



EUROPEAN COMMISSION

DIRECTORATE-GENERAL
TAXATION AND CUSTOMS UNION

Brussels, 12 December 2013
TAXUD D1/JT

Digit/003/2013

EXPERT GROUP ON TAXATION OF THE DIGITAL ECONOMY

Scoping the work

WORKING PAPER

Origin: Commission Services

Meeting held on 12 December 2013

Berlaymont Building
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1. INTRODUCTION

Following a call from the European Council in its conclusions of 22 May 2013¹ to look into issues related to taxation of the digital economy, the Commission has established the Expert Group on Taxation of the Digital Economy ("the Group") by decision of 22 October 2013, C(2013)7082. The general tasks of the Group have been laid down in Article 2 of the decision. This note aims at describing in more detail what the issues are that need to be addressed with a view to scoping the work of the group.

2. SCOPING THE WORK OF THE GROUP

2.1 Introduction

The group has been asked to review the 'taxation of the digital economy'. This has the implicit assumption that there is a problem with applying current tax rules to the digital economy. The direct occasion for the work is the public and political attention for reports that large digital companies do not pay their fair share of tax in jurisdictions where they are active, including the EU. This is an issue related to direct taxation. However, also in indirect taxation, the digital economy raises specific issues that could be addressed by the Group. And finally, one may want to consider to what extent there is a need for tax rules that are specifically designed to foster the development of the digital economy in the EU.

2.2 Tax rules to foster the digital economy

Direct and indirect tax rules are in principle horizontal in nature. This implies that the same set of rules apply regardless of the type of activity, the sector, the nationality of the taxpayer or the type of income. Such horizontal application ensures that the levying of taxes is neutral and that economic distortions caused by levying taxes are limited to the minimum. This applies both to rules that are burdensome for taxpayers (e.g. limiting deductions) as for rules that are positive for taxpayers (e.g. tax incentives). Concerning the latter, EU rules regarding the ban on State Aid clearly prevent the beneficial tax treatment of individual sectors.

Given these general limitations, the group should review the need and – when applicable – the potential for tax provisions that eliminate competitive disadvantages of EU digital companies in comparison to their non-EU competitors, with a view to creating a level playing field that fosters the growth and development of the digital economy in the EU.

2.3 Direct tax

The existing rules regarding international corporate income tax are to a great extent about adequately and fairly attributing overall profits of a multinational company to the

¹ Doc. EUCO 75/1/13. According to the conclusions, the Council will report back on progress on all taxation issues by December 2013.

different jurisdictions where it is active. In order to do this, one must essentially answer two questions:

1. When does a company operating in a foreign market have a **taxable presence** in that foreign market?
2. How much profit must be **allocated** to such taxable presence?

To answer these questions it is vital to determine the relevant business functions as well as their location. In more abstract terms, one must identify how and where within a multinational group of companies value is created and profit is generated.

With a view to determining the taxing rights of a country in which a foreign enterprise operates, current international tax standards rely on the presence of a 'permanent establishment', 'permanent representative' or '(in)dependent agent'. They all imply some minimum form of physical presence of the foreign enterprise in the country concerned. Many businesses operating in the digital economy, however, have been successful in limiting their physical presence in the foreign countries where they operate. Physical presence is not always needed under the new business models they apply. Adapting the international tax standards to the digital economy thus could be a solution.

However, adapting the rules requiring a minimum physical presence would not be sufficient to ensure a fair level of taxation of the digital economy. One would also have to look at the international Transfer Pricing rules that attribute global profits to different jurisdictions where a taxable presence exists. The degree of presence is relevant also for this 'attribution exercise', but equally important is the increasing role of intellectual property. For many businesses in the digital economy the IP is what makes them unique and valuable, which under current transfer pricing rules makes it an important factor when attributing profits. Such IP may in some cases be developed and owned by one distinct entity and therefore be clearly identifiable. In other cases, however, determining who is entitled to tax the profits generated by IP becomes increasingly problematic, for example for IP of which the value is jointly created within highly integrated groups. This seems to be an issue that is particularly relevant, though not necessarily unique for the 'digital economy'.

Understanding how and where value is created and profits are generated in the digital economy is not easy. The 'digital economy' is not a homogenous sector organised and operating in a uniform way. It therefore would seem to be necessary to make a division or categorisation of various types of operators active in the digital economy in a way that is relevant for direct tax purposes. This could be a categorisation on the basis of functions performed in the digital economy, it could be on the basis of the revenue model applied, it could be done on the basis of the function in the internet value chain or on any other basis, provided the categorisation is relevant in view of the current international criteria for attributing taxable profits and levying direct income tax.

Subsequently, the Group should identify and describe per relevant category the presence, relevance and causes of direct tax challenges related to:

1. Problems for EU Member States to tax foreign digital operators with activities in their territory;
2. Problems for EU Member States to levy withholding tax at source on outbound royalty payments;

3. The fact that such outbound payments out of EU Member States are typically not (or low) taxed at the level of the recipient;
4. The problem that such outbound payments out of EU Member States are not (or low) taxed at the level of the ultimate foreign parent company.

The Group should describe a range of possible solutions to address the tax challenges identified, either based on existing or new approaches. Since a solution for a tax challenge in one category could affect the tax challenges for other categories, the Group should take into account how the various solutions interact. The Group should also consider how solutions would relate to or interact with global developments in taxing the digital economy, taking into account the work of the Taskforce on the digital economy active within the OECD.

The Group should give insight in the economic and financial consequences of the suggested solutions for the EU. How would any proposed solutions affect or contribute to the further development and growth of digital businesses in the EU? Is there a risk that a review and amendment of international tax concepts creates additional administrative burdens, especially for small and medium-sized enterprises (SMEs)? If existing international rules on the allocation of income between source and residence countries were to be amended, what would be the impact on the corporate tax base of the non-digital economy?

Finally, the Group should take into account the practical feasibility of the identified solutions. For example, for some solutions the source country may need to rely on administrative cooperation to acquire the necessary information to audit foreign digital businesses without any physical presence. Also, some solutions may require a review of existing bilateral or multilateral treaties which may take considerable time.

2.4 Indirect Tax

Current VAT legislation makes a clear distinction between the supply of goods and the supply of services. For VAT purposes, some e-commerce transactions are either supplies of services (i.e. telecommunications, broadcasting and electronic services including downloads) or are supplies of goods (i.e. ordered via a web shop or by other on-line access), each with their own rules regarding place of taxation, chargeable event and chargeability of VAT, obligations and applicable rates.

Establishing the place of supply, (mini) One Stop Shop

Telecommunications, broadcasting and electronic services suppliers to final consumers in the EU (B2C) are currently treated differently for VAT purposes depending on whether they are provided by an EU supplier or by a non-EU supplier. For the former, VAT is due in the MS where the EU supplier is established² and for the latter VAT is due in the customer MS.

² This explains why e-commerce businesses like Amazon are established in MS with a low VAT rate such as Luxemburg.

From 1 January 2015, this will change and for both EU and non-EU suppliers VAT will be due in the customer's MS³. This essentially puts an end to base erosion or shifting issues for telecommunications, broadcasting and electronic services as far as intra-EU commerce is concerned as it no longer matters where the supplier is located. Remaining issues, such as whether the supply is subject to the standard or to the reduced VAT rate, do not really have a base erosion character but are of concern to many operators on certain markets.

In addition, a so-called mini One Stop Shop (MOSS) will be introduced, to avoid EU suppliers having to register in all MS in which they sell. The MOSS allows both EU and non-EU suppliers (who have had this possibility since 2003) to choose one MS for VAT identification and declaration purposes. Via a clearing system, MS administrations ensure that each MS receives the VAT revenues it is entitled to. The scope of the MOSS only covers telecommunications, broadcasting and electronic services. Other digital services as well as internet distance selling will not be allowed to use the facility. The Group should explore the pros and cons of an extension of the MOSS.

Non-EU e-commerce suppliers of on-line B2C services have been liable for collecting VAT on supplies to EU consumers since 2003. A simplified registration and remittance system (One Stop Shop, OSS) was created to facilitate compliance. A primary objective in 2003 was to remove any incentive for EU based suppliers to re-locate offshore. Although difficult to prove in practice, the perception is that the e-commerce measures for non-EU suppliers introduced in 2003 achieved a reasonably high level of compliance. More recently, however, questions have arisen as to whether these levels of compliance can be sustained. Business models have evolved with a greater number of small players and new forms of intermediation in e-commerce. Also, problems have been identified in specific sectors (*e.g.*, on-line travel agents moving offshore, on-line gaming) which have probably been facilitated by more familiarity with on-line shopping among consumers and a willingness of some businesses to exploit mismatches in taxation. The group should therefore also look at ways to ensure compliance of non-EU suppliers with EU VAT obligations.

3. SUMMARY

Following the above description of issues which all need to be addressed, the group's final report is expected to essentially contain three elements:

(A). Fact Finding

This section will set out the development of the digital economy both in the EU and globally. It will describe the application of current direct and indirect tax rules to new business models. It explains why the situation needs to be addressed and contains the empirical and/or circumstantial evidence to substantiate this. It also addresses potential deficiencies in the tax structure disturbing a level playing field between EU and non-EU digital enterprises.

³ In case of non-EU customers, normally no VAT will be due in the EU unless the effective use and enjoyment is in EU and the MS concerned has used the option to tax the services.

(B). Institutional Context

This section will set out the current regulatory framework governing the taxation of the digital economy, both on direct and on indirect taxes. This includes national tax legislation, EU tax legislation, the EU Treaty, international tax standards developed by the OECD and current developments driven by the G20 and G8 to review these standards. It also concerns the role of current tax policy in fostering the digital economy in the EU.

(C). Policy Options

The final section contains a range of policy options to ensure both a fair level of direct taxation on digital activities in the EU and a smooth alignment of indirect tax rules to the digital economy. For each policy option, it will take into account the consequences for the non-digital EU economy and the relation with global developments in taxing the digital economy.
