European Economic and Social Committee

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Taxation in the digitalised economy

OPINION

European Economic and Social Committee

Taxation in the digitalised economy
[Own-initiative opinion]

Rapporteur: **Krister ANDERSSON**

Legal basis	Rule 32(2) of the Rules of Procedure Own-initiative opinion
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1. **Conclusions and recommendations**

1.1 The EESC considers the digitalisation of the economy to be a great opportunity, and the EU Digital Agenda to be a key policy for the European Union. As digitalisation continues to be an important driver for global economic growth, the EESC believes that policies related to taxation of the digitalised economy should seek to promote, not hinder, economic growth and cross-border trade and investment.

1.2 The EESC underlines the need for tax systems to take due account of new business models. The principles of a fair tax system – consistency, predictability, neutrality – are just as relevant as ever for public authorities, businesses and consumers.

1.3 The Committee therefore shares the Commission's ambition to continue to prevent aggressive tax planning behaviour by businesses and non-transparency by Member States to ensure equal treatment of firms and to promote European competitiveness.

1.4 The EESC strongly believes that, in the context of the digitalisation of the economy, any changes to the rules for allocating taxation rights of profits among countries must be coordinated globally, in order to better harness the benefits of globalisation, with proper global governance and global rules. The EESC therefore welcomes the close cooperation between the Commission, Member States and the OECD/G20 to support the development of an international solution, which will limit the risk of international double taxation. However, if an international solution cannot be reached, the EU must consider proceeding on its own.

1.5 The EESC would like to suggest that Member States that set up specific national systems should carefully look for the most efficient solutions in order to avoid supplementary complications and costs for both the tax administrations and companies alike.

1.6 The EESC encourages the Commission and Member States to carefully consider all possibilities to eliminate any under-taxation of digital services, irrespective of where the company is located, for those sales that end up in a Member State. Services provided through platforms used by European consumers should be fully incorporated in the VAT system, as an essential component in addressing the tax issue. It should be noted that digital communications customers e.g. Facebook etc. access these services at no apparent charge which raises the question as to how VAT could reasonably be applied.

1.7 The allocation key suggested for the Common Consolidated Corporate Tax Base (CCCTB), with its three factors, could be used and applied, as a starting point, for the allocation of the residual profit, if this is the method agreed upon at the OECD. The EESC supports such an approach.

1.8 The EESC believes, however, that resources spent on R&D are important for developing intangibles and that the country in which such activities take place should be remunerated for them. The EESC therefore suggests that a formula consisting of four factors be used for the allocation of the residual profit, rather than the three factors included in the CCCTB formula.

The EESC fully recognises the complexity of the calculation of international taxation rights. At the same time an acceptable and fair allocation of taxation rights among countries is necessary.

1.9 To the extent that reallocation of international taxation rights cannot be obtained within the existing transfer pricing framework, the EESC supports allocating residual profits from market intangibles by using a four factor formula.

1.10 Given the growing size of markets outside Europe, in particular in countries like China, India and Brazil, allocating taxation rights on the entire corporate tax base, or even on the entire residual profit, would result in substantial revenue losses in many Member States and could result in difficulties in meeting social objectives in European countries.

1.11 The EESC considers it necessary to strike a reasonable balance between the re-allocation of corporate profit taxes among net-exporting countries and net-importing countries, not to jeopardise the possibility of countries to meet their social and environmental objectives.

1.12 Agreed changes to the international rules for allocating taxation rights among countries should be beneficial to all the Member States and the Single Market.

2. Background

2.1 The present corporate tax systems in the world and the Base Erosion Profit Shifting (BEPS) endeavour are based on assessing the corporate profit where economic activities generate profits and where value is created. The digitalisation of the economies has however raised the issue of where the profits are created and how they are distributed. Digital services, broadly defined, can be supplied at a distance, without any physical presence where consumption takes place.

2.2 As a result of the BEPS project, the international tax system is already undergoing a major transformation resulting in many changes in the taxation of companies[1]. The BEPS project was initiated to tackle base eroding and profit shifting activities, not to alter existing international standards on the allocation of taxation rights on cross-border income among countries[2].

2.3 Action 1 of BEPS dealt with the challenges of the Digital Economy[3]. Since no consensus was reached on how to tax these new business models, it was followed by an interim report of the OECD/G20 Inclusive Framework on BEPS, in 2018[4]. This report sets out the Inclusive Framework's agreed direction of work on digitalisation and the international tax rules through to 2020. It describes how digitalisation is also affecting other areas of the tax system, providing tax

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1 OECD. BEPS 2015 Final Reports

2 In the EU, corporate profit shifting and base erosion by companies have been reported by the Commission to amount to EUR 50-70 bn, equivalent to less than 0.4 per cent of EU GDP. SWD(2018) 81 final.

3 OECD. BEPS Addressing the Tax Challenges of the Digital Economy, Action 1: 2014 Deliverable.

4 OECD. Tax Challenges Arising from Digitalisation: Interim Report 2018 – Inclusive Framework on BEPS, OECD/G20 BEPS Project (OECD Publishing 16 Mar. 2018); OECD.

authorities with new tools that are translating into improvements in taxpayer services, improving the efficiency of tax collection and detecting tax evasion.

2.4 On February 13, 2019, the OECD issued a Public Consultation Document "Addressing the Tax Challenges of the Digitalisation of the Economy"[5]. It outlines revised profit allocation rules and nexus rules as well as a global anti-base erosion proposal.

2.5 A final report from the OECD/Inclusive Framework is expected in 2020. The finance ministers of the USA and France have however said that they want to accelerate the talks at the OECD to find a solution already during 2019[6]. The US have presented a proposal focusing on allowing market jurisdictions to tax returns on marketing intangibles used within that jurisdiction, even when the investment in developing those marketing intangibles is made in another country. There is also a German-French proposal for a minimum corporate tax rate. This EESC opinion could be seen as providing input into the ongoing debate.

2.6 The EU Commission had already in 2014 issued a report on taxation of the digital economy[7]. The High Level Expert Group on Taxation of the Digital Economy concluded that digital technology offered 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 Expert Group discussed extensively the principles that should guide international taxation.

2.7 These principles are important also for this Opinion. The Expert Group concluded that there should not be a special tax regime for digital companies. The general rules should rather be applied or adapted so that "digital" companies are treated in the same way as others.

2.8 With its communication entitled *Time to establish a modern, fair and efficient taxation standard for the digital economy*, published on 21 March 2018, the Commission presented its legislative package for a harmonised reform of the EU's corporate tax rules for digital activities. The package contained two Council Directives accompanied by a soft-law recommendation relating to the corporate taxation of a significant digital presence.

2.9 The EESC issued an opinion in July 2018 on the Commission proposals – Taxation of profits of multinationals in the digital economy[8]. The negative effects of turnover taxes as well as the need for international consensus were stressed in the Committee opinion.

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5 Public Consultation Document Addressing the Tax Challenges of the Digitalisation of the Economy, OECD.

6 "US and France accelerate plans to make global tech groups pay tax. Finance ministers agree on need for international minimum corporation tax level", Financial Times, February 28, 2019.

7 Commission Expert Group on Taxation of the Digital Economy, 28/05/2014. The group was chaired by Vítor Gaspar, a former finance minister of Portugal, and brought together six experts from across Europe with different backgrounds and expertise relevant to the subject.

8 See EESC opinion Taxation of profits of multinationals in the digital economy, OJ C 367, 10.10.2018, p. 73.

3. **General comments**

3.1 The EESC considers the digitalisation of the economy to be a great opportunity, and the EU Digital Agenda to be a key policy for the European Union. As digitalisation continues to be an important driver for global economic growth, the EESC believes that policies related to taxation of the digitalised economy should seek to promote, not hinder, economic growth and cross-border trade and investment.

3.2 The internet enables companies to scale across global markets without a significant physical presence – a feature that is notably helping small businesses to export to an unprecedented degree. Digitalisation is also often accompanied by the growing importance of intangible assets, such as intellectual property and data.

3.3 The EESC underlines the need for tax systems to take due account of new business models. The principles of a fair tax system – consistency, predictability, neutrality – are just as relevant as ever for public authorities, businesses and consumers.

3.4 The EESC considers a level playing field in the area of corporate profit taxation to be very important. Recent years have demonstrated that individual companies have been able to make use of specific tax rules in some Member States, reducing their effective tax rate to almost zero. The lack of transparency has contributed to such an outcome. Some of the cases have involved multinationals active in the area of digital services.

3.5 The Committee therefore shares the Commission's ambition to continue to prevent aggressive tax planning behaviour by companies, digitalised or brick-and-mortar firms alike, and non-transparency by some Member States to ensure equal treatment of companies and to promote European competitiveness.

3.6 The EESC strongly believes that any changes to the rules for allocating taxation rights of profits among countries must be global ones, in order to better harness the benefits of globalisation, with proper global governance and global rules. The EESC therefore welcomes the close cooperation between the Commission, Member States and the OECD/G20 to support the development of an international solution. However, if an international solution cannot be reached, the EU must consider proceeding on its own.

3.7 The EESC would like to suggest that Member States that set up specific national systems should carefully look for the most efficient solutions in order to avoid supplementary complications and costs for both the tax administrations and companies alike.

3.8 The EESC notes that digital technologies also have the potential to revolutionise compliance and enquiry work. The OECD, in its 2018 report[9], shows how digitalisation has already had a threefold positive impact on tax administration: enhancing the effectiveness of tax compliance, improving taxpayer services and reducing tax compliance burdens.

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9 Tax Challenges Arising from Digitalisation – Interim Report 2018.

3.9 Greater amounts of third-party data available to tax authorities allows more reporting to be automated, saving both sides time and money, and can also be used to tackle underreporting, evasion or fraud. Data recording software adopted by several tax administrations that notes sales data at the time of a transaction – and can be submitted directly to tax authorities – has already increased some countries' value-added tax (VAT) revenues significantly.

3.10 When assessing the effective level of taxation of the digital sector, the EESC underlines the need to take into account the changes in the tax codes going forward due to the ongoing implementation of BEPS rules, since this may in fact lead to more revenue being taxed in the EU.

4. A possible way forward?

4.1 Not all countries in the world have a Value Added Tax. However, in the EU, all countries do. In principle all consumption of services and goods should be subject to VAT, unless explicitly excluded from the tax base. VAT revenues represent an own resource in the EU budget and the EESC considers it important to include digital services in the tax base.

4.2 The EESC encourages the Commission and Member States to carefully consider all possibilities to eliminate any under-taxation of digital services, irrespective of where the company is located, for those sales that end up in a Member State. Services provided through platforms used by European customers should be fully incorporated in the VAT system. It should be noted that digital communications customers e.g. Facebook etc. access these services at no apparent charge which raises the question as to how VAT could reasonably be applied.

4.3 The EESC notes that the present corporate tax systems in the world are based on assessing the corporate profit attributable to each relevant jurisdiction. Taxation should be based on where value is created. Given the difficulties in telling where in the value chain profit emerges, there is a need to find universal principles how to assess where value is created. Such rules have been developed within the comprehensive work of the OECD, formulating tax principles and definitions of how to price goods and services (transfer pricing rules) for companies within a business group.

4.4 The EESC believes that the international tax rules need to be revised from time to time as business models evolve. The current rules have very recently been revised in connection with the Base Erosion and Profit Shifting (BEPS) agreement[10].The new rules and definitions are now being implemented. They are expected to substantially reduce the opportunity for aggressive tax planning and erosion of tax bases.

4.5 A residual profit (or loss) may in particular occur if marketing or product intangibles give rise to non-routine profits. The use of customer lists or gathered data may for instance give rise to the existence of a residual profit. The concept is by no means new, and it could be used not only for

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10 OECD 2015.

dividing up the profit between related parties but also to allocate taxation rights among countries. It would, however, require some innovative thinking and exploration of the possibility of allocating taxation rights in line with value creation even if there is no physical permanent establishment in the country concerned. This is part of the OECD deliberations.

4.6 The EESC notes that the discussion regarding the taxation of so-called digital companies does not primarily relate to base erosion and profit shifting behaviour of companies but to the allocation of taxation rights among countries.

4.7 A residual profit (or loss) could be described as the profit (or loss) being recorded once each party has been remunerated for its routine contributions in such a manner that it is in accordance with the arm's length principle[11]. It would first involve a proper market valuation of the risks encountered, the value created by production factors and functions performed.

4.8 Sales would normally not be a decisive factor for allocation of profits to the companies involved in a transaction. However, if existing international rules are used – allocating profit to each company based on the OECD transfer pricing guidelines – the residual profit could then be allocated to countries where functions have been performed. One such function could be "sales".

4.9 The allocation key suggested for the Common Consolidated Corporate Tax Base (CCCTB), with its three factors[12], could be used and applied for the allocation of the residual profit[13].

4.10 It can, however, be argued that resources spent on R&D are important for developing intangibles and that the country in which such activities take place should be remunerated for them[14]. That would call for a formula consisting of four factors rather than the three included in the CCCTB formula.

4.11 To the extent that reallocation of international taxation rights cannot be obtained within the existing transfer pricing framework, the EESC supports allocating residual profits from market intangibles by using a four factor formula.

4.12 If the residual profit is 30 (out of a total profit for the Group of 100) and if production is divided equally in value creation terms in countries A and B, these countries would then get to tax

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11 For the definition, please see Transfer pricing in the EU context

12 Council Directive on a Common Corporate Tax Base (COM(2016) 0685 final – C8-0472/2016 – 2016/0337(CNS)). "The choice of the three factors stems from the need to reflect both the state of production (supply side, measured by assets and/or labour payroll) and the state of demand (sales to destination) to describe economic activity properly. Sales are weighted by one-third, payroll by one-sixth, the number of employees by one-sixth, and assets by one-third. The sum of the weights equals one so that 100% of the CCCTB is apportioned across the Member States. Member States can then apply the national corporation tax rates to their respective shares of taxable bases." SWD(2016) 341 final

13 It may be noted that businesses with social aims, like certain cooperatives connected with the local community, distribute value created in a more direct way and that the allocation key therefore may not be directly applicable to them.

14 If countries providing good infrastructure and ample R&D incentives do not get their fair share of the corporate tax revenues, their incentives to provide a conducive investment environment would be reduced or even eliminated altogether.

35 each[15]. Since the product is also sold to an equal amount in country C, the residual profit would be divided between A, B and C. Countries A and B would receive an additional tax base of 13 3/4, while C would be entitled to tax 2 1/2[16].

4.13 The EESC fully recognises the complexity of the calculation of international taxation rights among countries. It would entail calculating and agreeing between countries on the size of the residual profit. It would also entail knowing the size of each of the four factors in the allocation key. The use of a modified CCCTB formula could be seen as a step in the direction of getting acceptance for the CCCTB.

4.14 The CCCTB formula would allocate corporate taxation rights to countries where no innovation, production or risks and functions take place. The mere fact that sales take place in a country, without any other activity in that country, would then constitute a taxable base. This represents a major change from existing rules. However, with the CCCTB formula applied only to the residual, and not the whole, profit, the legitimate right of exporting countries to retain part of the taxation right would be recognised. The value created from entrepreneurship and innovation may have rendered tax concessions when R&D costs were encountered and as the company turns profitable, the same country would receive tax revenues.

4.15 We recommend that, if no OECD agreement is achieved, the new European Commission should present a new proposal to tax these companies in the EU, based on data already in their possession e.g. total advertising time during customers' connection time, etc.

4.16 Given the growing size of markets outside Europe, in particular in countries like China, India and Brazil, allocating taxation rights on the entire corporate tax base, or even on the entire residual profit[17], would result in substantial revenue losses in many Member States and it could result in difficulties in meeting social objectives in European countries.

4.17 According to a study from Copenhagen Economics countries being net-exporters could lose considerable corporate tax revenues if part of the profit is taxed where the goods and services are sold[18]. A conservative estimation suggests that 18-21 per cent of the current corporate tax base in the Nordic countries came from foreign residual profits in 2017. For Germany, the share is estimated to be 17 per cent. If the marketing intangible approach is introduced, the bulk of this corporate tax revenue would be allocated to other countries.

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15 The "normal" profit would be 70.

16 After arms-length pricing remuneration, the remaining profit is 30. After adding an R&D factor (R) to the CCCTB factor proposal, the factors in the allocation key would be capital, K, labour, L, sales, S, and R. They have equal weights (1/4 each). With 3 countries, there are 12 components to consider. Country C however only has one component, sales. The remaining 11 components are divided equally between A and B, i.e. 5 1/2 each (5,5/12 * 30) = 13 3/4. The tax base for country C is (1/12*30) = 2 1/2. For countries A and B, the additional tax base of 13 3/4 consists of 3 3/4 for K, 3 3/4 for L and 3 3/4 for R (total of 7 1/2 to K, 7 1/2 to L and 7 1/2 to R), and 2 1/2 each for S. The total allocated to S is also 7 1/2.

17 If the entire tax base were based solely on sales, country C in the example above would be allocated a tax base of 25. If only the residual profit would be allocated based on the sales component, the equivalent tax base for country C would be 7.5.

18 Future Taxation of Company profits – What to do with Intangibles? by Sigurd Næss-Schmidt, Palle Sørensen, Benjamin Barner Christiansen, Vincenzo Zurzolo, Charlotta Zienau, Jonas Juul Henriksen and Joshua Brown, Copenhagen Economics, 19 February 2019.

4.18 The EESC considers it necessary to strike a reasonable balance between the re-allocation of corporate taxes among net-exporting countries and net-importing countries.

4.19 If European companies were primarily taxed on where they sell their products, they might also structure their business activities in such a way that costs occurred in the same country as the sales. This process could result in shift of investments and jobs to large consumer countries like China and India, propelling further revenue losses in Member States. Such a development must be avoided by ensuring European competitiveness.

4.20 The EESC underlines the need for a global agreement and implementation for any new regime or rules for how to allocate taxation rights among countries. The absence of these conditions would result in double taxation and therefore reduced investments and jobs.

Brussels, 17 July 2019

Luca Jahier
The president of the European Economic and Social Committee

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