taxed on the basis of the destination principle with effect from 1 January 2015 and therefore the distortion will be removed as suppliers of electronic services will no longer be able to get a VAT advantage from establishing in a Member State with low VAT rates and revenues will correctly accrue

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<sup>48</sup> The exception to this rule is where a business engages in exempt supplies, in which case the business cannot deduct the VAT. Financial services are the most significant supplies in the EU VAT system exempt from VAT.

to the Member State of consumption<sup>49</sup>. A mini One Stop Shop (MOSS) will be introduced at the same time as a simplification measure. It will allow the supplier to register, declare and pay the VAT due on supplies of electronic services supplied to final consumers in other Member States via a web portal in the home Member State, instead of registering for VAT in each Member State in which there are customers.

One of the challenges for remote supplies of services is identifying the place of consumption when applying the destination principle i.e. determining where the tax is due. In the traditional economy, this is not usually an issue as the place of consumption of a meal is the restaurant, the delivery address for a good etc. Complications arise in respect of digital supplies as it can be difficult to identify the place of consumption especially with the growth of mobile devices such as tablets and smart phones. The Commission and Member States have taken measures to address this. Annex 6 gives a detailed overview of the developments at EU level in taxing the B2C supplies of electronic services.

#### *4.1.4. B2C supplies of services other than electronic services supplied over the internet*

The VAT treatment of remote supplies of B2C services other than electronic services does not always follow the destination principle. Taxation of services other than electronic services supplied B2C within the EU is as a general rule in the Member State in which the supplier is established with some notable exceptions<sup>50</sup>. Supplies from third countries are generally not subject to VAT.

#### *4.1.5. Remote supplies of goods in B2C transactions*

##### *4.1.5.1. Remote supplies of goods from within the EU*

Taxation in the Member State of destination is already in place for the B2C online sale of goods<sup>51</sup>, when the turnover of the supplier in that Member State is above a threshold (EUR 100,000 or EUR 35,000, depending on the Member State of destination concerned). The applicable rate is that of the Member State where the goods are actually received by the customer. Under current rules, the seller must register and account for VAT in the Member State of the customer.

This means that, in the case of some online retailers, especially those that sell large volumes of goods cross-border, the final VAT-inclusive retail price will include different VAT rates depending on the Member State of the customer. The rates of VAT in the EU Member States can range from 0% to as much as 27%. As a result, although businesses may establish equal ex-VAT pricing for their goods across the

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<sup>49</sup> Subject to a transitional period during which the Member States of Identification will keep part of the revenues.

<sup>50</sup> For instance services linked to immovable property, which are taxed in the country where the property is located, short term hiring of means of transport which are taxed where it is put at the disposal of the customer, admission to cultural, artistic, sporting, etc. events which are taxed where the event actually takes place.

<sup>51</sup> General rules applicable to any kind of distance selling.

EU, the differences in VAT rates will result in visible price differences to the customer.

The Group considers that the requirement to register and account for VAT in each and every Member State where supplies are made is an unnecessary burden and is a barrier to the Single Market particularly in respect of SMEs.

#### 4.1.5.2. Remote supplies of goods from third countries

Goods ordered in a third country are subject to importation rules. VAT on such goods is collected at the customs office of entry into the EU, at the rate applicable in the Member State of importation. However, EU VAT law provides, mainly to ease the burden on customs administrations, for a VAT exemption on the importation of small commercial consignments. These are goods not exceeding the threshold set by each Member State at an amount which is between EUR 10 and 22<sup>52</sup> per consignment. This special exemption, which has long been enshrined in EU VAT Law, is now generating distortions of competition, because third country suppliers of low value (and high volume) goods e.g. CD/DVDs, IT peripherals etc. are at an advantage compared to EU suppliers. This is notably the case with those third countries or third territories (parts of the EU which are outside the VAT territory) which are geographically close.

The Group notes that the Commission has launched a study to evaluate the application and the impact of the VAT exemption which will assist in developing the business case for removing the exemption, which has a high distortive risk, as outlined in the example below.

##### **Example – Purchase of printer cartridges**

The example below highlights four different transactions involving the same good (less than EUR 22) and demonstrates the lack of a level playing field. In all cases the consumer may not know the physical location of the supplier.

###### *Scenario 1*

A consumer in Member State A purchases a printer cartridge from an online supplier in his Member State. VAT is charged at the standard rate and accounted for by the supplier in the periodical VAT return.

###### *Scenario 2*

A consumer in Member State A purchases the same printer cartridge from a supplier in Member State B. This supplier is below the relevant threshold, and therefore charges the VAT rate in Member State B. He accounts for the tax in Member State B, with the result that Member State A does not gain the VAT revenues. If the tax rate is lower in B, the supplier may be able to supply the good at a lower price.

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<sup>52</sup> Member States may exclude goods which have been imported by mail order (online) from this exemption. Exemption does not apply for imported consignments of alcoholic products, perfumes and toilet waters and tobacco and tobacco products.

*Scenario 3*

A consumer in Member State A purchases the same printer cartridge from a supplier in Member State B. This supplier is above the relevant threshold, is registered for VAT and therefore charges the VAT rate in Member State A. He accounts for the tax in Member State A, but is subject to the administrative burden of periodically accounting for tax in Member State A (and indeed in the other Member States where he makes remote supplies).

*Scenario 4*

A consumer in Member State A purchases a printer cartridge from a supplier established in a third country. Because the good is covered by the exemption for small commercial consignments, the supplier is not required to charge or account for VAT. Given EU VAT rates of up to 27%, this will give the supplier significant room to offer a lower price, yet maintain the same margin as suppliers located within the EU.

*4.1.6. Mini One Stop Shop (MOSS): collection and audit*

One important issue which is not yet fully resolved is the audit of the businesses under the MOSS. EU legislation on the MOSS still envisages that controls and audits are to be carried out by the Member State of consumption, although several tools are available to Member States to enhance the coordination of audits. For both EU and non EU businesses, this may involve up to 28 different tax administrations auditing the same business without any coordination and leading to multiple information requests in multiple languages. Not only could this create disproportionate administrative burdens on business, it could also put at stake the efficiency of the audits themselves as well as the level of voluntary compliance (which is particularly sensitive where non-EU companies are involved). It is also questionable whether such an approach is an efficient use of tax administration resources.

*4.1.7. Distortionary effect of VAT rates in cross-border B2C service transactions*

As a general rule, the EU VAT Directive<sup>53</sup> envisages that a standard VAT rate will apply to all goods and services. Currently, standard rates applicable across the EU range from 15–27%. The VAT Directive (Annex III) provides that Member States can apply reduced VAT rates (of minimum 5%) for certain goods and services.

Under the current place of supply rules, as outlined in 4.1.3 there is a distortion in the Single Market whereby service suppliers can gain significant advantages from locating in a Member State with low VAT rates. While this distortion raises concerns, the Group notes that telecommunication, broadcasting and electronic services will be taxed on the basis of the destination principle with effect from 1 January 2015. Hence, suppliers of such services will no longer have a VAT advantage from establishing in a Member State with low VAT rates and revenues will correctly accrue to the Member State of consumption.

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<sup>53</sup> Council Directive 2006/112/EC.

#### 4.1.8. Complexity of VAT rates and ensuring compliance

While the VAT Directive provides a structure and minimum levels of rates to be operated by Member States, current legislation allows them a wide room to fix the levels of those rates and the categories of goods and services to which they apply. In practice, this results in 28 different VAT rate structures contributing to making the VAT system very complicated for business and tax administrations alike. There is further complexity with derogations and standstill provisions available to Member States. This complexity makes it difficult for business to comply as they require an in-depth knowledge of the rate structures in each Member State in which they do business, whether it is goods as is currently the case or telecommunications, broadcasting and electronic services from 1 January 2015. There is, of course, a counter argument in favour of reduced rates in that they can be seen to balance the regressive nature of the tax, but this does not stand up to economic scrutiny. It is useful to recall the findings of the Third Report of the Commission of Taxation in Ireland (1984)<sup>54</sup>:

*"Considerable savings in administrative and compliance costs arise from reducing the number of different rates of value-added tax and by having one rate for all goods and services. A general value-added tax levied at a single rate would improve economic efficiency by removing the waste of resources associated with the distortion of patterns of consumption and production".*

The succinct recommendation for a single VAT rate made by the Irish Commission on Taxation in 1984 is still very much relevant today, and indeed was confirmed in the 2011 Mirrlees review of the UK taxation system.<sup>55</sup> It is also relevant that the recent study on "A retrospective evaluation of elements of the EU VAT system"<sup>56</sup> (IFS, 2011), concluded that a 50% reduction in the dissimilarity of VAT rates for specified goods and services would increase intra-EU trade by 9.8%, GDP by 1.1% and consumption by 0.7%.

## 4.2. VAT policy options

### 4.2.1. Vision for the role of VAT in the taxation of the digital economy

The Group takes the view that neutrality should be at the forefront of policies for VAT in the digital economy. Neutrality should apply in respect of goods and services being supplied at a distance, within the EU and from third countries. The Group considers that to achieve neutrality, the Commission and Member States should pursue the objective of applying the destination principle for the supply of all goods and services. The Group considers that VAT has a significant role to play in ensuring that appropriate tax revenues accrue from businesses operating in the digital economy.

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<sup>54</sup> See: <http://www.fiscal.ie/documents/June1984ThirdReport1.pdf>.

<sup>55</sup> See: <http://www.ifs.org.uk/mirrleesreview/design/ch9.pdf>.

<sup>56</sup> A retrospective evaluation of elements of the EU VAT system, p. 23, [http://ec.europa.eu/taxation\\_customs/resources/documents/common/publications/studies/report\\_evaluation\\_vat.pdf](http://ec.europa.eu/taxation_customs/resources/documents/common/publications/studies/report_evaluation_vat.pdf).

The Group considers that the destination principle for the remote supply of goods and services can only be implemented if accompanied by a broadening of the vendor registration/remittance principle i.e. the One Stop Shop (OSS). This will reduce administrative burdens and therefore assist business and particularly SMEs to benefit from the Single Market.

It is recognised that while VAT is an EU tax, the VAT receipts accrue to each Member State and any amendments to the EU VAT Directive requires agreement by unanimity. It is also recognised that a full destination based VAT system underpinned by a One Stop Shop requires trust between Member States, trust of parliaments and citizens, and the trust of the business community to be acceptable. The Group supports the Commission in taking an incremental approach by building gradually to a full destination based VAT system through a series of initiatives, each carefully implemented and reviewed.

#### *4.2.2. Delivering a successful MOSS*

An important milestone in the digital agenda will be achieved on 1 January 2015 with the introduction of the new place of supply rules for electronically supplied services together with the MOSS. These new rules will ensure the taxation of economically significant B2C supplies of telecommunications, broadcasting and electronic services, at the place of consumption.

In terms of the overall vision for taxation, the successful implementation of the MOSS will lay the foundations for further developments. The Group notes that the Commission services are endeavouring to ensure that the necessary preparatory work for 1 January 2015 is completed in good time, which will give certainty to Member States and economic operators. To ensure that taxes accrue appropriately to Member States it is important that business, both in the EU and in third countries, are fully aware of their responsibilities to pay tax at destination in the EU, and therefore intensive communication activities both within and outside the EU are needed to this effect. Digital technologies could offer significant potential in securing the effectiveness of the MOSS, for example by providing an online database of the VAT rate applicable to products sold in each Member State or by enabling third country and EU suppliers to achieve an "EU VAT compliant" certification for their website.

The Group urges the Commission and Member States to continue their efforts to ensure the successful introduction of the MOSS and the new rules, which will lay the foundations for further developments. The Group also encourages Member States to put in place coordination of audits to ensure that the MOSS does not create unnecessary administrative burdens for business.

#### *4.2.3. A broader OSS*

The Group recommends that a broader OSS should be pursued as a priority for all EU B2C supplies of goods and services. The current requirement for suppliers (above applicable thresholds) to register and account in each Member State to which they makes B2C supplies of goods is a clear obstacle to cross border trade. Furthermore, the Group considers that a broader OSS is a critical instrument to facilitate access to the Single Market. In this respect, with such an extended OSS in place, it



recommends that the existing thresholds in respect of distance sales should be removed i.e. all remote supplies of goods should be taxed at the place of supply of the consumer, with a single return and payment to the Member State of the supplier.

The Group welcomes the Commission services' proposal to commence the necessary preparatory work for the broader one stop shop including an economic analysis, and an analysis of the implementation of the MOSS. This study can then assist with the necessary impact assessment before a formal proposal is made to Council. The successful introduction of the MOSS is crucial for delivering the necessary support by Member States for the broader OSS.

The Group considers that in preparing for the broader OSS consideration needs to be given to improving the weaknesses of the current legislation in the area of audit, and in this respect the principle of "home country control"<sup>57</sup> should be considered. The Group considers that a balanced and effective auditing regime based on the principle of risk, which does not put an undue burden on business or indeed tax administrations, is essential for the delivery of a broader OSS.

In order to combat abuse and enable fair competition there is also a need for extended EU provisions related to exchange of information and collection of taxes. Consideration should also be given to revenue sharing for tax administrations to ensure that there is compliance in accounting correctly for taxes due in another Member State. In practical terms, this would mean that a tax administration in the "home country" can retain a proportion of the VAT revenues due to other Member States. While revenue sharing provides a monetary incentive, it also brings with it the responsibility on tax administrations to ensure that taxpayers are compliant with respect to their VAT obligations in other Member States. Revenue sharing is well established in the EU in respect of customs duties, and is already provided for in the initial period of the MOSS (30% in 2015 and 2016, and 15% in 2017 and 2018).

The Group considers that the broadening of the OSS will significantly reduce the burden on businesses, who today have VAT obligations in many Member States.

#### *4.2.4. Removing the small consignments exemption and including low valued imported goods within the One Stop Shop*

Distortions of competition are generated by the different treatment of small consignments as there is currently a VAT exemption at importation while the same goods supplied within the EU are charged with VAT. The Group recommends that the small consignments exemption is abolished and that this should be pursued as a priority in tandem with the development of the broader OSS, in order to create a level playing field between EU and non EU suppliers.

In practical terms, this could involve third country suppliers accounting for the VAT through an EU portal or a portal in a specific Member State (as is currently the case

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<sup>57</sup> "Home Country Control" is where responsibility for control and auditing falls to the Member State where the business is established, even in respect of supplies where the place of taxation is in another Member State.

for electronic services). It is also relevant to note that under customs regulations<sup>58</sup>, goods supplied from third countries with a value of less than EUR 150 are not subject to customs duties, but there is still a requirement to collect the VAT on such transactions. This is an unnecessary burden, and therefore the Group recommends that the OSS should not just apply to the currently exempted small consignments but to other small consignments for which no customs duties are due. Such supplies could then benefit from a specific fast-track customs clearance.

The Group considers that these recommendations would result in a level playing field between EU and non-EU suppliers, and between supplies of goods and services, and should significantly reduce the burden on both customs administrations and parcel operators/couriers.

#### *4.2.5. Supporting the destination principle at a global level - agreements with third countries*

The Group considers it desirable that the OECD destination principle in respect of cross-border B2C supplies of goods and services is applied at a global level to ensure that VAT revenues accrue to the country of consumption.

To support this, consideration should be given to extending tax treaty provisions to include consumption taxes. Although this can be undertaken by each Member State, a solution may be achieved more rapidly and more effectively if there was an agreement between the EU (with each Member State participating, as they did when signing the Arbitration Convention) and individual third countries – for example EU-Norway, EU-Australia, EU-Canada etc.

Another route, which could be pursued in parallel, is to work towards global standards in this field, notably through the amendment of the OECD model tax convention. There is a need to adopt treaty provisions covering consumption taxes to a corresponding extent as already exists for taxation on income and on capital, preferably integrated with the existing Model Tax Convention. The Group also considers that consumption taxes should be included in exchange of information clauses in the treaties. There may also be scope to include vendor registration/remittance in the treaties (VAT collected in the State of supply and transferred to State of consumption).

#### *4.2.6. VAT rates*

In examining the role that VAT can play in ensuring taxation from the digital economy, it is relevant to consider VAT rates. As outlined in 4.1.7, many of the current issues relating to VAT rates on cross border services will not present a problem from 1 January 2015 with the implementation of the new place of supply rules, which will tax B2C supplies of telecommunications, broadcasting and electronic services at the place of consumption i.e. where the consumer is established or resident.

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<sup>58</sup> Council Regulation (EC) No 1186/2009 of 16 November 2009 setting up a Community system of reliefs from customs duty.

It is clear from our analysis in 4.1.8 that further complexity in terms of VAT rates needs to be avoided. The Communication on the Future of VAT<sup>59</sup> (December 2011) sets out a guiding principle of carrying out the review of the VAT rate structure, according to which “similar goods and services should be subject to the same VAT rate and progress in technology should be taken into account, so that the challenge of convergence between the on-line and the physical environment is addressed”. Since, under the current VAT system, electronically supplied services are taxed at the standard rate, the issue of different VAT rates applied to electronically supplied services such as e-books and on-line newspapers and their physical version, i.e. paper books and newspapers, is currently being evaluated by the Commission. This evaluation was not available in time to be taken into account in the work of the Group.

While the Group does not intend to anticipate the findings of this analysis, it agrees with the Commission that similar goods and services should be subject to the same VAT rate. However, in order to ensure that there is no further complexity in the VAT system and to ensure that tax revenues accrue to Member States to fund public services, such similar products should be taxed at the standard rate, as already provided in EU VAT law, rather than a reduced rate.

Moreover, the Group considers that there is a strong case for each Member State to move to a single VAT rate as it will reduce complexity, promote the Single Market, and ensure neutrality and efficiency.

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<sup>59</sup> Communication on the future of VAT -Towards a simpler, more robust and efficient VAT system tailored to the Single Market,  
[http://ec.europa.eu/taxation\\_customs/resources/documents/taxation/vat/key\\_documents/communication/com\\_2011\\_851\\_en.pdf](http://ec.europa.eu/taxation_customs/resources/documents/taxation/vat/key_documents/communication/com_2011_851_en.pdf).

## **5. CORPORATION TAX POLICY OPTIONS**

### **5.1. Main corporation tax issues in the digital economy**

#### *5.1.1. Introduction*

The Group takes the view that there should not be a special tax regime for digital companies. Rather the general rules should be applied or adapted so that “digital” companies are treated in the same way as others. These general rules must impose taxation based on real economic activities and must achieve a demonstrably appropriate result in the case of intergroup transactions. Given the changes in the business environment and the political priority for urgent action at international level, the process of adapting international rules should be evolutionary in nature to achieve the best chance of success and consensus.

In the short and medium term the immediate concerns that have triggered the G20/OECD BEPS project must be addressed. The international community is in the process of adjusting international tax rules to prevent base erosion and profit shifting that result in income being reported where no economic activity takes place. A successful outcome of the G20/OECD BEPS actions would to a large extent also address the immediate concerns related to the taxation of multinationals operating in the digital economy. The Group considers that it is in the best interest of the EU if Member States speak with one voice in the G20/OECD BEPS project to support a successful conclusion. In order to achieve this, Member States must establish a common position. The Group has outlined what it believes are the key priority issues in that area.

The G20/OECD BEPS project is strictly bound by its mandate and timeline; to a large extent it takes the existing international rules to determine and allocate the corporation tax base as a given. These international rules will be amended within the international tax framework. The EU, however, should also consider a more fundamental review of international corporation tax mechanisms, including a consideration of both the allocation of the right to tax and the most appropriate base for corporation tax. In the meantime, partial changes to the existing tax system should be managed to avoid adding additional layers of complexity.

The Group reviewed a number of possible options taking into account a broad set of objectives and principles including both the existing institutional framework and the EU agenda on growth and jobs<sup>60</sup> and makes a series of recommendations.

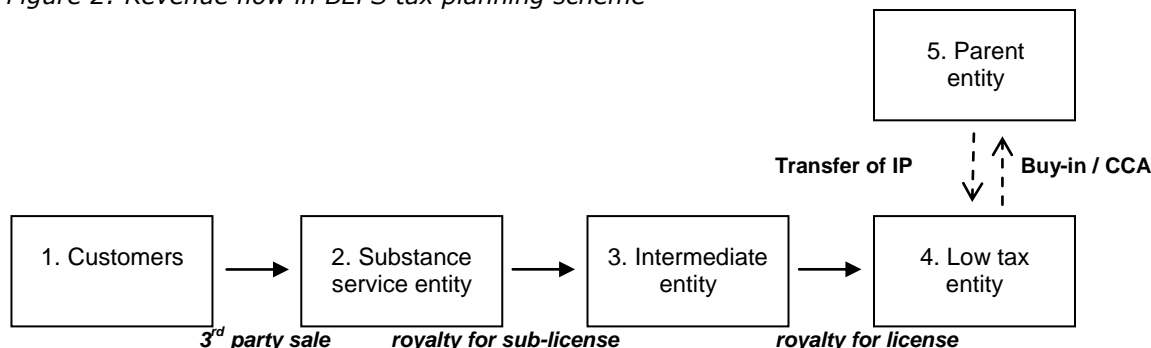
#### *5.1.2. G20/OECD BEPS project - analysis*

The underlying technical tax issues that trigger base erosion and profit shifting have been extensively documented in publicly available documentation already prepared by the OECD. We will not repeat that exercise. Nevertheless, to improve the readability of this report we will briefly recall a typical though simplified tax planning scheme that results in base erosion and profit shifting.

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<sup>60</sup> See "Compact for Growth and Jobs", Annex to European Council Conclusions of 28/29 June 2012, EUCO 76/12, [http://www.consilium.europa.eu/uedocs/cms\\_data/docs/pressdata/en/ec/131388.pdf#page=8](http://www.consilium.europa.eu/uedocs/cms_data/docs/pressdata/en/ec/131388.pdf#page=8).

Figure 2: Revenue flow in BEPS tax planning scheme



This simplified scheme contains the elements which are most frequently present in tax planning schemes undertaken in the digital economy:

1. **Customers** provide the revenues. They can be resident anywhere including in each Member State of the EU. These include the countries that are concerned about the contribution of digital economy to corporation tax revenues.
2. A **Substance service entity** generally receives the revenues and provides the digital service or products. This is typically a company with substantial offices/premises and a significant number of employees. The substance service entity has a sub-license to use the valuable intellectual property (IP) of the multinational group. It therefore pays a royalty which significantly reduces its taxable profits. There is no withholding tax on the royalties paid due to a treaty between the countries of residence of companies 2 and 3 or due to the EU Interest & Royalties Directive<sup>61</sup>, although there would be a withholding tax on payments directly from company 2 to 4.
3. An **Intermediate entity** collects the substantial royalties from the substance service entity free of withholding tax. However, the intermediate entity has received a license to use the valuable IP of the multinational group and thus it also has to pay royalties which typically reduces its net profit to a small percentage of the royalties received. This intermediate entity has the minimum substance required to be legally recognised. It is located in a country that in contrast to company 2 does not levy a withholding tax on royalties to company 4.
4. A **Low tax entity** owns the non-home country rights to the valuable IP of the multinational group. It is subject to no (or negligible) corporation tax, either because it is resident in a tax haven, because it is subject to a special tax regime or because it is structured as a disregarded entity not considered to be subject to tax in its country of incorporation. It has acquired the non-parent country rights to the IP at an early stage of its development for an arm's length price. It (together with the entity holding the parent country rights to the IP)

<sup>61</sup> Council Directive 2003/49/EC of 3 June 2003 on a common system of taxation applicable to interest and royalty payments made between associated companies of different Member States.

compensates group entities for subsequent R&D expenditure in accordance with a cost contribution agreement (CCA).

5. The **Parent entity** resides where the original business ideas have been created and where the global business strategy is developed. It makes sales in the home market but has established Substance service entities in each of the major geographic regions (e.g. Europe Middle-East and Africa, Asia etc.) to undertake international sales. As respects the EU market, most foreign revenues will end up in the low tax entity and remain free of tax as long as they are not distributed to the parent entity. The parent entity can avoid the application of provisions which would cause immediate taxation of the profits of the low tax entity (CFC provisions, see section 5.2.1.2).

These schemes are not specific or unique to the digital economy. Equivalent structures can be used by and applied in many other industries. For the reasons outlined in section 2.3.2, however, they are particularly profitable and easy to use in the digital economy.

## **5.2. Short and medium term policy options**

The overall result of schemes such as those described in section 5.1.2 above is that a significant part of a multinational group's profit escapes effective taxation. This is politically unacceptable and is incompatible with the objective of the arm's length principle. As an immediate step international standards should be amended via the G20/OECD BEPS project, taking into account appropriate transitional rules. This will not only restore public trust in the fairness of international corporation tax rules, it will also ensure the sustainability of a coherent international tax framework and may prevent unilateral measures that would negatively affect international trade.

In this respect, the Group recommends that priority should be given to three areas within the G20/OECD BEPS project.

1. Counter harmful tax practices;
2. Review transfer pricing rules; and
3. Restore taxable nexus provisions.

In OECD discussions, EU Member States should seek to achieve effective results in these three areas, bearing in mind the need to respect the Single Market principles. Once there is agreement on the G20/OECD BEPS Actions, EU Member States should implement the simplest solutions (on the assumption that the OECD may agree to a number of options) both amongst themselves and with third countries. This will require a coordinated approach.

### *5.2.1. Counter harmful tax practices*

Countering harmful tax practices is listed as a separate action (item 5) in the G20/OECD BEPS Action Plan. The Group considers it important to recognise that harmful tax competition between countries to a large extent has created the conditions which have allowed multinationals to set up their cross border tax planning schemes. For most if not all of the G20/OECD BEPS Actions, finding a solution to address that reality will determine the effectiveness of the deliverables.

Corporation tax policy is a difficult trade-off between collecting corporation tax revenues, international partnership and cooperation and establishing a tax environment that fosters investment and growth. To make the G20/OECD BEPS project a success, it is vital for the international community to agree that attracting foreign investment and business activity should not be an excuse to compromise on international partnership and cooperation.

Within the EU, the Member States have established a clear framework in the form of the Code of Conduct for business taxation. The Commission should encourage EU Member States to strengthen this political instrument and pursue a gradual global recognition and adoption of its underlying principles especially in three areas:

1. Address hybrid mismatch arrangements.
2. Apply effective Controlled Foreign Corporation (CFC) provisions;
3. Prevent the circumvention of withholding tax on interest and royalties through treaty shopping structures.

#### 5.2.1.1. Address hybrid mismatch arrangements

Hybrid mismatch arrangements, which can be entities or financing instruments, occur through differences of classification or qualification in two or more countries. They can be used to achieve double non-taxation, for instance by creating two deductions for one borrowing, by generating deductions without corresponding income inclusions, or by misusing participation exemption regimes. Country rules that allow taxpayers to select the tax treatment of domestic and foreign entities or financial instruments facilitate hybrid mismatches. The G20/OECD BEPS Action plan aims to develop recommendations regarding the design of domestic and treaty based rules to neutralise the effect of hybrid instruments and entities.

Within the EU, the issue of hybrid mismatch arrangements has been discussed in the context of the Code of Conduct, even though technically a mismatch between tax systems has not hitherto been considered a harmful tax practice of one country as such. From a viewpoint of mutual trust and cooperation, all countries have an obligation neither to facilitate nor encourage the use of mismatch arrangements. The Group recommends that the global implementation of the technical solutions that are being developed in the context of the G20/OECD BEPS project be guided by these considerations.

#### 5.2.1.2. Apply effective CFC provisions

CFC provisions are generally defined as rules which countries apply to prevent tax deferral of 'tainted income' earned by foreign subsidiaries (i.e. Controlled Foreign Corporation). The Group recognises that the principle that income earned by domestic companies is taxed while income earned by non-resident companies is not, is at the basis of the tax system in many developed countries, including in EU Member States. Such systems can be explicitly designed as territorial systems whereby foreign source profits are not included in the taxable base. They can also formally be a worldwide tax system which includes in the tax base all profits wherever earned, but effectively exempts profits earned through foreign PE or received as distributions from (foreign) subsidiaries.

Both systems, however, are normally combined with anti-avoidance provisions such as CFC provisions to curb excessive effects. It is important that the G20/OECD BEPS project provides for the necessary technical material to enable countries to optimise the design and functioning of their CFC provisions.

There is, however, also a more fundamental dimension. Countries have a direct interest in protecting their own tax base but they have less interest in protecting the tax base of foreign countries. However, in the context of international trust and cooperation, the Group takes the view that countries also have a responsibility to apply their anti-avoidance measures if the tax base of partner countries is being eroded. This is especially true within the EU, where this notion is to a certain extent already embedded in the Code of Conduct for business taxation. The Group encourages the Commission and the Council to strengthen the concept of politically committing to solidarity and cooperation and pursue its adoption at global level.

#### 5.2.1.3. Prevent circumvention of withholding tax on interest and royalties through treaty shopping structures

Tax policy concerning the levying of withholding taxes on interest and royalties differs between countries, both globally and within the EU. Several countries including EU Member States do not levy withholding taxes on interest and royalties under their domestic tax system; others strive to limit or avoid them under their bilateral tax conventions. Moreover, within the EU the elimination of withholding taxes on certain intergroup interest and royalty payments has been laid down in the EU Interest & Royalties Directive. The economic rationale for trying to avoid withholding taxes is that they can represent a heavy tax burden since they are levied on gross revenues even in the absence of net profits.

In the absence of harmonisation in this area, countries must cooperate to allow each country to enforce its chosen tax policy. Countries that do not levy withholding taxes domestically or under an applicable tax treaty must intensify their efforts to prevent their tax policy from harming countries that levy withholding tax. The interposition of intermediate entities between a debtor and creditor or between licensor and licensee to avoid a withholding tax obligation must be effectively addressed.

The Group believes that countries have an obligation to work cooperatively to avoid base erosion by disclosing relevant information to affected countries. The Group also considers that in negotiating bilateral tax treaties, treaty partners must ensure as much as possible that the provisions in their bilateral tax treaties cannot be abused. Adequate domestic or treaty based remedies that can counter such abuse should be introduced.

#### 5.2.2. Review transfer pricing rules

Intra-group transactions must be undertaken under the conditions which would have been obtained between independent enterprises in comparable transactions and comparable circumstances. This is referred to as the arm's length principle. These rules are particularly important because they determine the taxable profit at entity level within a group of companies. Indirectly they therefore also regulate the allocation of profits of a multinational group amongst the jurisdictions in which it operates.



One of the key sources of public and political concern with respect to the taxation of multinational companies is that profits are not appropriately taxed where business activities take place. Transfer pricing rules therefore require a fundamental review. The current application of the transfer pricing standards may allow room for interpretation giving businesses flexibility in allocating their profits. As a result, business profits may end up in entities with limited activities and functions and may escape effective taxation.

Actions 8, 9 and 10 of the G20/OECD BEPS project concern transfer pricing rules. The Group considers this a critical part of the success or failure of the project. Within the G20/OECD BEPS project five separate transfer pricing elements have been identified:

1. Profit allocation to intangibles,
2. Profit allocation to business risks,
3. Characterisation of transactions,
4. Base eroding payments, and
5. Global value chains and profit splits.

The Group considers especially the first two elements to be particularly important in the context of the digital economy. It supports the general direction suggested in these areas in the ongoing G20/OECD BEPS project and regards it as critical that the outcome provides real and effective solutions to the problems concerned.

#### 5.2.2.1. Profit allocation to intangibles

A significant part of today's businesses value is embedded in IP, whether in formal patents or copyrights, more informal trade secrets, effective production or distribution models, brands or trademarks. This broader trend is in particular present in the digital economy where the IP is what distinguishes companies. The importance of IP especially in the digital economy means that transfer pricing rules also allow a significant part of the aggregate profits of digital enterprises to be allocated to the underlying IP. Many companies have established structures in which these profits effectively accrue in entities that are not subject to taxation or in locations that do not impose taxation.

The G20/OECD BEPS project seeks to address these issues and the Group supports this. The Group is of the view that the temptation to add another layer of complexity to the existing OECD transfer pricing guidelines should be resisted.

While acknowledging the rule of law, the Group considers it vital that transfer pricing rules consider the economic relevance and purpose of an intercompany IP transfer. The Group recommends the Commission and the Council to undertake a review of transfer pricing standards to enable tax administrations to ignore intercompany transfers of IP in extreme circumstances where there is a lack of economic substance and the creation of a tax benefit is the main purpose.

#### 5.2.2.2. Profit allocation to risks

The Group has a similar concern when it comes to considering the intercompany transfer or allocation of risks. If two or more entities within a multinational group of

companies engage in a transaction with each other, transfer pricing rules make it possible to arrange this in a way such that the risk is borne mainly by one group entity rather than another. Since bearing risk generally justifies a higher profit under transfer pricing rules, this opens opportunities for businesses to assign attribute financial consequences by reference to the tax characteristics of the companies in the group, rather than by reference to underlying economic realities.

The G20/OECD BEPS project recognises that these are issues that need to be addressed. The Group recommends that a consideration of the more fundamental question of the economic substance of contractual allocation of risks amongst group entities forms part of the review of this aspect of the transfer pricing principles. Ultimately, where a multinational group of companies is concerned, risk is generally borne by the group as a whole, not by its constituent subsidiaries and branches. The OECD analysis opens the door to an approach under which certain risks are by their nature borne by the multinational group as a whole and cannot be assigned to a single group entity. The Group would support making this approach a generally applicable rule.

The Group recommends that the fundamental review of transfer pricing standards mentioned above should also examine the feasibility of disregarding contractual allocation of risks and related attribution of profits amongst group entities if the risks are actually borne by the group as a whole and the actual allocation lacks economic substance.

### *5.2.3. Restore taxable nexus provisions*

#### *5.2.3.1. No new concept of "digital taxable presence"*

It has been argued that one of the key components in the digital economy, i.e. the collection, processing and monetising of data, must be reflected in the definition of a taxable nexus. This would imply that at some stage, the extensive collection of personal data in a country over the internet could trigger a taxable nexus in that country. This does not occur under current tax rules. The absence of such taxable nexus means that there is no taxable presence to which profits could potentially be attributed, even if this was considered reasonable from the viewpoint of an appropriate international allocation of profits.

The Group has extensively considered this question and has come to the conclusion that there is currently no valid justification for such a fundamental change specifically for digital activities. There is no convincing argument why the collection of data via electronic means in a country should in itself create a taxable presence in that country. Deficiencies in the interpretation and application of the existing nexus provisions will be addressed under the G20/OECD BEPS project and the Group supports these efforts. Revenue concerns of the country where digital services and products are consumed should be adequately addressed via the VAT system.

#### 5.2.3.2. Review the PE concept

Determining whether a country has a right to tax business operations within its territory relies on the concepts of 'PE' or 'dependent agent'<sup>62</sup> under current international tax standards. They imply some minimum form of physical presence and permanence in the country. It is important to consider whether the way in which these concepts are defined and applied is still appropriate and adequate to establish the jurisdiction to tax and whether they will continue to be so also in the short and medium term.

Physical presence and permanence are logical criteria from the point of view of traditional business models. In the context of the G20/OECD BEPS project, the rules to determine a taxable presence of a non-resident company are being reviewed, especially as respects the deliberate avoidance of the treaty threshold below which tax may not be charged. In the digital economy, physical presence and permanence are often not required to establish significant business operations in a foreign market. The Group therefore believes that given the business models applied in the digital economy such a review is justified and necessary. The Group suggests that the review should focus on two elements in the definition of the existing concepts (Article 5 of the OECD Model Tax Convention):

- A. Remote contracting and the distinction between the dependent agent and the commissionaire;
- B. The definition of the "preparatory or auxiliary activities" exemption.

A. Remote contracting and the distinction between the dependent agent and the commissionaire

In the digital era, interacting with potential customers has become much easier. The conclusion of business arrangements and contracts over the internet has become the norm in many instances. Instead of having representatives in a foreign market that have the authority to sign contracts, they may have people on the ground that provide information and support for contracts that are then formally concluded over the internet.

The existing definition of dependent agent is based on the authority to conclude contracts in the name of the enterprise (the principal). While an undisclosed agent would have sufficient authority to legally bind its principal, a commissionaire according to the continental European civil law acts in his own name, but for the account of the foreign enterprise. Operating through local affiliates which act as commissionaire agents thus allows foreign businesses to stay below the PE threshold. This difference is not a specific issue of the digital economy but based on differences in the treatment according to civil law.

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<sup>62</sup> Whether an agent active for an enterprise in a foreign jurisdiction creates a taxable nexus for that entity in the foreign jurisdiction depends on whether he has and habitually exercises an authority to conclude contracts in the name of the enterprise. Independent agents – brokers, general commission agents etc. – acting in the ordinary course of their business do not create a taxable nexus for the enterprises for whom they work.

The Group supports work within the G20/OECD BEPS project considering whether and under what circumstances sales of goods or services of one company in a multinational group should be treated as effectively concluded by dependent agents, considering the respective civil law perspective. This should ensure that where a foreign online seller of tangible or digital products or a foreign online provider of advertising or other services has an established presence in a country, a PE cannot be formally circumvented, for example by concluding contracts via the internet or via a commissionaire agent.

#### B. The scope of the "preparatory or auxiliary activities" exemption

The second threshold that should be reviewed is the scope of "preparatory or auxiliary activity" in the digital economy. Proximity to customers and the need for quick delivery are typically key components in the business model of an online seller of physical products. International tax rules must reflect that in such cases the maintenance of a local warehouse constitutes a core activity of that seller and is not of a preparatory or auxiliary nature. The digitalisation of the economy has changed the way businesses are organised. Auxiliary activities have become core activities and vice versa. The Group recommends that these realities are taken into account when defining exceptions to the concept of a PE.

The Group agrees that a revision of these PE-concepts in itself may not have a big impact since the question remains how much taxable income can be allocated to such PE as discussed in the previous section. Nevertheless, establishing a taxable nexus is a prerequisite for allocating taxable income.

### **5.3. Long term policy options**

While underlining the importance of contributing to a successful implementation of the G20/OECD BEPS Action Plan, the Group recommends a review of the more fundamental and systemic issues related to the taxation of multinational corporations. The digitalisation and transformation of the economy suggests that IP whose value is created within highly integrated groups will be more and more the rule. It is therefore appropriate to raise the question how long transfer pricing rules based on the arm's length principle can be relied upon to give an objective outcome that is not susceptible to manipulation.

The Group would like to stimulate wider consideration on how to tackle corporation tax in a fair and transparent way, ultimately at global level but initially at EU level. The EU Member States should therefore examine to what extent the new international standards and in particular a possible movement towards transfer pricing profit split methods would justify additional simplification within the EU, particularly if the new rules generate significant costs. This could be done in the Council in the context of the continuing work on a common corporation tax base and also on the appropriate allocation of the common base where businesses operate in more than one Member State e.g. via consolidation and formula apportionment.

Within the EU, the CCCTB as proposed by the European Commission<sup>63</sup> does not require an allocation of profit between countries based on transfer pricing methods. It combines a common consolidated corporate tax base (determined on an accruals basis) with an allocation of the taxable profit across jurisdictions according to prescribed factors. The proposed allocation factors include capital, labour and sales. The proposed formula takes into account supply as well as demand factors but does not include intangible assets.

Given the pace of technological development and the need to avoid creating barriers to trade, more radical changes to the corporation tax system have been proposed in academic literature. Some of these focus on a "destination based" corporation tax. This would be similar to a VAT in that its key feature would be that exports would be zero-rated and imports would be taxed. It would differ from a VAT in that wage costs would continue to be deductible, and the tax would continue to be levied on an accounting basis, rather than using the invoice-credit method. It has been claimed that a version of such a destination-based corporation tax based on cash flow (with immediate expensing of capital expenditure but no relief for interest payments, and therefore even more similar to VAT) would be neutral with respect to corporate location, investment, financing and transfer pricing decisions,<sup>64</sup> thus addressing some fundamental concerns of international tax competition between countries. These conclusions are not uncontested.

A destination based corporation tax on cash flows would fundamentally change the current tax system. This would require a thorough analysis of the economic effects and specific design in order to find a common alignment for such a new definition and allocation of the tax base and thus tax revenues among countries. Despite ongoing research on how such a tax would be implemented,<sup>65</sup> much more information would have to be gathered before a policy line could be agreed.<sup>66</sup>

An important motive for reflecting on radical proposals is that they assist consideration of conceptual issues and evolutionary dynamics that the current debate on BEPS leaves aside.

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<sup>63</sup> Proposal for a Council Directive on a Common Consolidated Corporate Tax Base (CCCTB), COM(2011)121.

<sup>64</sup> See Auerbach A. and Devereux M.P., "Consumption and Cash-Flow Taxes in an International Setting" (2012) *Oxford University Centre for Business Taxation Working Paper Series*, WP 12/14, 2012.

<sup>65</sup> See de la Feria R. and Devereux M.P., (2014) "Designing and Implementing a Destination-Based Corporate Tax (2014) *Oxford University Centre for Business Taxation Working Paper Series*, WP 14/07, 2014.

<sup>66</sup> Careful consideration of international redistribution of tax revenues would be necessary. Moreover, possible empirically significant effects on resource allocation, including trade and cross-border investment would have to be considered. And, finally, questions of tax administration and tax compliance would have to be covered.

## **ANNEX 1: TECHNOLOGICAL TRENDS**

Future technological trends and potential impact on the digital economy are detailed below.

### (1). Cloud Technology

Cloud technology creates value for consumers and businesses by making the digital world simpler, faster, more powerful, and more efficient. By delivering Internet-based services and applications, it provides a more productive and flexible way for companies to manage their ICT. This has the potential to disrupt entire business models, giving rise to new approaches that are asset-light, highly mobile, and flexible. Furthermore, Cloud technology is an enabler of other highly impactful emerging technologies, such as Big Data or the Internet of Things. McKinsey Global Institute estimates that the total potential economic impact for Cloud technology could be 1.7 to 6.2 trillion USD in 2025, with 1.2 to 5.5 trillion USD in the form of surplus from use of cloud-enabled Internet services and 500 to 700 billion USD from productivity improvements for enterprise ICT.<sup>67</sup> Cloud technology can reduce the up-front capital spending and turn part of it into operational spending. The majority of organisations adopting Cloud technology can reduce costs by around 20%.<sup>68</sup>

### (2). Big Data

Big Data has been at the core of ICT-led innovation based on measurement, experimentation, sharing and scaling up. Recent research shows that firms using data-driven decision making are 5-6% more productive with respect to other firms.<sup>69</sup> Therefore, the economic impact of Big Data can already be noticed and will take very significant proportions in the near future. Worldwide Big Data technology and services are expected to grow from 6 billion USD in 2011 to 23.8 billion USD in 2016. This represents a compound annual growth rate of 31.7%, or about seven times that of the overall ICT market. In the labour market, Big Data's impact will manifest itself via the creation of data analytics and related jobs. For instance, estimates indicate that, in the UK alone, the number of specialist Big Data staff working in larger firms should increase by 243% to approximately 69,000 people by 2017.

### (3). The Internet of Things

Over 9 billion devices are currently connected to the Internet, and this number is expected to increase dramatically within the next decade to an estimated 50 billion to 1 trillion devices. This is the expanding Internet of Things, where nearly every aspect of human life and economic activity is being equipped with networked sensors

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<sup>67</sup> McKinsey Global Institute (2013), "Disruptive technologies: Advances that will transform life, business and the global economy", McKinsey Global Institute, McKinsey & Company, 2013.

<sup>68</sup> Quantitative Estimates of the Demand for Cloud Computing in Europe and the Likely Barriers to Up-take - SMART 2011/0045. IDC July 2012.

<sup>69</sup> Brynjolfsson, E. and Hitt, L.M. and Kim, H.H., Strength in Numbers: How Does Data-Driven Decisionmaking Affect Firm Performance? (April 22, 2011). Available at SSRN: <http://ssrn.com/abstract=1819486> or <http://dx.doi.org/10.2139/ssrn.1819486>.

and actuators that monitor the surrounding environment, report their status, receive instructions, and even take action based on received information. Different estimates of the economic impact of the Internet of Things report numbers in the same order of magnitude. According to McKinsey Global Institute, potential impact will be between 2.7 trillion and 6.2 trillion USD annually by 2025.

(4). Advanced Robotics

Robotics is seeing major advances that could result in the substitution of human labour by machines in an increasing number of manufacturing and service applications, as well as in extremely valuable activities such as robotic surgery and human augmentation. Robots are becoming capable of performing more delicate and intricate tasks and becoming more adaptable and able to operate alongside humans in chaotic conditions, while at the same time declining in cost. McKinsey Global Institute estimates that the application of advanced robotics in health care, manufacturing, and services could result in significant impact, from saving and extending lives, to transforming both product creation and service delivery. This could generate an economic impact of \$1.7 trillion to \$4.5 trillion per year by 2025, about half of which from health-care uses.

(5). Autonomous Vehicles

Autonomous Vehicles could potentially reduce the number of motor vehicle accidents and CO2 emissions. Computer-controlled vehicles with coordinated acceleration, braking and steering can safely travel at higher speeds, and since most driving accidents are caused by human error, they can increase traffic safety and reduce deaths, injuries, and property losses. Furthermore, drivers could be free to use their time to work, relax, or socialise while being transported. The introduction of self-driving autonomous vehicles could have a total economic impact of \$200 billion to \$1.9 trillion per year by 2025 from improved safety, time savings, productivity increases, and lower fuel consumption and emissions, provided that regulators approve autonomous driving and the public accepts the concept.

(6). 3D Printing

3D printing has the potential for disruptive impact on how products are designed, built, distributed, and sold. 3D printers are commonplace for designers, engineers, and architects, who use them to create product designs and prototypes, they are becoming popular for personal use (sales of personal 3D printers grew 200 to 400% per year between 2007 and 2011), and also gaining traction for direct production of tools, moulds, and even final products. Such uses could enable unprecedented levels of mass customisation, smaller and cheaper supply chains, and even the "democratisation" of manufacturing by allowing consumers or entrepreneurs to print their own products. In the long term (beyond 2025) 3D printing could even enable bio-printing of living organs, with the potential to save or extend many lives. MGI estimates that 3D printing could generate economic impact of \$230 billion to \$550 billion per year by 2025, with the largest source of potential impact from consumer uses, followed by direct manufacturing and the use of 3D printing to create tools and moulds.

(7). Automation of knowledge work

Advances in artificial intelligence, machine learning, and natural user interfaces (e.g., voice recognition) are making it possible to automate many knowledge worker tasks that have long been regarded as impossible or impractical for machines to perform. This opens up possibilities for sweeping change in how knowledge work is organised and performed. Sophisticated analytics tools can be used to augment the talents of highly skilled employees: some examples already in development concern expert systems assisting physicians with diagnoses and lawyers with legal search.



## ANNEX 2A: TAX OVER INCOME AND SALES – MAJOR DIGITAL COMPANIES

		Sales (mln USD)			Income (mln USD)			Tax (mln USD)			Tax over income			Tax over sales		
		Total	US	non-US	Total	US	non-US	Total	US	non-US	Overall	US	non-US	Overall	US	non-US
<b>Google</b>	2011	37,905	17,560	20,345	12,326	4,693	7,633	2,589	2,341	248	21.0%	49.9%	3.2%	6.8%	13.3%	1.2%
	2012	50,175	23,502	26,673	13,386	5,311	8,075	2,598	2,166	432	19.4%	40.8%	5.3%	5.2%	9.2%	1.6%
	2013	59,825	26,768	33,057	14,496	5,828	8,668	2,282	1,539	743	15.7%	26.4%	8.6%	3.8%	5.7%	2.2%
<b>Apple<sup>70</sup></b>	2011	108,249	38,315	69,934	34,205	10,205	24,000	8,283	7,681	602	24.2%	75.3%	2.5%	7.7%	20.0%	0.9%
	2012	156,508	57,512	98,996	55,763	18,963	36,800	14,030	13,317	713	25.2%	70.2%	1.9%	9.0%	23.2%	0.7%
	2013	170,910	62,739	108,171	50,155	19,655	30,500	13,118	11,985	1,133	26.2%	61.0%	3.7%	7.7%	19.1%	1.0%
<b>Amazon</b>	2011	48,077	26,705	21,372	934	658	276	291	260	31	31.2%	39.5%	11.2%	0.6%	1.0%	0.1%
	2012	61,093	34,813	26,280	544	882	-338	428	406	22	78.7%	46.0%	N/A	0.7%	1.2%	0.1%
	2013	74,452	44,517	29,935	506	704	-198	161	11	150	31.8%	1.6%	N/A	0.2%	0.0%	0.5%
<b>eBay</b>	2011	11,652	5,484	6,168	3,910	1,746	2,164	681	603	78	17.4%	34.5%	3.6%	5.8%	11.0%	1.3%
	2012	14,072	6,778	7,294	3,084	605	2,479	475	400	75	15.4%	66.1%	3.0%	3.4%	5.9%	1.0%
	2013	16,047	7,712	8,335	3,466	594	2,872	610	447	163	17.6%	75.3%	5.7%	3.8%	5.8%	2.0%
<b>Facebook</b>	2011	3,711	2,067	1,644	1,695	1,819	-124	695	687	8	41.0%	37.8%	N/A	18.7%	33.2%	0.5%
	2012	5,089	2,578	2,511	494	1,062	-568	441	426	15	89.3%	40.1%	N/A	8.7%	16.5%	0.6%
	2013	7,872	3,613	4,259	2,754	3,197	-443	1,254	1,188	66	45.5%	37.2%	N/A	15.9%	32.9%	1.5%
<b>Yahoo<sup>71</sup></b>	2011	4,984	3,303	1,681	828	533	294	242	203	38	29.2%	38.2%	13.0%	4.9%	6.2%	2.3%
	2012	4,987	3,462	1,525	5,214	5,057	158	1,940	1,869	71	37.2%	37.0%	44.8%	38.9%	54.0%	4.6%
	2013	4,680	3,482	1,199	633	539	94	153	102	51	24.2%	19.0%	54.2%	3.3%	2.9%	4.3%
<b>Tripadvisor</b>	2011	637	360	277	272	121	151	94	58	36	34.6%	47.8%	24.0%	14.8%	16.1%	13.1%
	2012	763	409	354	282	133	149	87	58	29	31.0%	43.7%	19.5%	11.5%	14.3%	8.2%
	2013	945	494	451	285	129	155	79	64	15	27.8%	49.3%	10.0%	8.4%	12.9%	3.4%

- Data are from the publicly available Form 10-K, a summary of a company's financial performance required by the U.S. Securities and Exchange Commission (SEC).
- Tax over income = Tax / Income. Tax includes the provisions for current and deferred taxes.
- If income before taxes is negative (loss), also tax over income is negative (i.e. N/A). For comparison purposes tax over US and non-US sales has been included.

<sup>70</sup> The US Income figures for Apple are not explicitly mentioned and have been calculated as the difference between total income and other income.

<sup>71</sup> Figures for Yahoo are somewhat blurred due to an exceptionally large amount of 'other income' realised in 2012.

## ANNEX 2B: TAX OVER INCOME AND SALES – MAJOR NON-DIGITAL COMPANIES

		Sales (mln USD)			Income (mln USD)			Tax (mln USD)			Tax over Income			Tax over Sales		
		Total	US	Other	Total	US	Other	Total	US	Other	Total	US	Other	Total	US	Other
<b>Johnson &amp; Johnson</b>	2011	65,030	28,908	36,122	12,361	3,634	8,727	2,689	1,702	987	21.8%	46.8%	11.3%	4.1%	5.9%	2.7%
	2012	67,224	29,830	37,394	13,775	4,664	9,111	3,261	1,903	1,358	23.7%	40.8%	14.9%	4.9%	6.4%	3.6%
	2013	71,312	31,910	39,402	15,471	4,261	11,210	1,640	343	1,297	10.6%	8.0%	11.6%	2.3%	1.1%	3.3%
<b>GE Company</b>	2011	146,542	69,900	76,642	20,159	10,206	9,953	5,745	3,198	2,547	28.5%	31.3%	25.6%	3.9%	4.6%	3.3%
	2012	146,684	70,500	76,184	17,381	8,309	9,072	2,534	436	2,098	14.6%	5.2%	23.1%	1.7%	0.6%	2.8%
	2013	146,045	68,600	77,445	16,151	6,099	10,052	676	-1,945	2,621	4.2%	-31.9%	26.1%	0.5%	-2.8%	3.4%
<b>Procter &amp; Gamble</b>	2011	81,104	29,900	51,204	14,997	8,858	6,139	3,299	2,226	1,073	22.0%	25.1%	17.5%	4.1%	7.4%	2.1%
	2012	83,680	29,500	54,180	12,785	7,584	5,201	3,468	2,242	1,226	27.1%	29.6%	23.6%	4.1%	7.6%	2.3%
	2013	84,167	30,300	53,867	14,843	8,351	6,492	3,441	2,344	1,097	23.2%	28.1%	16.9%	4.1%	7.7%	2.0%
<b>Pfizer</b>	2011	61,035	25,275	35,760	11,481	-2,655	14,136	3,621	1,487	2,134	31.5%	N/A	15.1%	5.9%	5.9%	6.0%
	2012	54,657	21,313	33,344	11,242	-5,148	16,390	2,221	-465	2,686	19.8%	N/A	16.4%	4.1%	-2.2%	8.1%
	2013	51,584	20,274	31,310	15,716	-1,678	17,394	4,306	2,127	2,179	27.4%	N/A	12.5%	8.3%	10.5%	7.0%
<b>Coca-Cola</b>	2011	46,542	18,699	27,843	11,458	3,029	8,429	2,812	1,277	1,535	24.5%	42.2%	18.2%	6.0%	6.8%	5.5%
	2012	48,017	19,732	28,285	11,809	3,526	8,283	2,723	1,645	1,078	23.1%	46.7%	13.0%	5.7%	8.3%	3.8%
	2013	46,854	19,820	27,034	11,477	2,451	9,026	2,851	1,158	1,693	24.8%	47.2%	18.8%	6.1%	5.8%	6.3%
<b>Merck &amp; Co</b>	2011	48,047	20,495	27,552	7,334	2,626	4,708	942	57	885	12.8%	2.2%	18.8%	2.0%	0.3%	3.2%
	2012	47,267	20,392	26,875	8,739	4,500	4,239	2,440	2,112	328	27.9%	46.9%	7.7%	5.2%	10.4%	1.2%
	2013	44,033	18,246	25,787	5,545	3,513	2,032	1,028	503	525	18.5%	14.3%	25.8%	2.3%	2.8%	2.0%
<b>Pepsico</b>	2011	66,504	33,053	33,451	8,834	3,964	4,870	2,372	1,578	794	26.9%	39.8%	16.3%	3.6%	4.8%	2.4%
	2012	65,492	33,348	32,144	8,304	3,234	5,070	2,090	1,245	845	25.2%	38.5%	16.7%	3.2%	3.7%	2.6%
	2013	66,415	33,626	32,789	8,891	3,078	5,813	2,104	1,286	818	23.7%	41.8%	14.1%	3.2%	3.8%	2.5%

- Data are from the publicly available Form 10-K, a summary of a company's financial performance required by the U.S. Securities and Exchange Commission (SEC).
- Tax over income = Tax / Income. Tax includes the provisions for current and deferred taxes.
- If income before taxes is negative (loss), also tax over income would turn out to be negative (i.e. N/A). For comparison purposes tax over US and foreign sales has been included

## **ANNEX 3: INTERNATIONAL TAX POLICY – THE INSTITUTIONAL FRAMEWORK**

### **1. Introduction**

The levying and collection of taxes has always been seen as one of the fundamental elements of sovereign states. As a consequence, tax legislation is essentially created at national level, tax obligations are audited at national level and taxes are collected at national level. Nevertheless, national tax provisions are influenced or governed also by a series of international provisions, either legally binding bilateral or multilateral obligations or non-legally binding political guidance. For the EU Member States this means that they are competent to amend their domestic tax systems and tax rates or to introduce new taxes as they see fit, provided they observe EU and international legal obligations and political commitments.

The international influence on national tax provisions is exercised at two different levels. In the first place the Member States of the EU must ensure that their tax legislation complies with EU law<sup>72</sup>. Secondly, their legislation must ensure the rights and obligations warranted under bilateral tax conventions typically based on global standards established in the framework of the OECD and more recently also influenced by political pressure exercised at G20 level.

### **2. Global standard setting**

#### *2.1 The G20*

##### *2.1.1 General*

The Group of Twenty Finance Ministers and Central Bank Governors (G20) is an informal forum that promotes open and constructive discussion between advanced and emerging-market countries on key issues related to global economic stability. The G20 was created as a response both to the financial crises of the late 1990s and to the growing recognition that key emerging-market countries were not adequately included at the core of global economic discussions and governance fora. It consists of the finance ministers and central bank governors from 20 major economies: 19 countries<sup>73</sup> plus the European Union<sup>74</sup>. In addition to these 20 members, the chief executive officers of several other international forums and institutions participate in meetings of the G20. These include the Managing Director of the International Monetary Fund (IMF), the President of the World Bank, the Chairman of the International Monetary and Financial Committee and of the Development Assistance Committee. The G20 Finance Ministers and Central Bank Governors meet on average 2 to 3 times a year but more frequently when the global financial situation requires it.

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<sup>72</sup> This concerns in the first place hard law such as the four freedoms vested in the Treaty on the Functioning of the European Union, but also soft law such as the Code of Conduct on business taxation which aims at eliminating harmful tax competition within the EU and its overseas territories.

<sup>73</sup> Argentina, Australia, Brazil, Canada, China, France, Germany, India, Indonesia, Italy, Japan, Mexico, Russia, Saudi Arabia, South Africa, South Korea, Turkey, the United Kingdom and the United States of America.

<sup>74</sup> Spain participates in every meeting as a permanent guest.

There are no formal criteria for G20 membership. The G20 members do not reflect exactly the 19 largest national economies of the world in any given year. It rather consists of countries and regions of systemic significance for the international financial system. Aspects such as geographical balance and population representation also play a major part. The composition of the group has remained unchanged since it was established.

#### G20 summits

For almost a decade the G20 was mainly a discussion and consultation forum on international financial issues between finance ministers and central bank governors. The global financial crisis of 2008 changed the nature of the G20. The rapidly deteriorating economic situation in the autumn of 2008 made evident to the leaders of advanced economies that emerging markets had also to be part of the solution. The decision to raise its profile was taken at the EU-US meeting in Camp David in October 2008 driven by the French EU Presidency. The Statement of France, the United States, and the Presidency of the European Commission issued on 18 October after the meeting indicated that *"The three leaders ... agreed they would reach out to other world leaders ... with the idea of beginning a series of summits on addressing the challenges facing the global economy"*. Accordingly, the forum was steered by the G20 Leaders, who meet to discuss the economic situation, and to take the actions needed to stabilise the global economy and to strengthen the recovery. G20 Summits have been held since then at Leaders' level, initially twice a year but since 2011 on an annual basis.

#### Role of the EU

The EU is a full member of the G20. At finance ministerial level, the EU is currently represented by the Commission and the European Central Bank (ECB). At leaders' level, the EU is represented by the President of the European Council and the President of the European Commission. The G20 exerts significant and growing influence in areas of EU competence and where strategic interests of the EU are at stake, such as multilateral trade issues, regional integration, financing for development, combating the financing of terrorism or exchange-rate issues. At present, the European Commission participates in the G20 summits, the ministerial meetings, the meetings at deputies' level and in the G20 working groups.

Since taxation is a shared competence (see 3.1 below), the opportunity to represent a common EU position on tax matters in G20 discussions is not evident. Nevertheless, the Council Presidency and the Commission aim at coordinating Member States' positions in tax matters to ensure maximum EU influence in the global debate.

#### 2.1.2 G20 instruments

The G20 studies, reviews, and promotes high-level discussion of policy issues pertaining to the promotion of international financial stability. It lacks any formal ability or legal basis to enforce rules, but its economic weight and prominent political membership gives it a high degree influence over the management of the global economy and financial systems, including tax systems. The G20 effects this influence through Leader Declarations, which contain the conclusions of the deliberations at a

G20 Summit, and the Communiqués that are published following the G20 Finance Minister and Bank Governor meetings.

The general and political nature of the language used in the Declarations and Communiqués means that they do not require implementation in order to reach their effect, but they rather need to be followed-up and executed by the countries that agreed the general policy line. Occasionally, the G20 statements also contain calls upon international organisations to take a specific line of action or set priorities. This is for example the case in taxation where the G20 call for action to promote international exchange of information in tax matters was fundamental in pushing the OECD to develop the necessary framework and instruments to achieve this.

### 2.1.3 G20 decision making process

The G20 does not have a permanent secretariat or staff. The group's chair rotates annually among the members and establishes a temporary secretariat for the duration of its term, which coordinates the group's work and organises its meetings. Australia currently holds the G20 presidency with the annual G20 summit taking place in Brisbane on 15-16 November 2014. Turkey will hold the next Presidency in 2015.

In preparation for the annual Leader's Summit, G20 Sherpas meet several times during the year<sup>75</sup>. G20 Finance Ministers and Central Bank Governors meetings are supported by corresponding preparatory meetings of Finance Deputies<sup>76</sup>. The preparatory meetings of Finance Deputies and Sherpas are essential in preparing the draft texts for the final Communiqués and Declarations. There is no formal voting in this process; the final outcome is based on deliberations, negotiations, compromises and is finally agreed by consensus.

### 2.1.4 G20 and taxation

Since the global financial crisis in 2008, the G20 has also taken a more prominent role in promoting coordinated reforms and more cooperation in international tax policy. In response to a G20 request the Global Forum on Transparency and Exchange of Information was restructured in September 2009 to strengthen the implementation of the global standard for tax information exchange on request; more recently the G20 has been fundamental in fostering automatic information exchange to become the new global standard in the area of international tax compliance.

G20 Leaders also identified the need to look at international corporation tax issues as a priority in their tax agenda at their Summit meeting in Los Cabos, Mexico, in June 2012. This specifically concerns tax planning that may be used by multinational enterprises to artificially shift profits out of the countries where they are earned

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<sup>75</sup> A Sherpa is the personal representative of a head of state or government who prepares an international summit. This reduces the amount of time and resources required at the negotiations of the heads of state at the final summit. Sherpas are quite influential but generally lack the political authority to independently make any final decisions.

<sup>76</sup> These meetings are at high administrative level, typically involving the Secretary-General or Director General of the responsible Finance Department.

through a lack of interaction of different national tax rules, resulting in very low taxes or double non-taxation. The G20 Leaders put this phenomenon - described as Base Erosion and Profit Shifting (BEPS) - high on their agenda. At the request of G20 Finance Ministers, the OECD launched an Action Plan on Base Erosion and Profit Shifting in July 2013, which inter alia also recognises the importance of addressing the borderless digital economy. Both the G20 Finance Ministers and Central Bank Governors Communique of July 2013 and the G20 Leader's Declaration of the Saint-Petersburg Summit in September 2013 fully endorsed the BEPS Action Plan.

The G20 therefore does not have any formal decision making or legislative powers in the area of international taxation, but it has been and will continue to be vital in providing for the necessary global political influence and pressure to ensure the execution and implementation of global tax reforms. Such reforms would not be possible without the strong political backing of the G20 and any possible solutions to address existing deficiencies in global tax systems will need the support of G20 to be effectively addressed.

## 2.2 *The OECD*

### 2.2.1 General

The Organisation for Economic Co-operation and Development (OECD) is an intergovernmental organisation aiming at the promotion of sound economic policies both for its members and globally. The OECD currently has 34 member countries which include 21 EU Member States<sup>77</sup> and Australia, Canada, Chile, Iceland, Israel, Japan, Korea, Mexico, New-Zealand, Norway, Switzerland, Turkey and the United States. The EU, represented by the European Commission, participates in OECD meetings in the same way as the member countries with two exceptions: the Commission representative holds no right to vote and the EU is not obliged to contribute to the regular OECD budget.<sup>78</sup>

The OECD aims to contribute to the development of the world economy by achieving sustainable economic growth and employment, while maintaining financial stability. It focuses on the sound economic expansion of both its members and of non-member countries in the process of economic development and as such provides a forum in which governments work together to share experiences and seek solutions to common economic and social problems.

In the area of taxation, the main role of the OECD is the analysis and comparison of data related to tax policies and the development and setting of international standards. The OECD has been critical in developing the international principles and practices to solve international tax conflicts. This is mainly reflected in the OECD Model Tax Convention on Income and on Capital and in the OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations, the two primary OECD contributions in this area.

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<sup>77</sup> Bulgaria, Croatia, Cyprus, Lithuania, Latvia, Malta and Romania are currently not a member of the OECD. The accession process for Latvia is in an advanced stage.

<sup>78</sup> However, the EU is amongst the largest contributors of Voluntary Contributions to the OECD, which make up a significant part of the OECD's budget.

- In 1963 the OECD first published a Draft Double Taxation Convention on Income and Capital and in 1977 the Model Tax Convention on Income and on Capital was published. Since 1992, the OECD Model Convention and the OECD Commentary are updated on a regular basis. The Model Tax Convention and the related OECD Commentary are at the basis of most of the bilateral tax conventions concluded by OECD member states.
- The OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations provide guidance on the application of the "arm's length principle" for the valuation, for tax purposes, of cross-border transactions between associated enterprises. The Guidelines were originally approved by the OECD Council in 1995. They were completed with additional guidance in several areas in 1996-1999 and again supplemented and amended in the 2009 edition, primarily to reflect the latest developments on dispute resolution.

#### 2.2.2 OECD instruments

The OECD has a series of instruments at its disposal such as decisions, recommendations, memoranda of understanding, declarations and guidelines. The OECD operates as a consensus organisation; guidelines and other instruments are therefore agreed by consensus amongst all members.

The instruments are not legally binding upon its members but the fact that principles and guidelines are agreed by consensus and thus supported by all OECD member countries means that they have a strong standard setting character. Where one or more countries do not agree on a specific common standard or guideline and consensus is therefore not possible, the OECD has developed the practice of disclosing the dissenting opinion(s) and their originator(s) thereby indicating that the standard or guideline is not shared by all.

#### 2.2.3 Decision making process

Decision-making power within the OECD is vested in the OECD Council. It is made up of one representative per member country, typically the Minister for Economic Affairs, plus a representative of the European Commission. The Council meets regularly at the level of permanent representatives to OECD and decisions are taken by consensus. These meetings are chaired by the OECD Secretary-General. The Council also meets at ministerial level once a year to discuss key issues and set priorities for OECD work. The work mandated by the Council is carried out by the OECD Secretariat. The OECD Secretariat in Paris is made up of some 2,500 staff that supports the activities of committees, and carries out the work in response to priorities decided by the OECD Council. In the area of taxation this is done by the OECD Centre for Tax Policy and Administration (CTPA).

To advance ideas and review progress in specific policy areas, including in the area of taxation, representatives of the 34 OECD member countries meet in specialised committees. For taxation this is the Committee on Fiscal Affairs (CFA), in which OECD member countries are represented by their Director (General) for International Tax Affairs. The CFA meets twice a year, typically end of January and end of June. The CFA has a Chair and a Board, both of which are elected by the CFA from amongst its members. The more technical and practical work is prepared and

executed in various working parties, taskforces and other sub-committees of the CFA. These sub-committees also have a chair and board, the election of which are approved by the CFA. Most sub-committees also meet twice a year, sometimes more, sometimes less. Both the CFA and its subcommittees are assisted by the OECD Secretariat provided by the CTPA.

The CFA bi-annually establishes its Program for Work and Budget (PWB), in which the priority work areas for the next two years are established. Areas of work laid down in the PWB are then prepared by the responsible sub-committees, typically in the form of a draft report, draft guidelines or a draft amendment of an existing OECD instrument. All sub-committees report to the CFA on the results of their deliberations, including whether or not they have been able to reach consensus. The CFA subsequently decides on the issue, again by consensus and reports to the Ministerial Council for a final adoption of the instrument.

#### Timing

The whole process from the developing a policy initiative, agreement of the PWB and endorsement by the PWB by the Ministerial Council, execution by sub-committees and approval of the result by the CFA and Ministerial Council can take anything from two to five or even more years, depending on the size and complexity of the instrument. For illustration, the BEPS Action Plan was developed in 2013 and agreed in 2014. Its first results are expected to be adopted by the Ministerial Council in 2015. By OECD standards this is considered to be extremely fast.

#### Implementation

If and to what extent OECD instruments need to be implemented by the member countries in order to achieve the desired effect, depends on the instrument. For example, if the OECD were to agree on guidelines for the tax treatment of partnerships, the countries wishing to follow the guidelines will most likely need to amend their domestic tax legislation. Similarly, if the OECD were to agree on a different allocation of taxing rights under the OECD Model Tax Convention, OECD member countries wishing to reflect this new standard in their existing bilateral tax treaties will have to renegotiate the bilateral tax treaties concerned.

### *2.3 Other international taxation standard setting organisations*

The OECD and its primary instruments – the OECD Model Tax Convention and the OECD Transfer Pricing Guidelines – have been developed and are used by most of the developed countries. The UN Tax Committee has also gained importance in recent years as an international tax standard setting organisation. It has developed the UN Model Double Taxation Convention, which is used as the basis in double tax treaty negotiations by non-OECD and developing countries. The main structure of that model is the same as the OECD Model, but the UN Model puts a larger emphasis on attributing taxing rights to source states as opposed to the state of residence. This is reflected, for example, in setting higher rates of withholding taxes on outbound dividend, interest and royalty payments and in a wider definition of the PE concept used to describe a the minimum presence required for a non-resident entity to become liable to tax.



### **Summary Global Standard setting**

Following the financial crisis in 2008, the G20 has taken a more prominent role in seeking coordinated reforms in international tax policy. Although it lacks a formal or legal basis to enforce standards, its economic weight and prominent political membership makes it a critical factor in setting the global direction for new or amended international tax standards. G20 decision making is not based on formal voting rules. The G20 instruments (Communiqués and Declarations) are drafted in several preparatory meetings of Finance Deputies and Sherpas. The final texts are agreed by consensus and hence based on deliberations, negotiations and compromises.

While G20 provides for the general direction and political impetus, the OECD – in an extended format including non-OECD countries – provides for the actual implementation. The technical discussions at OECD level are very detailed and take place at subsidiary body level, with general steering from the CFA. Agreed standards or recommendations are agreed in the realm of soft law based on consensus. This also holds true for the implementation of the standards by the individual countries, but since countries with a dissenting opinion typically indicate this when agreeing the standard, non-application of agreed standards is in practice a rare exception.

## **3. The European Union**

### *3.1 Limitations for the EU to act in the area of taxation*

Legal basis for EU action in the area of taxation

Articles 113 and 115 on the Treaty on the Functioning of the European Union (TFEU) provide the basis for EU legislation in the area of direct or indirect taxation. EU indirect tax legislation is based on article 113 TFEU which expressly mentions the harmonisation of indirect tax legislation.

#### *Article 113 TFEU*

*The Council shall, acting unanimously in accordance with a special legislative procedure and after consulting the European Parliament and the Economic and Social Committee, adopt provisions for the harmonisation of legislation concerning turnover taxes, excise duties and other forms of indirect taxation to the extent that such harmonisation is necessary to ensure the establishment and the functioning of the internal market and to avoid distortion of competition.*

EU direct tax legislation, on the other hand, must be based on the broader provision in article 115 TFEU which does not have an explicit reference to (direct) taxation.

*Article 115 TFEU*

*Without prejudice to Article 114, the Council shall, acting unanimously in accordance with a special legislative procedure and after consulting the European Parliament and the Economic and Social Committee, issue directives for the approximation of such laws, regulations or administrative provisions of the Member States as directly affect the establishment or functioning of the internal market.*

Nevertheless, both provisions deal with approximating measures for improving the establishment or functioning of the Internal Market. As a consequence, all EU legislative proposals related to taxation must have a cross-border dimension aimed at improving the establishment or functioning of the Internal Market to comply with the legal bases given by both articles.

The competences given to the EU under Article 113 and 115 TFEU concern so-called shared competences<sup>79</sup>. The list of areas where shared competence applies is not exhaustive. Therefore, the conferral of shared competence on the Union may be explicit as in Article 113 TFEU or implicit as in Article 115 TFEU. Shared competence means that Member States may exercise their competence to the extent that, within the scope of shared power, the Union (i) has not acted; and (ii) has decided to cease to exercise its competence in a precisely delineated field.<sup>80</sup>

In the field of direct tax, this means that the competence to determine the criteria by reference to which income and capital should be taxed lies with the Member States<sup>81</sup> whereas in the area of VAT, the existence of extensive EU legislation implies that competence has passed to the Union in the fields covered by the VAT Directive and Regulations. Consequently, for taxing income and capital Member States are for example free to agree the connecting factors for the allocation of taxing rights in a cross-border context, which is commonly achieved via bilateral tax treaties. Yet, in exercising this competence, Member States remain subject to the *acquis communautaire* (e.g. the Treaty freedoms, as interpreted by the case law of the CJEU in the field of direct taxation, secondary Union law, such as the VAT Directive and Regulations and so on).<sup>82</sup>

Subsidiarity and proportionality

Apart from a valid legal basis, any EU legislative action in the area of taxation must also meet the principles of subsidiarity and proportionality.

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<sup>79</sup> Article 4(2)(a) TFEU. The Union shall share competence with the Member States where the Treaties' conferral does not relate to either exclusive competence (Article 3 TFEU) or cases where the Union is limited to supporting, coordinating or supplementing Member States' action (Article 6 TFEU).

<sup>80</sup> Article 2(2) TFEU. In this regard, the Union is considered to have taken action in an area of shared competence only regarding the specific elements covered by its act in question and not the entire policy area (Protocol 25).

<sup>81</sup> There is at present no Union legislation on these areas.

<sup>82</sup> Bilateral tax treaties signed by Member States with third countries prior to their accession, remain valid as regards the rights which they accord to the third countries (Article 351 TFEU). To the extent that these agreements are not compatible with the Treaties, Member States shall take all appropriate steps to eliminate incompatibilities (in practice, by re-negotiating the agreements).

Subsidiarity means that the Union shall act only if (and insofar as) the objectives of the proposed action cannot be sufficiently achieved by the Member States acting individually but, instead, can be better achieved at the level of the Union due to their scale and effects. Subsidiarity applies to areas where the EU does not have exclusive competence, so tax matters are typically reviewable under this principle.

In practice, the existing tax Directives aim to tackle obstacles which discourage commercial activity in a cross-border intra-EU context. In the absence of this cross-border element, the proposed measures would fall outside the scope of the legal bases of the Treaty. It is on this premise that the principle of subsidiarity is by definition complied with in tax initiatives since only harmonised (or coordinated) rules can reduce or eliminate distortions resulting from national disparities in regulation. Individual, un-coordinated, action by Member States can only further fragment the current fiscal landscape.

The subsidiarity principle is set out in Article 5 of the Treaty on European Union (TEU) and in Protocol 2. The procedure of the Protocol involves an obligation of the Commission to notify its Proposals to national Parliaments at the same time as to the Union legislator, i.e. Council and European Parliament (EP). National Parliaments are given 8 weeks from the date of transmission to react on the Proposal if they consider that the text does not comply with the principle of Subsidiarity. If this is the case, they set out their views in a reasoned opinion and communicate it to the Commission and also the Council and the EP. Each national Parliament has two votes, which, in the case of bicameral systems, means that each chamber is given one vote. If the reasoned opinions on non-compliance of an EU tax proposal amount to at least 1/3 of the overall number of votes granted to national Parliaments, the Commission reviews the draft legislation and may decide to maintain, amend or withdraw it<sup>83</sup>. The Commission must provide reasons for its decision.

Under the principle of proportionality, the Union actions shall not exceed what is necessary to achieve the objectives of the Treaties. Article 5 TFEU prescribes that the institutions shall apply the principle of proportionality as laid down in the Protocol. Although the review by national Parliaments under Protocol 2 is typically limited to subsidiarity, experience has shown that national Parliaments' reasoned opinions usually also discuss proportionality.

### *3.2 Legal instruments*

Article 113 TFEU on indirect taxation refers to the general term "provisions". Consequently, in indirect taxation the Commission may act by all types of legislative acts provided for in the Treaty, i.e. Directives, Regulations or Decisions. Article 115 TFEU, however, specifically refers to directives which are therefore the only instrument available to propose binding direct tax measures. In addition, the Commission may always adopt Recommendations and Opinions<sup>84</sup>, which are non-

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<sup>83</sup> Protocol 2 also provides for a second procedure of review which sets out stricter justification requirements on to the Commission and also engages the Council and EP. However, this is not applicable to policy areas where decision-making requires unanimity, such as taxation.

<sup>84</sup> Article 288, last subparagraph TFEU and Article 292 TFEU (Recommendations).

binding legal acts but their adoption does not go through the legislative procedure prescribed in the Treaties.

Based on the so-called 'new Comitology' rules, the Commission may also adopt acts for the purpose of amending or supplementing non-essential elements of a legislative act (i.e. delegated acts) or implementing binding Union acts (i.e. implementing measures) in a uniform manner.<sup>85/86</sup> In delegated acts, the legislative instrument must lay down the conditions to which the delegation is subject. The essential elements cannot be subject to a delegation of power. As a consequence, the EP or the Council may be given the power to revoke such delegation or permit a delegated act to enter into force only if they express no objection to it.<sup>87</sup> In agreeing to these terms, the EP acts by the majority of its members and the Council by qualified majority.

The adoption of legislative acts in taxation requires unanimity in Council and the European Parliament is only consulted. In interpreting Article 290(2) TFEU for the purpose of the CCCTB proposal<sup>88</sup>, the right to revoke a delegation or object to delegated acts was assigned exclusively to the Council, with the EP only being informed.

### *3.3 Decision-making procedure*

The European Commission first proposed legislation in direct and indirect taxation in the 1960s and has since consistently based its legislative acts on Articles 115 and 113 TFEU respectively. Both provisions lay down a requirement for a unanimous vote in Council<sup>89</sup> according to the 'special legislative procedure'. Article 115 TFEU is drafted as an exception to the default provision of Article 114 TFEU which prescribes the 'ordinary legislative procedure', i.e. decision taking by qualified majority, as the

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<sup>85</sup> Article 290(1) and 291(2) TFEU respectively.

<sup>86</sup> As a matter of principle, Member States have so far been firmly opposed to the prospect for granting delegated or implementing powers to the Commission in tax matters. This is evidently related to the fact that legislative decision-making in taxation requires a unanimous vote whilst the 'new Comitology' rules retain the tradition of qualified majority in Council. Member States usually view the referral of items to delegated acts or implementing measures as a loophole which permits circumvention of the principal voting rules of the Treaties. So far, it appears that in the field of tax, references to implementing measures (under the 'old Comitology') went through only in the Directives on mutual assistance for the recovery of claims and administrative cooperation. In contrast, the VAT Committees operate outside the scope of Articles 290 and 291 TFEU. Their legal base is Article 398 of the VAT Directive.

<sup>87</sup> Article 290(2) TFEU.

<sup>88</sup> Proposal for a Council Directive on a Common Consolidated Corporate Tax Base (CCCTB), COM(2011)121.

<sup>89</sup> The Treaty of Lisbon incorporated an additional dimension of the so-called 'escalator clause' (Article 48(7) TEU). That is, decision-making in a policy area (e.g. taxation) can be moved from unanimity to a vote of qualified majority in Council or from a 'special' to the 'ordinary legislative procedure'. A number of Member States feared that the possibility of shifting from unanimity to qualified majority voting could undermine their current veto right in tax matters. In reality, however, decision-making remains double locked in the sense that the decision to shift from unanimity to qualified majority voting still requires a unanimous vote at the Council. In addition, the shift cannot be materialised if a single national parliament, being notified of such initiative, opposes to it within 6 months. Further, the EP must also give its consent to the envisaged shift. It therefore seems unlikely that this clause will be invoked in tax matters in the foreseeable future.

rule for measures that directly affect the establishment and proper functioning of the Internal Market.<sup>90</sup>

In the field of indirect taxes (i.e. VAT, Excise Duties and energy taxes), the wording of Article 113 TFEU (Article 93 Treaty establishing the European Community) was amended under the Lisbon Treaty, where the aim to '*avoid distortion of competition*' was added to '*ensuring the establishment and the functioning of the internal market*' as a justification for enacting indirect tax rules. Whether the two objectives are set out as alternatives or in a cumulative manner appears to be of a minimal practical importance.

The involvement of the EP and the European Economic and Social Committee (EESC) is limited to a consultation in the framework of which they issue an 'Opinion'. The Committee of the Regions (CoR) may also publish an Opinion on its own initiative<sup>91</sup>. As mentioned before, national Parliaments have the right to review Commission legislative proposals for compliance with the principle of subsidiarity. If they decide to put forward a challenge, they may revert to the Commission with a reasoned opinion within 8 weeks of the adoption of the act.

### Timing

1. Development of an idea till adoption of the legislative proposal by the College of Commissioners <sup>92</sup> .	<b>1 year<sup>93</sup> or more</b>
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This typically involves an external study, a public consultation, the preparation of the impact assessment and approval by the Impact Assessment Board, drafting of the legislative proposal, inter-service consultation, translation and adoption by the College.

2. Adoption by the Council	<b>1 year or more</b>
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Following the adoption of a legislative proposal by the College, the proposal is normally tabled for discussion at a Council Working Party, based on the Agenda of the Presidency. The number of sessions at Council Working Party level depends on the technical and legal complexities, divergent policy views between Member States and political sensitivities. The proposal may also be tabled

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<sup>90</sup> Conversely, the Treaty of Nice treated Article 95 TEC (currently Article 114 TFEU) as the exception and unanimity as the rule.

<sup>91</sup> Article 307 fourth subparagraph TFEU. The Committee of the Regions made use of this possibility in the case of the proposal for a CCCTB.

<sup>92</sup> The Commission is composed of the College of Commissioners of 28 members, including the President and vice-presidents. The Commissioners, one from each EU Member State, provide the Commission's political leadership during their 5-year term. Each Commissioner is assigned responsibility for specific policy areas by the President.

<sup>93</sup> The period from the conception of the plan till adoption can be longer in case of complex or politically sensitive topics and could be shortened to a few months for urgent straightforward proposals.

to High Level Working Groups. Since unanimity in Council is required, some proposals may take a long time to be agreed<sup>94</sup>.

In parallel, the EP and the EESC will issue an 'Opinion' to which the Commission has to respond, the CoR may publish an Opinion and national Parliaments may review the proposal for compliance with the principle of subsidiarity.

### 3. Implementation by Member States

**1-2 years**

Assuming it concerns a legislative act other than a regulation which is directly applicable and effective, EU legislative acts must be implemented in national legislation in order to achieve their legal effect. The implementation period is usually prescribed in the legislative act itself and typically amounts to 1 to 2 years depending on the complexity of the measure.

*Total*

*3 years or more*

### 3.4 Enhanced cooperation

Enhanced cooperation is potentially an alternative in the area of taxation if adoption of a proposal by the Council is blocked through the veto by one or several Member States. The procedure allows a group of at least 9 Member States to move ahead of the other Member States and develop common policies which further the objectives of the Union<sup>95</sup>. A key condition for the legitimacy of enhanced cooperation is that the participating Member States seek to pursue objectives for which it has been established that they cannot be attained by the Union as a whole within a reasonable period. It is therefore an alternative of last resort.

The cooperation may also concern areas that fall within the scope of the Treaties but that are not within the Union's exclusive competence; tax matters therefore list amongst the areas which can be submitted to enhanced cooperation. A condition is that the Union has not previously legislated in this area. Moreover, acts and decisions taken in the context of enhanced cooperation do not become part of the *acquis communautaire*<sup>96</sup>.

The proposal authorising enhanced cooperation is submitted to the Council by the Commission subject to a formal request from at least nine interested Member States. The Council decides on this proposal by qualified majority and the EP must

<sup>94</sup> The proposal for a Common Consolidated Corporate Tax Base, COM(2011)121, was agreed by the Commission in March 2011 and is still subject to technical discussions at Council Working Party level. Similarly, the Commission proposal for a recast the Interest and Royalty Directive, COM(2011)714, was made in November 2011. Progress via discussion at Council Working Party level has been limited so far due to fundamentally diverging views between Member States.

<sup>95</sup> Article 20(2) TEU.

<sup>96</sup> Article 20(4) TEU.

give its consent<sup>97</sup>. The legal base for proposals under enhanced cooperation stays the same. Therefore, in tax matters where the voting requirement is unanimity, Member States participating in enhanced cooperation must also decide unanimously. All Member States may participate in the discussion in Council but only those participating in the enhanced cooperation mechanism have a vote.

### *3.5 The Court of Justice of the European Union*

#### The role of the CJEU - general

The Court of Justice of the European Union (CJEU) is the judicial institution of the EU and of the European Atomic Energy Community. Its primary task is to examine the legality of European Union measures and to make sure that EU law is applied in the same way in all EU Member States. It also settles legal disputes between the governments of Member States and EU institutions. Individuals, companies or organisations can also bring cases before the Court if they feel their rights have been infringed by an EU institution.

The CJEU works in conjunction with the national courts of the EU Member States, which are the ordinary courts applying EU law. Any national court or tribunal which is called upon to decide a dispute involving EU law may, and sometimes must, submit questions to the CJEU for a preliminary ruling. The Court must then give its interpretation or review the legality of a rule of EU law. The CJEU is composed of 28 Judges and 9 Advocates General to assist the Court. The Judges and Advocates General are appointed by common accord of the governments of the Member States. They are appointed for a term of office of six years, which is renewable.

The Court sits as a full court in the particular cases prescribed by the Statute of the Court, when a Member State or an institution which is a party to the proceedings so requests and in particularly complex or important cases. Other cases are heard by Chambers of three or five Judges. The Court gives rulings on the cases brought before it, in particular:

1. Requests for a preliminary ruling
2. Actions for failure to fulfil an obligation
3. Actions for Annulment
4. Actions for failure to act
5. Direct actions

#### The CJEU in the area of taxation

The types of decisions that have the most direct influence on the EU legal tax framework are the preliminary rulings. In the area of indirect taxes they concern, in particular, whether Member States have correctly implemented the harmonised VAT provisions in their national VAT laws. In the absence of harmonisation in direct tax law, preliminary rulings in the area of direct tax consider mainly whether Member States' tax provisions are respecting general principles of EU law, i.e. non-

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<sup>97</sup> Article 329(1) TFEU in conjunction with 16(3) TEU.

discrimination, the freedom of establishment and the free movement of goods, services and capital.

Over the last 20 years, the CJEU has established a significant body of jurisprudence in these areas. This case law concerns the interpretation of the Treaty (Primary law) and also in some cases the interpretation of taxation Directives (Secondary law). Where the CJEU rules that a Member State's legislation does not respect primary or secondary law it does not propose an alternative, that is for the Member State to do; or in some circumstances for the European Commission to propose.



## ANNEX 4. EMPLOYEE TAXATION AND SSC ON STOCK OPTIONS AND SHARE SCHEMES

Type of plan	Stock Options <sup>98</sup> (focus non-tradable options)			Employee Shares	
	Country:	Moment taxation	Tax treatment of benefit <sup>99</sup>	SSC <sup>100</sup>	Tax treatment of benefit
Belgium	grant	reduced tax rate (special rules for value / tax base)	no	reduced tax rate at grant; at sale depends on holding period	no, if 2-5 years blocking period
Bulgaria	exercise	full taxation	no	full taxation	no
Czech Republic	exercise	full taxation	yes	full taxation	yes
Denmark	exercise	full taxation	yes	for qualified plans reduced taxation subject to conditions	no
Germany	exercise	full taxation	yes	PIT exemption subject to ceiling (€ 360 p.a.); conditinal incentives;	exemption + annual ceiling (€ 360)
Estonia	exercise	full taxation	no	full taxation	no
Ireland	exercise	PIT exemption and incentives subject to conditions	yes	PIT exemption and incentives subject to conditions	no
Greece	exercise	full taxation	no	full taxation	yes
Spain	grant	80% PIT exemption subject to conditions;	no	PIT exemption subject to ceiling (€ 12,000 p.a.) and conditions	base reduction
France	exercise	full taxation	yes	full taxation; restricted exemptions when held in FCPE	yes; reduction for FCPE
Croatia	exercise	full taxation	no	taxation with reduced tax rate	no
Italy	exercise	reduced taxable income subject to conditions;	base reduction	PIT exemption subject to annual ceiling (€ 2,066) and conditions;	exemption + annual ceiling (€ 2,066)
Cyprus	exercise	full taxation	yes	full taxation	yes
Latvia	exercise	full taxation	yes	full taxation	yes
Lithuania	exercise	full taxation	yes	full taxation	yes
Luxembourg	exercise	full taxation	yes	full taxation	no
Hungary	exercise	reduced tax rate; reduced taxable income, conditional + ceiling (appr € 3,700 p.a.)	no	approved plans: reduced taxable income, conditional + ceiling (appr € 3,700 p.a.)	no
Malta	grant / exercise	stamp duty / tax exemption subject to conditions	no	full taxation	no
Netherlands	exercisable & exercise	reduced tax rate once exercisable; full tax at exercise	no	full taxation	no
Austria	exercise	reduced tax rate subject to conditions and ceilings	no	PIT exemption subject to ceiling (€ 1,460 p.a.) and conditions	exemption subject to ceiling (€ 1,460 p.a.)
Poland	exercise	full taxation	no	full taxation	yes

<sup>98</sup> Data on the treatment of (broad based) stock options plans and employee share ownership schemes for 2012 stem from the 2012 EP-Study „Financial Participation of Employees in Companies’ Proceeds”. The description of the tax treatment is limited to the value of the benefit; capitals gains from the sale at the moment of liquidation are taxed separately.

<sup>99</sup> The description of the tax treatment is limited to the value of the benefit; capitals gains from the sale at the moment of liquidation are taxed separately.

<sup>100</sup> Data on social security contributions for 2012 stem from the 2012 edition of the EU-Report „Taxation trends in the European Union” or are downloaded from the database of the European Union: [http://ec.europa.eu/taxation\\_customs/taxation/gen\\_info/info\\_docs/tax\\_inventory/index\\_en.htm](http://ec.europa.eu/taxation_customs/taxation/gen_info/info_docs/tax_inventory/index_en.htm).

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Type of plan	Stock Options (focus non-tradable options)			Employee Shares	
	Country:	Moment taxation	Tax treatment of benefit	SSC	Tax treatment of benefit
Portugal	exercise	full taxation	no	full taxation	no
Romania	exercise	exemption under approved plan subject to conditions	no	full taxation	no
Slovenia	exercise	full taxation	yes	PIT deduction subject to ceiling (€ 5,000 p.a.) and conditions	exemption sub-ject to conditions
Slovakia	exercise	full taxation	no	full taxation	no
Finland	exercise	full taxation	yes	PIT exemption subject to conditions	exemption sub-ject to conditions
Sweden	exercise	full taxation	no	full taxation	no
United Kingdom	exercise	exemption under approved plans (conditions and ceilings)	no	exemption under approved plans subject to conditions and ceilings	exemption sub-ject to conditions

## ANNEX 5: CAPITAL GAINS – GENERAL TAX TREATMENT FOR INDIVIDUALS IN THE EU

Tax Feature	1. Resident individuals		2. Non-resident individuals	
	Income tax rates	Capital gains	Income tax rates	Capital gains on sale of shares in resident companies
Austria Last reviewed: 1 March 2014	progressive; top rate 50% (over EUR 60,000)	generally exempt; business, speculative and substantial shareholding gains are subject to income tax	progressive; top rate 50% (over EUR 60,000); base increased by EUR 9,000	generally exempt; 25% if substantial shareholding (under conditions)
Belgium Last reviewed: 1 March 2014	progressive; top rate 50% (over EUR 37,750); municipal surcharge may apply	normally exempt; certain gains taxed at separate rates	progressive; top rate 50% (over EUR 37,750); 6% surcharge applies	normally exempt; certain gains taxed at separate rates
Bulgaria Last reviewed: 1 January 2014	flat rate 10% in general; flat rate 15% for sole traders; lump-sum tax for certain business activities	generally subject to income tax; part of business income; gains on shares exempt if sold on Bulgarian or EEA stock exchange	flat rate 10% in general; flat rate 15% for sole traders	subject to income tax; exempt for EEA residents if sold on Bulgarian or EEA stock exchange
Croatia Last reviewed: 1 February 2014	progressive; top rate 40% (over HRK 105,600)	0% on sale of movable property and securities; 25% on immovable property and proprietary rights, but exempt under certain conditions	progressive; top rate 40% (over HRK 105,600)	exempt
Cyprus Last reviewed: 1 March 2014	progressive; top rate 35% (over EUR 60,000)	generally not taxable; 20% on disposal of Cyprus-situs immovable property and unlisted shares in companies holding Cyprus-situs immovable property	progressive (only on certain income); top rate 35% (over EUR 60,000)	generally not taxable; 20% on disposal of unlisted shares in companies holding Cyprus-situs immovable property
Czech Republic Last reviewed: 1 February 2014	flat rate 15% (19% from 1 January 2015); 7% solidarity surcharge on part of income	yes, part of aggregate income taxed at ordinary rates; 0% on gains from securities under conditions	flat rate 15% (19% from 1 January 2015); 7% solidarity surcharge on part of income	yes
Denmark Last reviewed: 11 March 2014	progressive; 15% top rate (over DKK 449,100); 27% on income from shares not exceeding DKK 49,200 (42% on any excess); municipal income tax - average total 29.9%	exempt, except for certain gains on immovable property, shares in corporate entities, intangibles, bonds and other debt claims (taxed at ordinary rate)	progressive; 15% top rate (over DKK 449,100); 27% on income from shares not exceeding DKK 49,200 (42% on any excess); municipal income tax - flat rate 24%	yes, but only if attributable to permanent establishment in Denmark
Estonia Last reviewed: 1 February 2014	21% flat rate (20% from 1 January 2015)	21% (20% from 1 January 2015)	21% (20% from 1 January 2015)	no, except gains on sale of shares in companies holding more than 50% of assets in immovable property, under conditions

Finland Last reviewed: 11 March 2014	national tax: - earned income: progressive - top rate 31.75% (over EUR 100,000); - income from capital: progressive - 30% (up to EUR 40,000) and 32% on excess; municipal tax on earned income only: flat rate 16.55%-22.5%, depending on municipality; church tax on earned income only: flat rate 1%-2%, depending on municipality	yes, included in income from capital (30% or 32%)	national tax: - earned income: (a) 35% flat rate on gross income or (b) progressive, top rate 31.75% (over EUR 100,000); - income from capital: progressive - 30% (up to EUR 40,000) and 32% on excess; municipal tax on income subject to progressive national tax: 19.75% flat rate	no (except shares of real estate companies)
France Last reviewed: 1 January 2014	progressive; top rate 45% (over EUR 151,200)	yes, exemptions for general/specific regimes apply	French-source income same rates as residents, special rules if one or more dwellings in France and no French-source income	45% if substantial participation (above 25% in capital), progressive exemptions apply; (75% withholding tax is applied to gains realized by a resident of a NCST)
Germany Last reviewed: 1 February 2014	progressive; top rate 45% (over EUR 250,730); 5.5% solidarity surcharge	25% on the sale of share and bonds (26.38% including 5.5% surcharge); 40% exempt if derived from business transactions	progressive; top rate 45% (over EUR 250,730)	40% exempt, if derived from business transactions and the seller has owned a substantial interest of at least 1%
Greece Last reviewed: 14 December 2013	progressive; top rate 33% (over EUR 50,000); employment and agriculture: top rate 42% (over EUR 42,000)	part of business income, taxed at ordinary rates; 0% on listed shares acquired by 31 December 2012, thereafter subject to income tax (15% from 1 January 2014); 20% rate on participations in limited liability companies, partnerships or a business as a whole and trademarks and goodwill sold separately; (15% on gains from transfer of a sole business, participation in a partnership or a limited liability company from 1 January 2014); 20% on gains on sale of immovable property (partial exemption on conditions)	progressive; top rate 33% (over EUR 50,000); 10% surtax (under conditions)	0% on listed shares acquired by 31 December 2012, thereafter subject to income tax (15% from 1 January 2014); 5% on non-listed shares (15% from 1 January 2014)
Hungary Last reviewed: 1 March 2014	16%	yes, part of normal income; 25% under certain circumstances	16%	no, however, 16% tax on capital gains realized upon transferring interests in qualifying real estate holding companies
Ireland Last reviewed: 1 March 2014	progressive; top rate 41% (over EUR 32,800); 2%-10% Universal Social Charge applies	33%; 40% on disposal of certain offshore life assurance policies and investment products	progressive; top rate 41% (over EUR 32,800);	no

Italy Last reviewed: 15 January 2014	progressive; top rate 43% (over EUR 75,000); regional surcharge of 1.23% to 2.33% applies; solidarity surcharge of 3% on income over EUR 300,000	for gains on sale of shares, a partial participation exemption applies; non-substantial participations are subject to 20% substitute tax	progressive; top rate 43% (over EUR 75,000); regional surcharge of 1.23% to 2.33% applies; solidarity surcharge of 3% on income over EUR 300,000	yes, subject to 20% substitute tax; gains on transfer of non-substantial participations in listed companies are exempt
Latvia Last reviewed: 15 February 2014	24% flat rate; 23% in 2015; 22% in 2016+; "licence fee" may be payable instead of standard income tax by certain small traders; a micro-enterprise tax regime is available whereby turnover is taxed at 9%; an annual minimum tax applies; 10% on income analogous to dividends	15%; gains on disposal of personal property is exempt	24% flat rate; 10% on income analogous to dividends	no; however, 15% on proceeds of disposal of participations in an entity more than 50% of whose assets consists, directly or indirectly, of Latvian immovable property if sold to another non-resident or to a private person in Latvia. If, however, sold to a Latvian company or to an individual entrepreneur, the purchaser deducts a final 2% withholding tax from the sale proceeds.
Lithuania Last reviewed: 5 January 2014	15% flat rate; 20% on dividend income up to 2013; 5% on independent activities income	15% generally; 0% on gains up to LTL 10,000 per tax year on disposal of shares	15% flat rate	no
Luxembourg Last reviewed: 1 March 2014	progressive; top rate 40% (above EUR 100,000); in addition a 7% or 9% surcharge is levied	yes; generally part of ordinary income; gains on disposal of a business taxed as business income; special rules for speculative gains	progressive; top rate 40% (above EUR 100,000); in addition a 7% or 9% surcharge is levied	yes, generally taxed at standard income tax rate; qualifying participations are exempt
Malta Last reviewed: 1 February 2014	progressive; top rate 35% (over EUR 60,001)	generally included in the taxable income; capital gains on shares or units in a Maltese-licensed collective investment scheme, investing more than 15% of its total investments in foreign-based securities may be subject to a final withholding tax of 15%; exemption is available on securities listed on the Malta Stock Exchange	progressive; top rate 35% (over EUR 7,801)	generally exempt, except for capitals gains on Maltese companies consisting wholly or principally of immovable property situated in Malta
Netherlands Last reviewed: 15 January 2014	progressive; top rate 52% (over EUR 56,531)	business gains taxed at progressive rates; gains on substantial shareholdings are taxed at 22% up to EUR 250,000, 25% on excess; otherwise exempt	progressive; top rate 52% (over EUR 56,531)	only gains from substantial shareholdings are taxed at 22% on gains up to EUR 250,000, 25% on excess
Poland Last reviewed: 1 March 2014	progressive; top rate 32% (over PLN 85,528); flat rate of 19% for business income (optional)	yes, part of business income; flat rate of 19% for gains on shares	top rate 32% (over PLN 85,528); flat rate of 19% for business income (optional)	19%

Portugal Last reviewed: 1 March 2014	progressive; top rate 48% (over EUR 80,000); 60% (unjustified wealth increase of more than EUR 100,000); solidarity tax of 2.5% and 5% on income exceeding EUR 80,000 and EUR 250,000, respectively; extraordinary surtax of 3.5% on net income exceeding annual minimum wage	generally subject to income tax rates; 50% of net gains from sale of immovable property subject to progressive rates; 28% on gains from the sale of shares; exemption for gains from the sale of permanent residence (under conditions)	taxed as residents on Portuguese-source income depending on the category; employment, business and professional income: 25%	exempt, unless the recipient is resident in listed tax haven or shares in Portuguese resident real estate company
Romania Last reviewed: 17 January 2014	16% flat rate	16% on securities, foreign currency futures contracts, company liquidation; 0% on government and municipal bonds	16% flat rate	16%; 0% on gains from trading in securities issued by Romanian residents and realized on foreign capital markets
Slovak Republic Last reviewed: 1 February 2014	progressive; top rate 25% (over EUR 35,022.31)	yes, part of ordinary income; 0% on sale shares (ceiling applies)	progressive; top rate 25% (over EUR 35,022.31)	yes, part of ordinary income
Slovenia Last reviewed: 1 February 2014	progressive; top rate 50% (over EUR 70,907.20)	25% (rate is reduced by 5 percentage points per each 5 years of holding)	progressive; top rate 50% (over EUR 70,907.20)	0%; 25% if more than 50% of the entity's value stems from immovable property or for holdings over 10%
Spain Last reviewed: 1 February 2014	general income: progressive - top rate 45% (over EUR 175,000.20); surcharge - top rate 7% (over EUR 300,000); savings income: progressive - top rate 27% (over EUR 24,000)	part of savings income if assets are held for more than 1 year; subject to progressive income tax rates if assets are held for less than 1 year	rates depend on type of Spanish-source income; business and employment income: 24.75%	21% (specific exemptions for shares transferred on stock exchange and there is a tax treaty or if derived by certain EU residents)
Sweden Last reviewed: 20 January 2014	progressive; top rate 25% (over SEK 602,600); municipal flat tax - about 31.86% (depending on the municipality)	30%	progressive; top rate 25% (over SEK 602,600); municipal flat tax - about 31.86% (depending on the municipality)	no (however, 10-year rule for former residents)
United Kingdom Last reviewed: 1 January 2014	progressive; top rate 45% (over GBP 150,000); 37.5% rate applies to dividend income exceeding GBP 150,000	generally 18%; 28% generally for higher income earners; 10% for gains qualifying for entrepreneurs' relief; short-term gains part of business income	UK-source income same rates as residents	exempt unless held for a trade

## **ANNEX 6: VAT – PREPARING FOR THE 2015 PLACE OF SUPPLY RULES AND MOSS**

The successful introduction of the 2015 Place of Supply rules and the MOSS has been a high priority for the Commission as outlined in the Communication on the Future of VAT (December 2011).

Preparatory work has proceeded in the following respects:

1. Legislative framework;
2. Guidance for Member States and business;
3. Communication;
4. IT implementation; and
5. Auditing and mutual assistance.

### *1. Legislative framework*

To prepare for the 2015 changes and the MOSS, it was essential to put in place a clear legal structure to fully support this significant development. The Commission has proposed three implementing regulations to this effect, which have been agreed by Member States.

A Council Regulation relating to the obligations under the MOSS was adopted in October 2012<sup>101</sup>, along with a Commission Regulation relating to the standard forms and returns<sup>102</sup>. In addition, a further Council Regulation, laying down measures helping to identify correctly the place of supply of certain services such as how to determine customer location, and providing for a number of proxies in that respect, was adopted by the Council on 7 October 2013<sup>103</sup>. In particular, it clarifies the issue of customers having multiple locations, or using devices to buy electronic services, telecommunications or broadcasting in a Member State in which they are not established. Based on this new legal framework, clear and very detailed definitions of electronic services, broadcasting services and telecommunication services will also be available.

### *2. Guidance for Member States and business*

The Communication on the Future of VAT included a clear recommendation that the Commission will publish guidance in order to inform businesses and promote a more

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<sup>101</sup> Council Regulation (EU) No 967/2012 of 9 October 2012 amending Implementing Regulation (EU) 282/2011 as regards the special schemes for non-established taxable persons supplying telecommunications services, broadcasting services or electronic services to non-taxable persons (OJ L 290, 20/10/2012, p. 1–7)

<sup>102</sup> Commission Implementing Regulation (EU) No 815/2012 of 13 September 2012 laying down detailed rules for the application of Council Regulation 904/2010, as regards special schemes for non-established taxable persons supplying telecommunications, broadcasting or electronic services to non-taxable persons (OJ L 249, 14/09/2012, p. 3–10)

<sup>103</sup> Council Implementing Regulation (EU) No 1042/2013 of 7 October 2013 amending Implementing Regulation (EU) No 282/2011 as regards the place of supply of services (OJ L 284, 26.10.2013, p. 1).

consistent application. This is seen by the Commission services as fundamental for the success of the new rules and MOSS.

#### Explanatory Notes on the Place of supply rules

Following agreement of the Implementing Regulation in Council, the Commission in collaboration with Member States and business representatives prepared extensive explanatory notes which were published in April 2013. The 'Explanatory Notes'<sup>104</sup> are intended as a guidance tool that can be used to clarify the practical application of the new place-of-supply rules for telecommunications, broadcasting and electronic services. They are currently available in English but will soon be translated in all other EU languages, as well as in Japanese, Chinese and Russian.

#### MOSS Guidelines

The Commission services have drafted a comprehensive Guide to the MOSS<sup>105</sup>, which has been adopted by the Standing Committee on Administrative Cooperation (SCAC) in October 2013. This Guide gives detailed information on how the MOSS will work in practice and covers areas such as registration, deregistration, making returns, the payment process and record keeping. The guidelines have been published in the EU languages, Japanese, Chinese and Russian.

### 3. *Communication*

The Commission has recognised the need to inform business, both in the EU and in 3<sup>rd</sup> countries, on the forthcoming 2015 changes and the MOSS. The Commission, in collaboration with Member States and business organisation, will participate in a number of seminars over the coming months to explain to business how the new rules will work, and what it can offer them in terms of simplicity. The Commission made a keynote presentation at the OECD Global VAT Forum in Japan in April. Further events are scheduled in the coming months in Luxembourg and the UK, with others foreseen in Poland and the US. In addition, the Commission has a dedicated web portal<sup>106</sup> with all the relevant information on the 2015 changes and MOSS.

### 4. *MOSS IT implementation*

The success of the MOSS is dependent on IT systems and development. While responsibility primarily lies with Member States to ensure that the web portals are fully functional for registration in October 2014, and for live operation in January 2015, the Commission has worked very closely with Member States to ensure that the systems are ready. Technical specifications have been prepared by the Commission and the Standing Committee on Information technology (SCIT) and agreed at the SCAC. The Commission is very closely monitoring the implementation

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<sup>104</sup>[http://ec.europa.eu/taxation\\_customs/resources/documents/taxation/vat/how\\_vat\\_works/telecom/explanatory\\_notes\\_2015\\_en.pdf](http://ec.europa.eu/taxation_customs/resources/documents/taxation/vat/how_vat_works/telecom/explanatory_notes_2015_en.pdf).

<sup>105</sup>[http://ec.europa.eu/taxation\\_customs/resources/documents/taxation/vat/how\\_vat\\_works/telecom/one-stop-shop-guidelines\\_en.pdf](http://ec.europa.eu/taxation_customs/resources/documents/taxation/vat/how_vat_works/telecom/one-stop-shop-guidelines_en.pdf).

<sup>106</sup> [http://ec.europa.eu/taxation\\_customs/taxation/vat/how\\_vat\\_works/telecom/index\\_en.htm#new\\_rules](http://ec.europa.eu/taxation_customs/taxation/vat/how_vat_works/telecom/index_en.htm#new_rules).



of MOSS by Member States, and will propose fall back solutions to national administrations in case any Member State would have part of its system not ready on time. A very close bilateral follow-up is ongoing with each Member State.

*5. Coordination of audits*

One important issue which is not yet fully resolved is the audit of the businesses under the MOSS. EU legislation on the MOSS still foresees that controls and audits are to be carried out by the Member State of consumption, although several tools are available to Member States to enhance coordination of audits. For both EU and non-EU companies, this may involve up to 28 different tax administrations auditing the same companies without any coordination and leading to information requests in multiple languages. Not only could this create disproportionate administrative burdens on business but it could also put at stake the efficiency of the audits themselves as well as the level of voluntary compliance (which is particularly sensitive where non-EU companies are involved). Member States have developed audit guidelines in order to promote the principle of coordination of audits, with the aim of reducing burdens on business, promote voluntary compliance and raise the efficiency of audits. These guidelines will be published very soon by the Commission, as well as the names of participating Member States. Unfortunately, not all Member States have agreed to implement them. They will be available in English and will be translated in all other EU languages, as well as in Japanese, Chinese and Russian shortly thereafter.

Appropriate new tools, such as joint audits, to enhance the efficiency of audits in this sector may be useful, provided Member States can agree on the legal basis. Delivering a successful MOSS as a precursor to the broader OSS requires full trust by each Member State that taxes will be collected and that the necessary auditing (on the principle of risk) will take place.

